



This Bulletin highlights some of the key issues from last weeks press and from time to time includes the views of some of the St. James's Place fund managers.

5<sup>th</sup> July 2010

### Markets Stage Broad Retreat

Global equity markets retreated across the board last week as the bears gained the upper hand, sending share prices south as investors headed for the safety of the sidelines. After a more confident start, markets gradually gave ground in the face of poor economic news and data which raised fears of a so-called 'double-dip' scenario. Already worried about the impact on future growth of austerity measures being taken by many European countries, investors were additionally forced to think about a possible economic slowdown in two of the world's largest economies – America and China. Boosted by unprecedented economic stimuli by their respective governments back in 2008-09, the world's two engines of growth looked to be on track, with China quickly resuming double-digit growth and the US returning to long-term trend growth of around 3.5%.

On Thursday though, the mood changed when it became clear that firstly, the Chinese economy was slowing. The country's official purchasing managers' index for June fell from 53.9 to 52.1 - less than expected but still positive (any figure over 50 means positive growth). However, a separate survey of Chinese manufacturing activity by HSBC fell from 52.7 in May to a 14-month low of 50.4 in June and new orders signalled the first contraction since March 2009. But as **The Financial Times** pointed out, HSBC also said that its sub-index for Chinese factory output fell to 49.6, consistent with a slight fall in production – at the start of the year the index stood at 60.6. China's National Bureau of Statistics said the official numbers reflected the impact of tighter government policies and a weakness of the global recovery. In April the government unveiled a package of policies aimed at reducing speculation in the country's property market.

### Rocky Road to Recovery

Over on Wall Street, fears that the US recovery is losing steam were reinforced late in the week as a stream of new data on the health of the economy, from manufacturing sector, to housing and the labour market, all came in below expectations. The Institute for Supply Management's overall index fell from 59.7 in May to 56.2 in June – larger than expected, but still meaning positive growth. Investors interpreted this as a possible sign of damage to the US economy from the European sovereign debt crisis. Within the figures, components such as employment and new order gauges showed falls, highlighting a loss of momentum, according to economists. On top of this, new export orders which have been consistently above 60 in recent months fell back to 56 – again a possible sign, said observers, that the drop in the value of the euro and weaker European demand could hurt US exporters.

Already disappointed, analysts and economists were given no solace from figures released on the health of the US housing market. The National Association of Realtors reported that pending home sales, a measure of activity in home purchases that have been agreed but not completed, tumbled by 30% - again worse than expected. The main reason for this is unsurprising though – the government's first-time buyer tax credit, introduced to support the market, expired in April which means many hopeful homebuyers have been temporarily sidelined. And finally, for good measure, there was news that US payrolls fell in June for the first time this year as temporary census jobs ended. The report revealed that 125,000 jobs were lost, whilst private hiring of 83,000 was somewhat less than expected. However, the unemployment rate declined from 9.7% to 9.5%, reflecting a shrinkage of 652,000 in the labour force, suggesting that many Americans are taking themselves out of the employment field. With

mid-term elections due in November, stubbornly high unemployment is an obvious concern to President Obama and congressional Democrats. Despite the poor news, shares rallied from their lows on Friday as investors dipped their toes back in the water.

### Eurobillions

Meanwhile, over in the eurozone, much vaunted worries over the ability of Europe's banks to repay their debts to the European Central Bank failed to materialise. Some €442 billion of liquidity, injected into the European financial system by the ECB as a support measure fell due for repayment on Thursday and there were fears that many banks would be unable to do so. As it transpired, no one defaulted, contrary to the markets' expectations - international stock markets and the euro had fallen sharply the previous day in anticipation of trouble. So on Friday European bourses were able to regain their composure and managed to move into positive territory. Not that there weren't other issues apart from the banks to think about: unemployment, which has been declining for two years, increased slightly for the first time in May, although unemployment in the region declined slightly to 10%. The figures hide significant differences though: in Germany unemployment continues to fall but in Spain it has risen to almost 20%.

### Double-dip?

This is the current dichotomy for investors. Some are taking the view that the global economy faces a 'double-dip' recession, whilst others are in the camp which says growth will continue, albeit at a slower rate. At the weekend, Goldman Sachs' chief economist Professor Jim O'Neill voiced concerns about a possible slowdown in global growth, saying that any recovery was facing a "challenging period" and that he was troubled by evidence from the US. "Despite our global optimism of the past year, we have remained rather cautious about the US, expecting the past problems of housing excess and domestic savings weakness to plague domestic consumption for some time" he said. He said that China was currently carrying out a difficult rebalancing act of trying to slow its high-speed economic growth without derailing the global recovery, but would succeed. The firm still expects China to grow at a respectable 10.1% this year, down slightly from its earlier forecast of 11.4%.

Here in the UK, economist David Smith, writing in **The Sunday Times**, thinks a double-dip in the UK is very unlikely, saying Britain's recovery looks secure for now. Citing official figures, he pointed out that there was a 7.8% jump in business investment in the first quarter of this year and purchasing managers' surveys (PMI) suggest that British industry has had a bumper second quarter. The PMI for manufacturing recorded a level of 57.5 last month, close to 15-year highs seen in April and May. Employment in the sector grew at its fastest rate since 1995, in a sign that the recovery in activity is helping to boost jobs. According to the Bank of England's credit conditions survey, default rates among households and businesses have both fallen. One potential glitch though might be that with the euro having fallen, British exports growth might slow.

### 'Risk on, Risk off'

According to Fidelity fund manager Tom Stevenson, writing in **The Sunday Telegraph**, a measure of the current volatility in financial markets is the speed

with which this trading-floor catchphrase has caught on. 'Risk on' describes those days when the glass seems half-full and investors are looking on the bright side. 'Risk off' is used on glass-half-empty days when the outlook seems gloomiest. Undeniably the market has swung from 'risk on' to 'risk off' since mid-April when the UK market was close to 6,000. But Mr Stevenson commented that, having sat out the correction, he was inclined to hold his nerve given the market's undemanding valuation and signs that this is a mid-cycle pause rather than the prelude to double-dip recession. And apparently that's how many other investors think too because, according to brokers TD Waterhouse, the number of investors buying shares last week jumped by more than a fifth as they sought to profit from the fall in share prices.

The point about every bull market unfolding in distinct phases was discussed by Chris Watling of Longview Economics in **The Financial Times**. Mr Watling pointed out that the long-term direction of equity markets is driven by the outlook for the economic cycle. Bear markets anticipate and price-in economic contractions. Bull markets anticipate and price-in economic recoveries and growth phases. Within those bull markets however, there are three distinct phases. Initially as equity markets begin to sense that the bad news is priced-in and that a recovery is on the horizon, then phase one of the bull market begins and prices rise – typically accounting for 40% of the entire bull market cycle with a median duration of 11 months. Phase two begins as markets start to anticipate the beginning of a monetary tightening cycle and again, typically lasts a few months. The final third phase, a resumption of rising prices, can last as long as five to six years depending upon the longevity of the economic cycle. He concluded that the recent market moves should be seen within this context.

### Going Continental

With mainland Europe acting as the centre of gravity for investors of late, it makes sense to find out what professional fund managers think about events. Stuart Mitchell manages European equities and here he shares his views and what it means for his portfolios. "The roller-coaster ride provided by equity markets in recent months has, it may be said, been less than comfortable. While the euro crisis has for the time being been contained by the 'bail-out' package put in place for Greece (and thus implied as being available for others) by the European Union and IMF, markets have been reluctant to settle down. The unease produced by European policymakers' inclination to adopt a heavier regulatory approach to financial markets has now been followed by the resurfacing of fears of a 'double-dip' in economic activity.

"While there remains plenty of cause for concern – governments, and central bankers, across Europe will be wrestling with fiscal demons for a good while – the backdrop for companies is much more reassuring. We continue to see little to deflect our view that our companies will be able to generate much stronger earnings growth than the market currently expects. We were very impressed by how quickly, and how aggressively, companies cut costs in the face of the crisis. Demand, surprisingly resilient in the Emerging World, also shows encouraging signs of recovery in the West. Combine these two factors and the result is a strong impulse to higher profits. Moreover, credit has become more readily available again, even if its uptake has lagged somewhat. Interest rates are – and are likely to remain for some time – breathtakingly low. We are also still seeing the economic benefits of the extraordinary government stimulus programmes implemented over the past 18 months.

Within this environment, European shares appear good value, trading on some ten times prospective earnings. European markets also continue to trade at significant discounts to the US market despite their corporate sectors being just as profitable. Equities are as cheap as ever relative to bonds and cash. Moreover, many investors remain encouragingly cautious. Our meetings with companies continue to confirm that many traditional institutions, such as insurance companies, still have scant exposure to equities.

Nevertheless, we draw a clear distinction between business and economic conditions in the southern periphery of the eurozone, labouring under the burden of higher cost structures, and its northern 'core' tier. For the south (roughly Greece through to Portugal) currency devaluation is not an option, and it will see relative deflation, which will doubtless be painful. But the reverse of this is the

prospect of rather better growth rates in the northern tier. This will provide a backdrop for northern European companies altogether more benign than that of the last year or two, further enhanced by the steep euro devaluation relative to the dollar since the autumn of last year. The overall shape of the fund book remains broadly unchanged, with a strong bias to 'northern-tier' companies, and with nearly three quarters devoted to cyclical and financial shares. Exposure to energy producers is limited, as it is to businesses, such as pharmaceutical companies, whose earnings may be relatively secure, but whose scope for demand-led growth is minimal".

Stuart Mitchell manages the St. James's Place Continental European Fund.

That's just one view - Alex Darwell, manager of the European element of the St. James's Place Jupiter Cautious Managed fund gives his views too on how he sees current events.

"The European Union has lagged the US and the UK in precipitating a recapitalisation of its banks' balance sheets, largely because of the nature of its political structure. In general, consensus is required from all member states. The first eurozone country to announce that it would be conducting bank stress tests was Spain in June. It did so because it felt that investors were overstating the problems faced by its banking system. It has not yet published any results, but the notion has caught on, and around 100 banks across the eurozone are now taking part in tests being conducted by the Committee of European Banking Supervisors (CEBS). The primary purpose of these tests is to seek to offer reassurance and transparency to increasingly nervous investors, but we are concerned that there has so far been no comprehensive indication of the methodology that will be deployed, nor have there been any emergency funds allocated for banks that fail the tests. There is a very real chance that some smaller, regional banks, such as Spain's *cajas* and Germany's *Landesbanks* are in a parlous position, but whereas the US set aside a fund through its Troubled Assets Relief Programme, there has been no equivalent assurance given in Europe. We feel that it is essential that both these issues – methodology and a recapitalisation plan – are addressed prior to the publication of the results.

In the face of these uncertainties, the European Central Bank (ECB) saw full repayment this week of the €442bn emergency funds it made available to markets a year ago. Moreover, take-up of its offer of interim 3-month liquidity was significantly less than expected at €131.9bn. However, while this acted as a fillip for markets, the fact that take-up came from a relatively small number of banks availing themselves of sizeable chunks of funding suggests there are financial institutions out there with very real funding problems. While it was good news for those that didn't need to participate, we feel it's still too early to be confident. The fact that 78 banks had to seek emergency funding to see them through the six days from the repayment of the 1-year ECB loans to the issue of the 3-month bonds is a sign of the fragility still prevalent in the bond markets.

For much of Europe, credit default swap spreads of financials remain volatile and systemic risk indicators are weakening. We feel there is scope for optimism if the stress tests are well executed. But in the meantime, markets really need a clear indication of the methodology according to which the tests will be conducted so they can have confidence in the results, and provisions to be made for banks which fail. For the time being, we remain cautious."



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