WEALTH MANAGEMENT

Market commentary October 2014

Brief overview

Financial analysts have been digesting the full implications of the end of Quantitative Easing (QE3) in the United States as the programme draws to a close in October. In anticipation of potentially higher interest rates in 2015, the US dollar has continued to appreciate against a global basket of currencies and early indications are that it has broken a thirteen year downtrend dating back to 2002 with serious implications for commodities and emerging markets.

Following the 'taper tantrum' of June 2014 when ten year interest rates (measured by 10 Year US Treasury yields) jumped from a low of 1.67% to just under 3%, it appeared inevitable that we would see interest rate rises in the U.S. sooner rather than later. Indeed, consensus forecasts at the end of 2013 were predicting an upward trajectory in the future path of interest rates. At the time of writing, the yield has fallen back to 2.3% and dis-inflation (falling inflation) seems to be creeping across the globe, leaving central bankers and policymakers with some difficult decisions on the next course of action. They can either choose to reflate their economies through policy stimulus, monetising their debt in real terms or to pay down debt in the old fashioned way, maintaining a balanced budget. The former inevitably comes with currency devaluation which can have a destabilising effect on capital flows in and out of the country with consequences to investment, interest rates and loss of control over government debt levels whilst the latter risks dragging the economy towards long-term stagnation. Japan has been caught in this trap for the last twenty five years resulting in severe economic stagnation with interest rates consistently below 0.25% and ballooning debt levels to over 240% of Gross Domestic Product (GDP). At this juncture, Europe looks like it is inevitably drifting towards the Japanisation of its economy.

Volatility has risen significantly in the equity markets in recent weeks in anticipation of the end of QE and it has become clear that liquidity is a problem when the sell orders hit the computers. There is now a genuine divergence in monetary policies across the globe with the UK and US ending their QE programmes whilst Japan and Europe are further back in the cycle. Japan launched its own monetary stimulus some eighteen months ago and has seen the Yen weaken materially against a basket of currencies but most significantly against the Dollar. Europe has managed to keep its powder dry thus far except for some specialised targeted action to support bank balance sheets to get credit lines flowing, however, slowing growth and outright deflation may prompt greater stimulus measures.

UK equities FTSE All-Share Index **-1.0%**

With Scotland voting to stay in the UK, policymakers can turn their attention towards the strength of the economy. There was a collective sigh of relief from economists and investors alike as they rose early to hear that Scotland backed the Union by 55.3% to 44.7% with an enormous turnout of 84.6%. The immediate reaction was a bounce in Sterling as traders were glad to avoid the inevitable loss of investor confidence associated with messy and protracted negotiations over the division of national assets and debt.

UK equities have struggled to make any headway throughout 2014 with the FTSE 100 entering the year at 6717 and now trading at just above 6400. The FTSE 250 and UK Smaller Companies have underperformed the FTSE 100 down -4.3% and-2.4% respectively. The Food and Drug retailing sector has continued to under- perform as the major supermarkets have met fierce competition from Aldi and Lidl, who are catering for cost conscious consumers experiencing little or no wage growth. The rise of internet shopping has turned many of the huge, out-of-town shopping superstores into loss making divisions prompting the expansion of smaller, local, convenience stores. What to do with the overvalued real estate is a problem for incumbent chief executives and it may be some time before a turnaround in the sector is evident with further casualties and even consolidation a distinct possibility.

The surge in economic growth which started in the middle of 2013 has continued unabated with projected real growth for 2014 likely to top 3.0%. The Office for National Statistics (ONS) has recently changed its methodology for calculating GDP. Most notable was the inclusion of consumption of illegal drugs and prostitution which raised activity by £12.5 billion post the financial crisis. Quite how the Bank of England treats the inclusion of these numbers is unclear but they have retrospectively reduced the size of the loss of economic output during the financial crisis. Recent official data suggest that overall growth is likely to moderate although industrial production is growing at 2.7% annualised for 2014, which is significantly better than the -0.4% for 2013 and -2.4% for 2012. The Bank of England's mortgage market review (which forces banks to take greater responsibility in checking the suitability of mortgages for borrowers) is likely to produce a slowdown in the housing market as price indicators are moderating although surveys from the Royal Institute of Chartered Surveyors (RICS) still show growth of +8.2% compared to a year earlier.

Headline CPI inflation fell to just 1.5% and with a softening of general business activity and a weaker outlook from our main trading partners in Europe, it could prompt the Bank of England to delay raising interest rates next year.

International equities FTSE World (excl. UK) Index **+4.7%**

In 2014, US corporate profits have grown at 8% per annum whilst valuations remain towards the top end of the range from a historical context. The S&P 500 returned +6.1% over the last six months recovering from a poor start to the year. Whilst Mark Twain said that 'history doesn't repeat itself but it does rhyme', we can deduce that interest rates have never been this low, allowing companies to re-finance their debt at very low rates, profit margins have never been this high and balance sheets are carrying record levels of cash. Broadly speaking, management teams with a lack of confidence about the state of the global economy and a dearth of profitable investment opportunities have engaged in large-scale share buy-backs. This is a process where shares are taken out of circulation using company resources enhancing the reported profits per share as a result. In April, Apple Inc, the iphone maker, announced that it would be increasing its share re-purchase programme to $90 billion of its own stock, a record in corporate history. Financial engineering of this nature provides a genuine dilemma for investment strategists as it is clearly inflating share prices in the short term but leaving them susceptible to any disappointment in the future. Conversely, an economic environment of permanently low interest rates would allow companies to extend these shareholder friendly actions which may very well be the catalyst for bubble-like conditions.

European stocks have performed poorly since April dropping by -4.9%. Europe is suffering from persistent dis-inflation, postponing a profits recovery until well into 2015. The OECD slashed its growth forecast from 1.2% to 0.8% for 2014 and from 1.7% to 1.2% for 2015 and unusually stated that aggressive policy support was required to avert the unfolding deflationary spiral. A weaker Euro against the Dollar should provide some reflationary support to the economy. Government bonds have reacted in a remarkable fashion, taking yields to multi-century lows with Dutch yields back to the lows of the year 1517 and French yields back to the lows of the year 1746!

In Japan, the Topix 500 has risen by +7.4% over the period under review but still remains flat year to date. 'Abemomics' is achieving good results so far but a rise in 'consumption tax' from 5% to 8% hit growth in the 2nd quarter of the year as private spending accounts for some 60% of the economy. Overall, Japan corporates are in good health with low debt levels and plenty of cash, valuations are still compelling and a powerful earnings (profit) recovery is underway. Japan still faces significant challenges to eliminate deflation and repair the government's fiscal position.

Emerging markets have returned a creditable +5.7% over the last six months and are showing positive gains for the year. The International Monetary Fund (IMF) is expecting economic growth of 4.6% which has slowed steadily over recent years. In such a broad index, it pays to look closely as the outperformers are dominated by Indian companies whilst the fallers are dis-proportionately represented by Turkish, Egyptian and Russian stocks. Russia is now starting to pay the economic price for its Ukraine interventions with the Russian Rouble depreciating by -23% since 2012, equity valuations are rock-bottom and investment is falling.

Growth in China is slowing markedly with house price declines reported in 68 out of the 70 cities surveyed by the National Bureau of Statistics. Officials are continuing their attempts to purge debt and the risk of a 'hard landing' in the economy remains a key risk. The Chinese stock market has not performed well since the financial crisis and trades at very low valuations although this is largely due to the pricing of state owned companies.

Fixed interest securities FTSE British Government All-Stocks Index **+4.8%**

At record lows, one would expect that interest rates could only go higher following 35 years of declines. Investing in a 'Long US Treasury Bond' over 30 years yielding 3.7% per annum didn't appear to be a terribly exciting prospect at the turn of the year. The yield has since fallen to a paltry 2.8% producing a healthy +18% return year for long bond investors who made the correct call (as yields decline, bond prices rise). According to Bank of America Merrill Lynch, 45% of global government bonds yielded below 1% in September, so there is plenty of room for further gains from here. Deflation is slowly permeating the global economy as growth in China is falling, Europe is stagnating and Emerging Markets are starting to struggle as the Dollar strengthens. Commodity prices have already dropped sharply since the financial crisis. In context, France has inflation of 0.5%; Italy's is -0.2% (as in deflation); the Euro area on the whole has +0.4% inflation. It has been a good year thus far for government bonds with calls for the end of the 35 year bond bull market appearing premature. If the 'debt deflation' scenario really takes hold then long bonds will continue to look good value even at these levels.

Commercial property	IPD UK All Property Index	**+6.8%**

Industrial properties returned +6.8%, Offices 7.4% and Retail 3.9%. Commercial property entered its sixth quarter of consecutive month-on-month gains with overseas investors leading from the front. The index is still 30% below its 2007 peak. Yields above 6% in the regions are providing support to the asset class. Summer discussions over the £200 million purchase of the former Scotland Yard building by a consortium of Middle Eastern sovereign wealth funds for conversion into a hotel, offered the latest example of the capital's allure to risk averse, foreign buyers looking for trophy assets.

Alternative assets

Crude oil has fallen precipitously from its five year high of \$115 to \$81 with most of those losses materialising within the last five months. Global commodities have continued to suffer against a backdrop of falling demand in China and global oversupply. Iron ore prices are down 45% year to date and copper is down 11% in the same period. China's property market has driven growth in recent years but as fixed investment in China declines, there is little to see commodities entering a new structural bull phase anytime soon.

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Indices performance statistics are for the period 6th April 2014 to 5th October 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.

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