



# MARKET BULLETIN



ST. JAMES'S PLACE  
WEALTH MANAGEMENT

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## Market Eye

Despite generally better-than-expected economic data, global equity markets went into retreat last week as concerns over the latest EU 'grand bargain' jangled investors' nerves and sent Italian sovereign debt yields higher once more. On the economic front, America's closely watched initial jobless claim figure (which tracks how many people apply for their first week of unemployment benefit) fell to its lowest level in three years, down to 366,000. This gave forecasters hope that the US economy might be recovering faster than expected. Here in the UK, there was good news on the inflation front, with the Consumer Price Index falling from 5% to 4.8% in November, its second month of moderation. Discounts in supermarkets and clothing shops together with falling petrol prices have helped ease the pace of inflation. Expectations are that the headline index will fall significantly in the first quarter of next year as one-off rises such as the VAT increase fall out of the equation; although the underlying level of prices will remain elevated, of course.

Away from the eurozone crisis, the one other area of disappointment was the fact that, contrary to a number of analysts' expectations, the US Federal Reserve kept its monetary policy firmly on hold. At its monthly rate-setting Federal Open Market Committee, the Fed, despite the significant downside risks posed by the eurozone crisis, noted that the US economy had been expanding moderately. Recent data on consumption and business confidence have been stronger, raising hopes that the economy will accelerate next year. The Fed also strengthened its wording on the labour market and continued to say it expected to keep interest rates exceptionally low at least until mid-2013. Despite this supportive policy statement, markets were somewhat disappointed and by the end of the week most major stock market indices had lost around 2%.

## The 'In and Out' Club

Franco-German hopes for a sweeping new treaty to bind more closely the region's economies came under pressure last week as several EU leaders warned of the difficulties of pushing the far-reaching pact through their parliaments. With Britain having used its veto at the recent EU summit in respect of closer fiscal integration, pressures mounted in other non-eurozone countries, where at least four governments warned that the small print would determine whether they would sign up to the newly proposed euro club or to join the UK on the sidelines. With little detail on the proposals emanating from Brussels, financial markets demonstrated their frustration over a failure by EU leaders to follow through their latest plan towards solving ongoing eurozone sovereign debt fears.

The euro slumped to its lowest level against the US dollar since the beginning of the year; and in the bond markets, buyers were hesitant to lend to Italy's struggling economy, preferring instead to opt for the safety of US Treasury bonds, causing yields to hit their lowest point in history. UK gilts and German Bunds were also favoured by investors who continued to eschew the usual haven of gold, which fell below \$1,700 per ounce. Exacerbating matters was news that prospects for a rapid increase in International Monetary Fund (IMF) firepower to cope with the eurozone crisis have receded after the Japanese government and the Bundesbank set tough conditions before making further contributions. Japan's finance minister said that the EU needed to present a more convincing plan before Tokyo put more money into the IMF. The UK and US have already said they will not contribute. Oddly, though, the head of Europe's international bailout fund (the EFSF) endeavoured to calm fears by saying he had sufficient firepower in the form of €600 billion to prop up both

Spain and Italy if required, even though the plan is predicated on channelling the cash through the IMF to act as a booster.

Towards the end of the week, relations between the UK and France became somewhat acrimonious as leading French policymakers, including President Sarkozy, reacted badly to the increasing likelihood of France losing its coveted 'AAA' credit rating. Rating agency Standard & Poor's has warned 15 of the 17 members of the euro that they may face a rating downgrade in the coming months; the consequence of which, for each, would be an increased cost of borrowing. French ministers are furious that the country has been targeted even though the likes of the UK have a larger fiscal deficit as a percentage of GDP: 7.3% versus 9.4%, respectively. Whilst Britain's government debt to GDP ratio is similar to that of France, our advantage lies in the fact that UK debt is of much longer duration, with an average maturity of 14 years against France's 7 years. The markets also take a more positive view of the UK government's policy to tackle the deficit.

### **Carry on Europe**

Another aspect that has aggravated the crisis and tested investors' patience is the refusal of the European Central Bank to be more assertive and step into the fray as a 'buyer of last resort', in the way the US Federal Reserve has via its own \$2.3 trillion quantitative easing programme. On the one hand, policymakers have said this is beyond the Bank's remit; despite the fact that the ECB has most certainly been an active buyer of Spanish and Italian bonds, not to mention Greek sovereign debt, in recent months. Mario Draghi, the president of the ECB, has officially ruled out a vast expansion of its bond-buying programme. However, what the ECB has agreed to do, arguably in a more subtle way, is to lend lots more money to European banks on very easy terms. In turn they will be 'persuaded' to use some or all of this money to buy government bonds. So what appears to be happening now is that the eurozone's €23 trillion banking system is deep in the *carry trade*; borrowing from the ECB at around 1% and then buying, for example, Italian debt at over 6%.

The plan might work. Investors are not unused to the idea of borrowing at ultra-low rates and then re-investing that money in higher-yielding assets – it was a strategy pursued heavily up until fairly recently, only using the Japanese yen as its host. One outcome of the yen carry trade was the strong appreciation of the yen, which has since remained strong but has caused numerous problems for Japanese exporters. The same will not happen this time, of course, because the borrowing and subsequent re-investment will all be in euros. On the other hand, the plan might not work. If one or more of Europe's big banks had to be nationalised, the contagion would be very considerable. For example, Commerzbank, which is 25%-owned by the German state, needs to find €5.3 billion in capital by mid-2012 to meet capital rules. So while loading up shaky European banks with otherwise unsaleable government debt is not a sustainable solution, the ECB's policy might well succeed in preventing the European economy suffering a terminal heart attack, thus giving Europe's leaders much-needed time to put a lasting plan into place.

### **BRICs & Mortar**

The importance of the emerging world to maintaining global growth is no revelation – with the eurozone debt crisis undermining confidence in the West, the ongoing wellbeing of China et al will be pivotal next year. Unlike the West which is struggling to generate more growth, China has the rich problem of trying to slow growth down from the heady levels of almost double-digit growth. This situation is mostly down to Beijing's decision to unleash an enormous – some \$658 billion – stimulus package in late 2008 to combat the effects of the then global financial crisis. Much of this wall of money went into property construction which has seen Chinese real estate prices mushroom. According to official figures, average housing prices have doubled in the last four years, while in Beijing and some other regions, price increases have been nearer 150%. Across the country, from Shanghai to the smallest regional towns, countless housing complexes have sprung up as developers and local governments have rushed to capitalise on the frenzy for property.

But now, following a decade-long boom and nearly two years of attempts by the central government to cool the overheated sector, the market appears to have turned. The fact that housing sales are going into reverse should hardly come as a surprise, though – prices are so high that the price of an average apartment is now

around 8 to 10 times the average annual income. This is more than twice the level seen at the top of the US housing market back in 2007, since when average house prices have fallen almost a third. For many Chinese, the dream of owning their own home has become just that. No one is more aware than Beijing as to the social pressures this is causing. Last week China's President, Hu Jintao, said, "China will ensure that macroeconomic regulation policies and overall consumer prices remain basically stable and will guarantee the steady growth of the economy and maintain social stability." He added that Beijing will also "unswervingly maintain its regulation policies on the property market next year to make housing prices return to a reasonable level and stick to a prudent monetary policy and proactive fiscal policy."

Beijing's policymakers have a narrow path to walk: the imperative of making property more affordable for the average Chinese family whilst, at the same time, avoiding the prospects of a hard landing. The consequences of a crash would be bad news for the wider economy and indeed for the economies of many other countries that rely on China to fuel their own growth, such as Australia, Brazil and Chile. Last year, property construction accounted for 13% of gross domestic product (GDP) and for more than 25% of all investment – in what is the most investment-dependent economy in the world. Property directly accounts for 40% of Chinese steel use and China itself produces more steel than the next top ten steel-producing countries combined. This makes it the most important buyer of inputs such as iron ore; and indeed of a host of other industries from copper, cement and coal to power-generation equipment. With the property sector being one of the key drivers for commodity demand, household expenditure, external trade and underlying heavy industrial profitability, many economists view it as the single most important sector in the entire global economy in terms of its impact on the rest of the world. Against this backdrop, the Chinese government is clearly in a difficult, if not invidious, position with little room for failure.

## **2012 and Beyond**










This year has probably been one of the most challenging investors have endured since 2008 which saw the collapse of Lehman Brothers; but unlike then, whilst financial markets have been undeniably volatile, we have not fortunately witnessed the wholesale collapse of equity markets. The worst-performing, perhaps surprisingly, have been the Asian markets. Less of a surprise has been a fall in European bourses; but against this, falls in London have been remarkably muted, whilst stocks on Wall Street are broadly flat. Peripheral eurozone debt has been dire but conversely UK gilts, German Bunds and US Treasuries have enjoyed large rises. The euro has remained resilient against sterling; the US dollar has achieved haven status, whilst commodities have fallen back after large gains. It's a surprisingly mixed picture given the global uncertainty. So how will next year unfold and, crucially, what steps should investors take to protect themselves?

Longstanding clients will know that we are not in the business of forecasting. The macroeconomic environment – or 'big picture' – will obviously influence outcomes; but experience tells us that it is folly to predicate our entire strategy on trying to 'time' entry into, or indeed exit from, the market. And as the chart overleaf shows, the performance of any asset class over a calendar year has absolutely no predictive power over how it is likely to perform in the following year.

Our investment philosophy is built around creating long-term strategies for our clients. One of the clear lessons to emerge from the 2008 'credit crunch' and financial crisis is that, in extreme times, simply holding a group of different asset classes, as a portfolio, doesn't necessarily reduce risk and volatility when compared to the market. So this year we introduced a new approach to creating portfolios, complementary to our longstanding approach to encourage our clients to diversify, which has proved timely. We believe that this type of approach is one of the ways investors can create more certainty in what is currently an uncertain world.

## Why diversifying is so important

Rank	2011 YTD	2010	2009	2008	2007
1st	<b>UK Gilts</b> 13%	Emerging Market Equities 23%	Emerging Market Equities 58%	<b>UK Gilts</b> 13%	Emerging Market Equities 34%
2nd	UK Property 7%	Far East Equities 22%	UK Equities 30%	Deposit A/c 4%	Far East Equities 15%
3rd	Deposit A/c 1%	Commodities 21%	Far East Equities 25%	Commodities -11%	European Equities 14%
4th	US Equities 0%	US Equities 19%	European Equities 24%	US Equities -13%	Commodities 14%
5th	UK Equities -3%	UK Equities 15%	US Equities 15%	Far East Equities -20%	US Equities 6%
6th	European Equities -9%	UK Property 14%	Commodities 6%	UK Property -23%	UK Equities 5%
7th	Far East Equities -12%	European Equities 8%	UK Property 2%	European Equities -27%	<b>UK Gilts</b> 5%
8th	Emerging Market Equities -15%	<b>UK Gilts</b> 7%	Deposit A/c 1%	UK Equities -30%	Deposit A/c 4%
9th	Commodities -15%	Deposit A/c 1%	<b>UK Gilts</b> -1%	Emerging Market Equities -40%	UK Property -5%

	FTSE World - North America		FTSE All Stocks
	FTSE World - Asia Pacific		FTSE All Share
	FTSE World - Europe		IPD Commercial Property
	Moneyfacts Instant Access notice 10K		MSCI - Emerging Markets
	Dow Jones UBS Commodity		

Source: Financial Express. Please be aware that past performance is not indicative of future performance. The value of an investment may fall as well as rise. Returns on equities are not guaranteed. Equities do not include the security or capital characteristics of a deposit account with a bank or building society. Data as at 16 December 2011.

All that remains is for us to wish our clients and readers a happy Christmas and, of course, a prosperous New Year.