



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Market Eye

Against a backdrop of worse-than-expected (or wished for) economic data, global markets maintained their stride for most of the week, recovering some of the losses seen last month. True, markets wobbled on Friday but, overall, most major indices advanced. Whilst not completely unexpected given the drip, drip of weaker economic data flowing from the developed Western economies in recent weeks, hopes for the global recovery received a setback following the release of a welter of purchasing managers' surveys (the PMI) for August. Across Asia, Europe and the US, the surveys produced the lowest reading of manufacturing activity and orders since mid-2009. Any figure below 50 indicates contraction so it was a relief to the markets that J.P. Morgan's global PMI came in at 50.1, albeit falling from 50.7 in July. The caveat though is that PMIs are far from perfect indicators of the health of the manufacturing sector but, even so, the numbers did disappoint analysts and economists alike.

Friday's setback in sentiment was caused by poor US data which showed zero growth in non-farm payrolls and an increase in private sector jobs of just 17,000 – this being offset by a loss of 17,000 government jobs. This left the US unemployment rate unchanged at 9.1% – uncomfortably high with an election due next year and thus increasing the pressure on President Obama to come up with a plausible recovery plan when he gives his keynote speech to Congress this coming Thursday. The markets are expecting him to announce new initiatives on infrastructure, reviving the moribund housing markets and extending tax breaks for employers. However, with Republicans in no mood to see an increase in the budget deficit, it will be interesting to see what room for manoeuvre the president has.

Likewise, there is further pressure on the US Federal Reserve to announce the launch of a much-vaunted QE3 (the third round of 'quantitative easing', or printing money) policy when the committee meets later this month. Investment bank J.P. Morgan Chase believes the likelihood is 'better than even' that the Fed will soon roll out a fresh programme of asset purchase or QE3. However, rather than expanding its balance sheet through fresh asset purchase as it has done previously, the markets are expecting a 'twist' operation where it sells short-dated securities and buys longer-maturity assets, thus keeping borrowing costs ultra-low. Analysts also think the Fed's chairman, Ben Bernanke, may lower the interest on the excess reserve rate (the amount the Fed pays on money deposited with it by banks) and also further enhance its forward guidance by being more explicit.

Rude Health

Without wishing to underplay the problems in the developed economies, are there any grounds for optimism? Whilst many Western governments are weighed down by too much debt, the corporate world – along with many governments in the developing economies – has spent the last two years bolstering its balance sheet. Firstly, unlike Western governments, companies have de-levered in the recession by cutting costs, unwinding or selling off assets and have issued equity to retire debt. This has left many companies awash with cash and is probably one of the main reasons why merger and takeover activity has been increasing. Lastly, also unlike governments, many high quality companies have not been affected by political uncertainties. This explains why, amongst other things, high quality (investment grade) corporate bonds have fared relatively well during

the recent turmoil. Corporate bond yields remain very favourable, especially when compared to cash. As discussed in previous bulletins, the markets price the ‘safety’ of both governments and corporates via the credit default swap market – this enables investors to compare the costs of insuring against the threat of default. The recent eurozone debt crisis has made investors wary about the quality of government promises and led to significant credit re-ratings by the markets. As a result, there are many companies whose stock is now rated safer than Uncle Sam, the UK and even mighty Germany and include the likes of Lockheed, National Grid, Nestlé and GlaxoSmithKline.

The aspect of strong corporate balance sheets was recently discussed by Jupiter fund manager Ian McVeigh. “In response to the last crisis, company balance sheets are far more conservative. Banks in particular have far less risk of running out of cash than they did last time. Reserves are much higher and many problem loans have either been sold or written down. In our view, none of this much-stronger position is reflected in current valuations. We think the current backdrop is reflecting extreme pessimism that could, but is in our view unlikely to, prove correct.” He went on to comment, “To us this is highly reminiscent of the panic we saw in the aftermath of the Lehman’s collapse. The world could slide into recession but we note that a lot of the emerging world has an issue with too much, rather than too little, growth. Even with the downgrades seen, the consensus for global GDP is still around 3–3.5% so we are talking of a global economy that is growing rather than contracting.”

A Parallel Universe

Whilst the Western world struggles with too much debt and too little growth, the Orient and other fast-developing economies represent the flip side: too much growth and little or no debt. China is the classic example. Currently, the country’s leaders have the opposite problem to the West – how to stop their economy from roaring ahead too quickly. China’s premier, Wen Jiabao, said last week that reining in soaring consumer prices remained Beijing’s priority – as it has been for most of this year – and that China’s macro-control and adjustment direction cannot be changed. Reading between the lines, most economists see this as a signal that Mr Wen is unlikely to unleash another enormous stimulus package, similar to the one seen in 2008, and that China’s leaders feel the economy is robust enough as it is. After a year of monetary tightening, the economy has responded in the way expected, with growth slowing from around 10% to closer to 9% (the US and UK might achieve growth of 1.3% this year). So it is likely that China will achieve a ‘soft landing’ rather than a sharp setback. Indeed, China’s PMI climbed 0.2 points to 50.9 in August after falling for four consecutive months.

Dragons’ Den

If quizzed about emerging markets (EMs) most investors would be familiar with the ‘BRIC’ economies: Brazil, Russia, India and China. But the emerging world consists of 44 countries which contribute over 50% of world GDP growth, a share which is set to keep rising for the foreseeable future. The increased significance of EMs to global growth, underpinned by domestic demand-driven growth and robust fundamentals has led to investors seeing them as a key component of their investment portfolios. This shift in investor perception has been reflected by record inflows of over \$95 billion into EM equity last year alone; but many clients may be confused about the best method for investors to gain exposure to these exciting growth opportunities. There are two fundamental approaches: to invest in developed companies carrying out business in EMs, or to invest in EM companies directly. The two are not mutually exclusive; rather it is a matter of risk appetite as to how one approaches the issue. For many clients, combining the two strategies is an effective solution.

Developed market companies are increasingly looking to the EMs to secure their future growth, and corporates in many developed economies are generating an increasing proportion of their revenue from the emerging world, from around 9% some twenty years ago to almost 20% today. This trend is expected to

continue as many multinationals are becoming increasingly reliant on EM growth to generate profits. Unilever is a classic example with over half its sales coming from EMs, whilst Nestlé derives around a third. So, as a result, an investment in many developed market stocks today is often an implicit investment in emerging economies – it can also mean less risk too. Taking Unilever as an example, it is a UK-listed stock, adheres to UK corporate governance rules (which can be virtually non-existent in many EMs) and has no explicit currency risk to a UK investor.

Whilst by their nature developing economies are undergoing structural change, which can lead to increased market volatility, one can take the view that they also represent something of a safe haven. They have low sovereign, corporate and household debt levels, high savings rates, large current account balances and huge foreign currency reserves. This is, as mentioned already, in complete contrast to the debt-laden developed world. So a complementary approach to gaining exposure to EMs, for those clients willing to accept more risk within a well-diversified portfolio, can be to invest directly in emerging stocks.

No Hiding Places

The high levels of volatility witnessed in global financial markets last month meant, unsurprisingly, that investors saw the value of their investments fall. For those who took no action, they would have also seen the value of their investments rise again from the mid-August low point. For some investors who thought they had greater protection by buying hedge funds with an absolute return bias, the outcomes have been surprising on the downside. According to the consultancy Hedge Fund Research, last month was the fourth-worst month ever with some of the industry's best-known stars racking up significant double-digit losses.

Another solution has been for investors to use other investments such as 'structured products' whereby capital is locked-in for predetermined periods and returns dependent upon the performance of a few benchmark indices. Whilst appearing attractive, the financial engineering involved can make these products very opaque and thus difficult to evaluate for risk purposes. Indeed the Financial Services Authority (FSA) is planning to issue 'health warnings' on products or banning them to protect consumers as part of a tougher regulatory line. The FSA has expressed concern about complex structured products, and plans to be clearer in future about highlighting the dangers of such products to consumers.

As clients will recognise, at St. James's Place we are always wary of advising on complex investment structures; sticking to the old adage that "if something seems too good to be true, it usually is".

Ian McVeigh manages funds for St. James's Place.