IFPC Market Commentary October 2013

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

Ben Bernanke, the Chairman of the U.S. Federal Reserve (the 'U.S. Central Bank' or 'the Fed') first announced on May 22nd that he was considering scaling back his policy of Quantitative Easing (reducing the scale of money printing by approximately $10-$15 billion per month) and the market reaction in equities, bonds and commodities was extremely negative. The Fed has been buying $85 billion of financial securities every month since September 2012 and markets have become somewhat addicted to this extraordinary monetary stimulus originally established to avert a 1930's style economic depression. In anticipation of better economic times ahead, interest rates (measured by U.S. 10 year Treasury bond yields) rose sharply to 2.8% from a historical low of just below 1.5% and the potential to damage the fragile recovery through higher borrowing costs and weaker asset prices became a real concern. Whilst the Fed were happy to see some froth taken out of financial markets particularly with mortgage rates at a two year high, Ben Bernanke clarified his intentions and deferred the decision until March 2014. The emerging markets suffered large money outflows as investors became concerned about countries with deteriorating economic fundamentals and volatile currencies.

UK equities FTSE All-Share Index +6.4%

In the UK, a recovery appears to be taking hold however, it is likely to be weak by historical standards. In his annual Mansion House speech, the Chancellor declared that 'Britain has left intensive care'. Economic growth measured by Gross Domestic Product (GDP) increased by almost 1% in the first half of 2013 and should be welcomed after almost a year of no growth. Growth has been supported by a moderate but sustained pick-up in global demand, assisted by the Bank of England's programme of £375 billion of asset purchases and a gradual fading of the full impact of the financial crisis to households and businesses. As expected, banks have continued to repair their finances since the crisis and the Funding for Lending Scheme established in July 2012 has in part helped to improve the availability of credit and keep funding costs down. The UK consumer remains subdued as total spending (adjusted for inflation) remains below the 2007 peak due to below inflation wage rises and hikes in energy bills. Mark Carney, the new Governor of the Bank of England stated that interest rates are likely to remain anchored at 0.5% until the unemployment rate has fallen to 7% although higher mortgage rates are likely in the near term. Inflation measured by the Consumer Prices Index (CPI) is likely to remain close to 3% reflecting the increase in import prices due in part to weak Sterling although the future outlook for inflation remains highly uncertain.

Throughout 2013, analysts have consistently revised their predictions for projected 2013 UK corporate profits downward whilst the market measured by the All-Share Index has continued to grind upwards. The decline in predicted profitability has been mainly due to adjustments to forecasts in the commodity and pharmaceutical industry but investors have been prepared to pay higher valuations for companies outside of these sectors given the perceived overall decline in external risk factors. At the sector level, personal goods and general retailers have performed well whereas the industrial metal and mining sector has performed poorly alongside food producers and tobacco companies.

International equities FTSE World (excl. UK) Index +10.0%

In the U.S., the S&P 500 returned +9.7% and the Dollar weakened against Sterling by -4.4% reducing the return to domestic investors to +5.3%. The economic recovery has continued throughout 2013 despite the fiscal headwinds associated with the rising costs of healthcare, the rising cost of debt and the political paralysis in Washington which resulted in federal workers being furloughed for over a week. The outstanding public debt owed by the federal government is currently $17 trillion and continues to be the major concern with the U.S. economy. The annual federal budget is likely to be in deficit at over 3% of GDP for at least the next ten years and projections show that this will represent 71.1% of GDP in 2023. However, the recovery in the U.S. still remains ahead of the UK, Europe and Japan and real GDP growth for 2013 is likely to be close to +2.5%. The official unemployment rate has continued to improve and is down to 7.3% having reached close to 10% at the height of the crisis. The housing market continues to show signs of recovery helped by ultra-low interest rates which has pushed the cost of servicing debt down to levels last seen in 1994 at 10.4% of disposable income. Banks are repairing their balance sheets and the private sector is paying down outstanding debts. This process of deleveraging is profoundly deflationary (or 'dis-inflationary' at the very least) to the economy and sits at the heart of the Federal Reserve's dilemma on the future for Quantitative Easing policies as they try to avoid the threat of endemic deflation.

In Europe, the FTSE World Europe (ex UK) Index returned a credible +11.3% allowing for a slight weakening of the Euro. The Eurozone finally emerged from recession in the second quarter of the year although there remains a disparity between core and peripheral Europe. The good news is that Spain achieved +0.1% GDP growth in the third quarter ending two years of recession. The news flow out of Europe continues to be positive (although Mrs. Merkel has decided to turn her mobile phone off!) and it should only be a matter of time before Italy returns to positive growth.

The major drag on growth has been the collapse in investment as banks have restricted the access to credit and demand from business, government and the property sector has remained subdued. In Spain, investment fell by a huge -39% from 2008, following the unwinding of the property bubble but even Germany, the engine of European growth, has not quite recovered from the crisis demonstrating some of the headwinds the union faces. One member state that is making a quiet comeback is Greece after years of depression and austerity and there are tentative signs of stabilization there.

In China, there were fears of an impending credit crunch with the Shanghai Interbank Offered Rate (the 'SHIBOR') spiking in June, not too dis-similar to movements seen in the West prior to the financial crisis. This rate essentially measures the level of trust between banks required to lend money to each other overnight and clearly signaled a level of strain in the system. The language from the People's Bank of China (the PBoC) suggested a preference for tightening credit conditions in the coming months although at this stage, it does seem that the worry of a credit crunch is overdone. The Chinese economy grew at a rate of +7.8% year-on-year and was a positive for equity investors. China is suffering from a real decrease in export growth since 2010 and this trend appears to be flowing over to the broader emerging economies.

A broad sell-off in equities and bonds occurred in the emerging economies following the QE announcements in May as some of the hot flows of money moved elsewhere. The MSCI Emerging Markets Index finished at -2.7% for the period under review. The markets in Brazil, India, Turkey, South Africa and Indonesia (the 'fragile five') witnessed sizeable losses and have been identified as the countries with the weakest political and economic dynamics. Currencies have also been highly volatile, generally weakening against their Western counterparts and reducing investment returns when translated back to Sterling. This appears to be an adjustment of expectations rather than a panic at this stage but analysts will be mindful of countries that are unable to borrow as much money from foreigners in the future and have the potential to suffer from greater financial instability. In broader terms, emerging economies are in a much stronger financial position than they were in the last crisis in 1997, as they have built up high levels of international reserves and their debt to GDP ratios are relatively low. Overall, the valuation levels of companies are not too demanding on a number of measures particularly when compared to the West.

Performance in the Asia Pacific region measured by the MSCI Far East (ex Japan) Index returned +0.9% allowing for currency adjustments. Japan remains one of the best performing markets year to date and achieved +10.3% in the period. The easy money has been made in Japan over the last year following the policy announcement now known as 'Abenomics'. Investors are waiting for further hard evidence of an economic revival before committing additional funds rather than relying on the rhetoric of the Prime Minister, Mr. Shinzo Abe. Early signs are encouraging with core inflation levels reaching 0% (yes, zero) which should be viewed as good news given that Japan has suffered from over a decade of year on year deflation. Since his original announcement in October 2012, the Yen has weakened by -22.8% and the Nikkei Index has appreciated by +62%.

Fixed Interest Securities FTSE British Government All-Stocks Index -4.9%

Ten year UK Gilts are now yielding 2.77%, a notable increase from the last commentary where they were 1.87%. This is indicative of upward pressure on interest rates for the first time post the financial crisis and we may have just witnessed the bottom of a 30 plus year interest rate cycle this year. A rising interest rate environment is not good for long term, fixed rate bonds and it appears the recent experience of high single digit, sometimes double digit returns on bond portfolios may be over. The outlook is similar in the U.S. as the equivalent U.S. ten year Treasury bond is currently 2.75% having bounced significantly off it's record low earlier this year. Investment grade corporate bonds will likely remain under pressure in a rising interest rate environment. High yield bonds tend to be less interest rate sensitive but are higher risk given their poorer credit qualities compared to investment grade securities.

Commercial property IPD UK All property Index +4.8%

Offices returned +6.2%, retail +3.4% and industrial units +6.1% including rents. Security of income remains a prime concern as institutional investors look to shift their allocation of low yielding bonds towards higher yielding assets avoiding the volatility of equities. Pockets of regional performance in the UK is promising but comes at a higher risk and capital growth still remains elusive.

Alternative investments

The Gold spot price declined by -15.0% in the period. Central Banks remain the largest purchasers of gold which has been the case in the gold market since 2010 following decades of net selling. China holds 1.6% of it's foreign reserves in gold compared to 13% for the world average. If China decides to make it's currency fully convertible, it may need to show international investors that it is backed by more than the 1054 tonnes of gold it currently owns and could easily purchase a large proportion of current annual global production.

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 5th April 2013 to 6th October 2013, total return with income reinvested and currency conversions back into Sterling as stated. Source of statistics: Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK).