IFPC Market Commentary April 2014

Market commentary - for the period 6th October 2013 to 5th April 2014

Economic activity in the United States (US) continued to lead the global recovery after a harsh winter as the annual growth rate of the economy rose to 3.7% per annum. Taking the last quarter of 2007 as a starting point, the US regained it's pre-crisis level of activity in 2011 and real GDP (size of the economy adjusted for inflation) is now some 6% higher than at the end of 2007. The US economy still faces considerable fiscal (essentially tax and spending) headwinds but is gradually normalizing as banks return to health and the private sector is paying down it's debts. Only Germany of the major developed economies has anywhere close to this performance but having led the US for much of the period, it now finds itself some 2% behind. On the same basis, the UK is about to celebrate a return to pre-crisis levels of economic activity but is still some 3 years behind the US recovery.

The boom in the UK residential housing market has returned to dominate the news agenda and there are concerns that yet another housing bubble is being created. However, price action is far from uniform across the UK with London posting the highest growth rates while Scotland has suffered a decline in prices over the last 12 months.

Chinese economic growth slowed in the first quarter of 2014 from 7.7% to 7.4% continuing it's steady decline from the recent peak in 2010 when the annualized growth rate was above 12% per annum. Demand for Chinese exports is waning and there is evidence that the housing bubble in the major cities is finally deflating. Events in China remains one of the principal risks to the global economic recovery as investors hope that a series of financial product defaults in the shadow banking system don't precipitate another crisis.

UK equities **FTSE All-Share Index** **+6.5%**

UK economic growth is estimated to have grown by 3.1% over the year to March 2014 with some indicators pointing to even stronger growth ahead. The expansion now appears broadly based with spending by both households and businesses having grown solidly in 2013. There has been a revival in the residential housing market with transactions up a third over the past year and strong growth in housing investment. The availability of mortgage lending has improved further, including at higher loan to value ratios. The recovery in output has yet to be matched by a material pick-up in productivity which is impacting on consumer incomes. Consumer Price Inflation (CPI) fell to 1.6% in March, below the Bank of England's 2% target. Private sector pay growth has begun to pick-up modestly, although it remains well below pre-crisis norms.

Short-term market interest rates imply that market participants expect the Bank Base Rate to rise gradually, from around the middle of 2015, to circa 2% in 3 years' time. The government continues to stimulate the housing market with ultra-low interest rates and with loan and capital guarantees but it may soon be time to take precautionary action. It is unlikely to withdraw the latter given the general election next year but the Financial Conduct Authority (FCA) and the Bank of England's Prudential Regulation Authority has introduced new tougher mortgage lending rules to ...'put common sense at the heart of the mortgage market and prevent borrowers ending up with a mortgage they can't afford'. New applicants are now tested for immediate affordability and for 3% higher interest rates in 5 year's time. There is a severe lack of supply in some areas most notably in the South East and London and the annual construction of new homes needs to double just to stabilise supply relative to population growth. The government will need to consider entering the construction market to compete with developers who are hording vast land banks.

In the FTSE 350, Healthcare Equipment and Services, Financial Services, Construction and Materials, Household Goods, and the Real Estate sectors all produced greater than +15% total returns, whilst Industrial metals and Mining, Food and Drug Retailers and Personal Goods companies posted hefty negative returns. Company valuations on a range of metrics appear to remain at the top end of their historical range and it remains difficult to find investment opportunities with any sense of conviction given the performance of stocks over the last four years. Quantitative Easing (QE) in the US is still having a major impact on asset prices and it remains to be seen how the investment landscape will look like when QE comes to an end in October alongside the change in investor psychology following the first interest rate rise in a developed market. Financial assets are clearly mis-priced but with few obvious alternatives, our approach continues to be one of caution and vigilance ahead of these events.

International equities **FTSE World (excl. UK) Index** **+9.9%**

In the US, the S&P 500 returned +11.1% and the Dollar weakened against Sterling by -3.7% reducing the return to UK investors to +7.4%. The Federal Reserve continues to 'taper' it's asset purchases from a high of $85 billion a month to the current level of $45 billion a month. At this rate of decline, the process of QE is projected to end in October of this year. Despite leading the global recovery, the US has maintained a relatively healthy trading position. Historically, an economic recovery would have led to greater demand for imports but this time around, the US export position remains resilient. Part of the explanation lies with the fracking revolution and an increase in oil production in the US which has reduced demand for imported oil. This is not the whole picture and there is evidence of a change in consumer behavior with a shift from purchasing PCs to tablets and mobile phones supporting domestic companies like Apple. Since 2002, the US Dollar has weakened by almost a third, raising the phenomenon of 're-shoring', bringing industrial production back from overseas to the US. In a post financial crisis world, it looks like US demand will have a lower impact on growth elsewhere as consumer spending declines with emerging markets likely to experience lower levels of demand as a result.

In Europe, the FTSE World Europe (ex UK) Index returned a credible +11.3% and the Euro weakened by -2.5% against Sterling. The Eurozone recovery continues to become more established as fiscal austerity measures and credit conditions eased in 2013. The general level of prices in the Eurozone is very close to outright deflation with inflation at a low of 0.5% as the European Central Bank (ECB) stands ready to either cut interest rates (to below zero!) or engage in further market interventions. It is difficult to comprehend that only 3 years after the Eurozone crisis, the yields or interest rates for government borrowing on 10 year bonds of the peripheral countries (rates in brackets), namely Italy (3.3%), Spain (3.2%), Portugal (4.0%) and Ireland (2.9%), have fallen to 8½ year lows providing brave investors with healthy returns in that period.

In China, slowing economic growth has had a notable impact on the weakness of real estate investment which is contracting sharply with signs of real financial stress. Chinese growth could weaken still further with the Chinese government unwilling to intervene to the same degree that it did following the financial crisis. So far in 2014, the Chinese Reminbi has weakened by –3.3% against the US dollar following decades of currency appreciation. The US government suspect that the Chinese government is intervening in the currency markets to shake out speculative investors such as Chinese exporters, creating disruption in global export markets. Further Reminbi devaluations will ensure a greater level of volatility in financial markets as the implications move beyond Chinese borders.

Performance in the Asia Pacific region measured by the MSCI Far East (ex Japan) Index returned +1.4%. The Japanese market measured by the Topix 500 returned +5.4% for the period under review although remains in negative territory for 2014 thus far. Overall, 'Abenomics' has achieved good results to date with GDP growth at +1.5% for the first quarter of 2014, the highest level in two years. The overall profit growth for companies has been stunning over the last 18 months and outstrips every other developed nation by a considerable margin. Indeed, forecasts for the year ahead are being revised upwards which cannot be said of any other country in the world. However, Japanese investors are all too aware that a falling Yen is positive for equity investors whilst a rising Yen is negative for returns. The downside risk is that the government remains complacent and with an inflation target of 2% and a current inflation rate of 1.5%, there is still much work to be done to convince investors that the market can make further progress.

Fixed interest securities **FTSE British Government All-Stocks Index** **+1.3%**

Ten year UK Gilts are now yielding 2.67%, and have remained stable since the last commentary. UK Investment grade corporate bonds are yielding just shy of 4% and US High Yield Bonds are offering circa 5.5%. Clearly, these yields are very low by historical standards and are symptomatic of the post crisis, QE induced, low interest rate environment we find ourselves in. In the US high yield market where investors lend to riskier companies with lower credit ratings, the number of companies defaulting on their obligations has remained remarkably low in recent years at less than 3% and as yet, there are still no signs of any serious distress in this asset class. Any rise in this measure will be a sign that US companies are starting to struggle and economic growth is slowing.

Commercial property **IPD UK All Property Index** **+8.8%**

Offices returned +12.0%, retail +6.0% and industrial units +11.4% including rents. Investor flows into pooled property funds have picked up significantly over the last 12 months as property portfolios have started to post double digit, calendar year returns. The UK commercial property sector now looks attractive as an asset class on a relative yield basis particularly compared with government and corporate bonds. International investors and large pension funds are buying London's 'trophy assets' but away from the City, regional property investment is currently offering net initial yields in excess of +7.7% with potential for greater, long-term rental growth.

Alternative investments

The Gold spot price has arrested it's decline of 2013 and seems to have stabilized at the $1250 level. Since, the beginning of 2011, China has imported over 3000 tonnes of gold from Hong Kong and other central banks around the world continue to build their gold reserves adding over 350 tonnes in 2013. Gold producers have had to be more disciplined in the management of their existing and planned exploration projects in light of a lower gold price and poorer quality ore. The industry has reacted sharply by calculating the 'all-in-costs' that a gold producer experiences to decipher at what gold price the miners can remain profitable. For 2014, the average costs are in the region of $1,292 indicating that the industry would suffer significant losses with a price much below these levels.

If you would like to find out more or speak to one of our advisers, please contact us:

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Important Information

IFPC Ltd is authorised and regulated by the Financial Conduct Authority (FCA).

Indices performance statistics are for the period 6th October 2013 to 5th April 2014, total return with income reinvested.
Source of statistics: Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.