MARKET BULLETIN

ST. JAMES'S PLACE WEALTH MANAGEMENT

Monday 9 January 2012

The week that was

The New Year continued on the front foot as fresh signs that the US economy was gaining traction outweighed lingering concerns about Europe's debt problems. Western equity markets enjoyed a broadly positive week as a string of encouraging US economic reports culminated in Friday's announcement of a decrease in unemployment to a three-year low of 8.5%. Furthermore, encouraging manufacturing data came from China and India, as did a drop in unemployment in Germany to a post-unification low. In the wider equity markets, the FTSE 100 gained around 1.4% for the week, alongside European gains of 1.2% and an S&P 500 rise of 1.9%.

The optimism was tempered by renewed concerns over funding requirements for European banks, as official data showed that borrowing from the European Central Bank remains elevated, while Italy's UniCredit bank had to price a €7.5 billion rights issue at a deep discount, prompting a sharp fall in its share price. These concerns prompted Italian bond yields to once again exceed 7%, the level recognised as unsustainable, while Spanish yields also pushed higher amid concern over the short term. Banks in the eurozone are also hoarding cash at record levels, official figures from the European Central Bank showed last week. The amount left on overnight deposit at the bank is seen as a key indicator of fear in the banking system, as it shows the degree to which the major banks would rather deposit for practically no interest rather than risk lending it to each other, or indeed to businesses in the wider economy. The average level on deposit over the past year has been €100 billion: last week it was €455 billion.

Unsurprisingly, the euro currency came under renewed pressure, falling to an 11-year low against the yen, as a fresh round of downbeat data raised fears of recession. The single currency also hit fresh lows against the dollar and the pound, as a combination of falling retail sale (falling 0.8% in November) and a sharp drop of 4.8% in German factory orders for November knocked investors' confidence.

Obama gets a lift

Unemployment data from the US last week revealed that more than 200,000 people joined the workforce in December, which was way ahead of expectations. The level of 8.5% is now at its lowest since February 2009 and will provide a lift for President Obama, who has faced a stubbornly high level of unemployment since taking office. For 2011 as a whole, the private sector in the US added 1.9 million jobs, while government employment fell 280,000, seen as confirming that there has been a tangible pick-up in economic activity across the Atlantic in the second half of 2011.

While much of the rest of the world has been slowing down, the United States appears resilient. The jobs market is improving, households are spending more than expected, while housebuilding and factory output is increasing markedly. The official growth data for the fourth quarter is eagerly anticipated as a measuring point for what may lie ahead in the rest of the Western world.

Friday's upbeat report pushed the dollar to a 15-month high against most major currencies, including the euro, while Treasury yields remained below 2%. This benign response may well be to do with the figures being treated with an element of caution, as investors still want to see further trends before making decisions. The general consensus is that the unemployment figure would need to fall a lot further before the Federal Reserve would

consider raising interest rates. Previous significant rate rises have come up against a backdrop of unemployment rates of 5.5% in 2004 and 6.5% in 1994 (source: Capital Economics).

As the American economy shows signs of recovery, it has prompted various media to highlight trends that have occurred historically in a Presidential election. Wall Street tends to do well as incumbent Presidents promote optimism among their electorate. The S&P 500 has fallen in only three election years since 1952, according to David Schwartz, the stock market historian. The index fell by around 3% when John F. Kennedy was elected in 1960, by 10% in 2000 when George W. Bush was voted in, and by 38% in 2008, Obama's election year; although this was largely attributable to the Lehman Brothers collapse. The other 12 election years over this period have seen the S&P 500 rise, with seven of these being by double-digit percentages.

European bond sales

The immediate focus for investors in Europe seems to be on France and its continued quest to keep hold of its AAA rating. Whilst there is no mechanical link between a country's credit rating and increased borrowing costs – for example, US Treasury yields are lower now at AA+ than they were at AAA in August – concerns were raised this week after another lacklustre bond auction. In fact, there are those who believe that the loss of the AAA rating is already priced in, especially given the wide 150 basis points spread between German and French yields over the last few weeks.

Given that US yields are so low despite a ratings downgrade, why is the AAA rating so important where France is concerned? In the eurozone at the moment, sentiment is everything. A ratings downgrade would increase anti-euro sentiment both within France and externally, with the rationale behind a downgrade being that the French position is being weakened by the need to underwrite peripheral debt, undermining the creditworthiness of the European Financial Stability Facility which is part-guaranteed by the French government.

One of the St. James's Place fund managers who has long called for optimism where European markets are concerned is Cato Stonex of THS Partners. He has positioned his portfolio for European recovery in the long-term, and recently reported, "There is no question that the European policy-makers who are now in the driving seat, predominantly in Germany, have the wherewithal to solve the immediate crisis. But do they have the will? We have dedicated much time to understanding their thinking. Usually, the question is answered positively because the alternative is so serious. But this misses the fact that, in Berlin especially, there is now a real sense of the enormous opportunity to accelerate the tackling of Europe's deepest structural problems, and of entrenching the principles of fiscal restraint.

"We believe the process will plainly take time, but don't rule out bumps along the road. Once progress is secured on the banks and on debt, the debate will turn to growth and democratic legitimacy. The very severe pain of restoring European sovereign balance sheets is only worth taking if there is a credible growth story at the end. Ultimately we believe that Europe has a fair chance to come out at the other end of this crisis in much better shape than any other major region of the world.

"We do believe Europe has serious problems in the short term, exacerbated by shocks that triggered the current debt crisis. However, we also believe that the ingredients are finally in place to not only overcome these problems but make Europe a more competitive economy in the process. Since December the ECB is effectively providing unlimited liquidity to European banks and sovereigns while fiscal reforms are being undertaken. Under German and French leadership, treaty change has been put into motion and recent opinion polls in the periphery show even the most-affected Europeans would rather stick with the common currency.

"In this light, we are encouraged to see equity valuations for Europe's many leading global champions not only cheap on an absolute basis, but also relative to the US. The US is trading at a premium of almost 40% to Europe, a level last seen about 10 years ago. Aside from the March 2009 lows, European equities have not been as cheap since the 1980s, despite the rise of emerging markets, China in particular, and the significant progress in European integration. We are reminded that in crisis, there is opportunity and remain committed to our investments in

high-quality European equities. Our resolve has been tested, in some cases severely over the past six months, but we believe the opportunity for significant outperformance is as high as it has ever been."

The week ahead

The UK's main event for the week is Thursday's meeting of the Monetary Policy Committee (MPC). With the current £75 billion of asset purchases still not completed, it is not likely that anything major will be announced. Some analysts believe that the nine members of the MPC will increase quantitative easing to £400 billion this year, but it would be a surprise if any announcement were made early in 2012. The MPC's key task is to keep inflation at an annual rate of 2%; and even though this currently runs at 4.8%, recession is the greatest risk, hence the low interest rates and continued quantitative easing.

In the eurozone, the European Central Bank could well hold fire on any further cuts after two successive rate reductions. The key piece of information is likely to be whether there is any discussion over the ECB taking more aggressive action to purchase peripheral sovereign debt. However, it is likely that President Draghi will try to dampen expectation by the wider market.

Markets will be keeping a close eye on the Italian and Spanish bond auctions on Thursday, particularly after France's efforts last week. Ben May of Capital Economics noted in the *Financial Times* that Italy and Spain needed to roll over a high proportion of the government bonds that mature this year in the three months to April. "The good news is that if Spain and Italy can get through to April, they will have some breathing space before the next round of major bond redemptions." But he warned that if next week's auction results disappointed, speculation would soon start to grow that one or both would request a bailout.

The difficulty of short-term forecasting

As we have stated many times over the years, it is extremely difficult to make predictions for the short term, even over the course of 12 months, and we do not believe that anyone can be consistently successful in making such decisions. To illustrate how tough predicting can be, you only need to look at analyst predictions for the year of 2012. At the beginning of this year, 14 analysts from the world's largest brokerages were asked for their forecast for the finishing point of major global indices in 2012. In the UK, FTSE 100 predictions range from 5,000 to 6,100. The diversity of views was more widely illustrated by the forecasts for the S&P 500, ranging from 1,190 (down around 6%) to a high of 1,500 (up around 20%); and when the same questions were asked for European indices, the answers ranged from -16% to +29%.

When looking back to last year's predictions at the beginning of 2011, the majority of major brokers were anticipating a closing level for the year of above 6,000 for the FTSE 100. There was widespread optimism for the future of economic growth and interest rates were forecast to rise, leading to widely reported suggestions that gilts and other fixed income investments should be avoided. The predictions were looking good until August when the US debt ceiling and eurozone concerns took over, driving equity prices down to levels around the 5,000 mark. While the market pulled itself back to 5,572 by 30 December, this shows that sharp market movements cannot be anticipated. Gilts, in contrast, continued to rise and ended the year as one of the best-performing asset classes.

There are many short-term factors which affect market movements, and no one can realistically claim full confidence over how these unknowns will play out. Our view is that company valuations are currently low and dividend payments are on the rise globally; it is accepted that over the long term there is potential for delivery of healthy real returns. However, volatility will continue in the short term, especially while driven by sentiment and, in particular, political action or inaction; so a long-term focus and a portfolio well-diversified across asset classes is essential to any investor.

UK members of the St. James's Place Wealth Management Group are authorised and regulated by the Financial Services Authority.
The 'St. James's Place Partnership' and the titles 'Partner' and 'Partner Practice' are marketing terms used to describe St. James's Place representatives.
St. James's Place UK plc Registered Office: St. James's Place House, 1 Tetbury Road, Cirencester, GL7 1FP, United Kingdom.
Registered in England Number 2628062.