Market commentary April 2015

Brief overview

One of the key developments in Europe was a well trailed announcement by the European Central Bank (ECB) of a quantitative easing (QE) programme to boost growth in the Eurozone. The head of the ECB, Mario Draghi followed in the footsteps of the US Federal Reserve, Bank of Japan and the Bank of England with planned purchases of €60 billion per month of Eurozone sovereign bonds until September 2016, for a total stimulus package of €1.1 trillion (€1,100,000,000,000). The immediate effect of this policy initiative was principally on the exchange rate with the Euro depreciating by a significant -25% against the Dollar since its recent high in April 2014 potentially boosting European competitiveness. The purchase of German government bonds ('Bunds') by the ECB pushed the seven year bund yield into negative territory for the first time in history, virtually guaranteeing losses on their investments over seven years. The ECB is ultimately funded by the taxpayers of the member states of the Eurozone and therefore any losses on the bonds will be shared across the region. This is where we are in Europe as the end is supposed to justify the means. QE remains a key policy tool for central banks to keep interest rates low in order to support economic growth whilst extending the financial repression of savers in the Eurozone and beyond.

There was more unfinished business in Greece as the anti-austerity, far-left Syriza party won the most votes and parliamentary seats in a January snap election. The government campaigned on a mandate to re-negotiate its €240 billion bail-out which is not going down well with the Troika consisting of the European Commission, ECB and International Monetary Fund (IMF). A new programme will require yet more money for Greece in exchange for some painful reforms but any failure to reach agreement could be very damaging for Greece and indeed the Eurozone. The size of the Greek economy is still some -26% (in real terms) below its previous peak in 2007, investors are nowhere to be seen and households and corporates are aggressively withdrawing money from the banks. There are a range of possible scenarios that could play-out as negotiations continue but a Greek exit ('Grexit') from the Eurozone remains a distinct possibility and a key market risk.

In commodity markets, there was an oil shock as crude oil prices fell precipitously from a 2014 high of $107 a barrel to a low of just above $42 impacting government revenues for those countries heavily reliant upon oil exports. On a more positive note, the IMF forecasted global growth of +3.5% in 2015 with lower oil prices likely to support economic activity. Russia is one of the largest energy exporters in the world and is likely to stay in recession throughout 2015 as a result. To make matters worse, the Rouble depreciated by over 70% at its lowest point against the Dollar as capital flowed out of the country due to European sanctions designed to counter further Russian incursions in Eastern Ukraine.

UK equities FTSE All-Share Index **+7.2%**

The FTSE All-Share Index performed well in the period under review as it bounced off the October lows although it produced a paltry, total return of +1.2% for the calendar year 2014. Since October, the FTSE 100 rose +5.9%, the FTSE 250 achieved an impressive +14.1% and UK Small Companies +7.1%. On the economic front, the consensus growth outlook for the UK economy in 2015 is moderating at +2.5% following its above average growth rate of +2.8% in 2014.

The outcome of the recent general election was a majority for the Conservative Party with its stewardship of the economy seen as a key determinant of the victory. The Institute for Fiscal Studies (IFS) estimates that a little over half of the Government's planned fiscal consolidation relative to the March 2008 budget had taken place by March 2015 with further consolidation through reductions in government consumption likely to continue throughout the next parliament.

Consumer Price Inflation (CPI) was quoted at 0.0% (yes, zero!) in February and March as falls in food, energy and other import prices continued to weigh on the annual rate. The prospect of negative inflation rates or deflation can generate adverse consequences for the economy, such as delayed consumption and/or debt deflation, which is caused by falling incomes servicing fixed levels of debt. However, real income growth in the UK has been picking up lately and debt affordability measures are showing few signs of distress due to historically low interest rates. The Bank of England is projecting inflation to pick up gently over the next two years towards their stated 2% target. Market interest rates imply that the Base Rate is expected to rise from early 2016 but to only 1.4% in 3 year's time.

The best performing sectors in the FTSE 350 indices were Food and Drug Retailers, Financial Services and Construction and Materials. In light of the lower oil price, oil services companies remain under extreme pressure with a dramatic slowdown in orders, oil and gas producers continue to mothball future exploration projects to preserve their cash flows whilst mining companies are making little headway in a global industry suffering from excess capacity and structurally low commodity prices.

International equities FTSE World (excl. UK) Index **+13.6%**

In the U.S., the S&P 500 grew by +6.1% and the Dollar appreciated against Sterling enhancing returns to U.K. based investors by a further +3.9%. The U.S. dollar continued to appreciate strongly against a broad basket of global currencies (including developed and emerging markets) as it maintained its upward trajectory from the trough in 2011 to its recent high in April 2015. There is evidence that the U.S. economy is on a self-sustaining path to recovery as it leads the global economic cycle prompting the U.S. Federal Reserve to raise interest rates either later this year or early next. The minutes released by the board of the Federal Reserve following their interest rate setting meetings are now analysed in minute detail by investors across the globe looking for nuances in the language used for the timing of future rate hikes. In the March minutes, the Chairwoman Janet Yellen removed the word 'patient' (implying they would not be patient anymore!) evident in previous meetings, causing heightened volatility in bond and currency markets as investors digested the news. Initially, the Dollar strengthened before selling-off whilst bond markets have been in decline ever since. This is a sign of the times as highly leveraged markets are becoming ever more sensitive to the future path of interest rates.

From a long term valuation perspective, U.S. stocks sit at the top end of a variety of reliable long-term measures substantially curtailing the projected future returns available from the asset class. Stocks in the U.S. can certainly continue to grind higher as global interest rates remain at record lows whilst the Central Banks of Japan and Europe continue to provide liquidity support in the form of QE. However, the prospects for further gains look priced for perfection and ever more dependent upon artificial stimulus and/or higher valuations rather than any significant progress in the underlying economic and corporate fundamentals.

The performance of European stocks can be best characterised through the performance of the FTSE Eurotop 300 (excl. UK) which achieved a +21.9% in Euro terms. UK investors received closer to +14% due to a weaker Euro. The ECB President, Mario Draghi announced QE in the Eurozone as annual inflation fell to -0.6% (deflation) in January. However, the Eurozone recovery is becoming more established with steady improvement in private sector lending in particular. Real GDP growth across the region is projected to be +0.9% in 2015 following the +1.0% achieved in 2014, which are reasonable numbers after many years of economic contraction due to the financial crisis. Lower energy prices and a weak Euro should support further progress and will be particularly beneficial for German exporters.

There was some fallout in the currency markets, as the Swiss National Bank (SNB) shocked markets by declaring an end to the Euro / Swiss Franc peg in a policy move to stop investors selling the weakening Euro and buying the stronger Swiss Franc. Trading was essentially frozen on the currency markets for an hour as the Swiss Franc appreciated by a record +40% at one point in the day against the Euro, sending many currency trading firms (holding the opposite position) into insolvency. In further extraordinary measures, the Swiss Central Bank announced an interest rate of -0.75% to discourage further capital inflows.

In Japan, the Topix 500 rose by +22.6% in Yen terms with UK based investors receiving +20.7% adjusting for some small Yen weakness. The rise in consumption tax appeared to reverse the nascent recovery repeating a similar policy mistake made by the Japanese government back in 1997. Annualised economic growth for the second quarter of 2014 was reported at a disappointing -7.6% pushing Japan back into technical recession. In a rapid response, the Prime Minister, Shinzo Abe called a snap general election in December requesting powers to increase his QE programme and was promptly re-elected with a firm majority. Japanese equities remain compelling from a valuation perspective, earnings (profit) momentum is the strongest of all of the three major developed regions and the huge Government Pension and Investment Fund (GPIF) needs to increase its weighting towards equities providing additional support to the market. There are still significant challenges in Japan with debt to GDP levels of 227% (UK is close to 89% for context), the economy is flirting with deflation and growth still remains anaemic.

The underlying growth rate in China has been slowing for many years from 11.7% p.a. to the current 6.8% p.a. as the economy is re-balanced for domestic consumption over its traditional export and investment led model. The China (Yuan / Reminbi is the currency) exchange rate has remained firm against the Dollar as China is seeking Special Drawing Rights (SDR) status from the IMF in November, making it the fifth reserve currency in the world behind the Dollar, Euro, Yen and the British Pound. The autumn vote, if passed, will lead to China offering a fully floating currency. Interest rates in China at 3% will likely attract significant foreign capital when compared to zero or close to zero rates for all of the existing reserve currency countries. In this calendar year, the Chinese equity market has already rallied considerably in advance of a positive vote although much of the gains have bypassed western investors due to restrictions in gaining direct access to the Chinese equity market.

Fixed interest securities   FTSE British Government All-Stocks Index   **+8.1%**

Interest rates have fallen further with 21 Central Banks cutting policy rates this year whilst a glut of global liquidity is anchoring longer-term rates. However, after six years of zero rates, global growth remains tepid and there are fears we remain in a period of ‘secular stagnation’. JP Morgan estimated that €1.9 trillion (30%) of the euro area bond market is on a negative yield and government bond yields are now below G7 core inflation for the first time in 20 years. It is extraordinary that the Federal Reserve, Bank of England, Bank of Japan and the ECB all have interest rates at or near zero.

The ten year UK gilt yield fell to a record low of 1.33% in February but has since pushed back up to 2.02% (an investor holding a bond for ten years would receive approximately 2.02% in total return per annum). The U.S. ten year bond yield trades at a lowly 2.2% at time of writing. Sovereign bonds issued by the major G7 economies offer very little intrinsic value at these low levels, if held to maturity, but should offer some capital protection in a deflationary environment and if interest rates were to decline further with other risk assets inevitably selling-off. In this context, they can offer some reasonable hedging benefits to a well-diversified investment portfolio but future returns are not compelling.

Commercial property IPD UK All Property Index **+7.6%**

Industrial properties returned +9.7%, offices +9.9% and retail +4.8%. Flows into pooled property fund vehicles have continued to pick-up throughout 2014 and 2015 as investors seek alternatives to their low yielding fixed interest allocations. This is the fifth consecutive year of strong returns since the financial crisis although it will be difficult to repeat 2014's performance again following a period of good capital growth. Rental growth remains just above 1% for the sector as a whole although the retail sector in particular continues to struggle with near zero rental growth. There is some evidence of a recovery in risk appetite with some room for capital improvement although property returns will still largely be driven by income collection in the near term. Good quality commercial property portfolios can still be found yielding income above 5%, significantly higher than for equities and bonds. The UK was one of the top performing markets in 2014 behind Ireland, which achieved a stunning +40% but from a much lower base, with notable double digit returns from Spain which experienced a marked turnaround last year.

Alternative assets

Crude oil continued its precipitous drop that started in July 2014 from a five year high of $107 a barrel before plummeting to $42 in January and recovering above $60 at the time of this review. Just as the decline in oil prices kicked-off concerns about the health of the global economy, the recovery is being viewed in some quarters as a strong indicator that growth prospects may be improving faster than expected. Supply is still exceeding consumption as Saudi Arabia announced that it wouldn't cut production to maintain its market share, OPEC countries have maintained their levels of production whilst there is evidence of some slowing in the U.S. Many companies have costs of production in excess of $100 a barrel and will likely prompt a raft of restructures and corporate activity.

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Indices performance statistics are for the period 6th October 2014 to 5th April 2015, 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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