MARKET BULLETIN

ST. JAMES'S PLACE WEALTH MANAGEMENT

Monday 3 June 2013

The song remains the same

- Concerns over the future of QE continue to dominate markets

After the previous week's gyrations, hopes of a more settled week were dashed as the 'What will the Federal Reserve do?' guessing game continued to preoccupy investors. The FTSE 100 Index retreated for the second successive week to end down 1.07%, with profit-taking on Wednesday contributing to a daily fall of 1.99% and heightening the volatility. The Eurofirst 300 Index dipped 0.9% on the week, although it gained 1.3% in May to achieve a record twelfth successive monthly gain. Wall Street's choppy week ended with the S&P 500 Index squeezing out a 0.3% gain.

However, Tokyo's stock market once again stole the unwelcome headlines as sharp price swings left the Nikkei 225 Average nursing a weekly decline of 5.7%, slipping 0.6% in May and recording its first monthly decline since October. The index has fallen 12% from its peak two weeks ago, but is still a third higher than at the start of the year.

Concerns about the future of US monetary policy hit bond markets worldwide. Ten-year US Treasury yields registered a year-plus high of 2.23% on Wednesday, up from 1.61% at the start of May, before ending the week at 2.20% and in doing so leaving holders with their worst monthly loss since December 2010. The yields of other highly-rated government bonds in Germany, the UK and Japan also rose accordingly. The release of May US jobs data at the end of this week is seen as the next in the sequence of dots which investors will seek to join up to determine if and how the Fed will start scaling back its bond-buying programme.

Quantitative easing (QE) has become the main influence on valuations and investor flows across financial markets, widening the gap between economic fundamentals and asset prices as it becomes increasingly difficult to distinguish between the symptoms of 'risk-on, risk-off' volatility and investors' interpretations of changing policy and the future of QE. "We're in a topsy-turvy world in which liquidity, not fundamentals, matters," said Richard McGuire at Rabobank.

The recent moves in equity and bond markets highlight the balancing act faced by central banks, led by the Federal Reserve. The Fed has sought to stimulate the economy by keeping interest rates low, encouraging investors into riskier assets; but as signs of US recovery grow, the fear is that the withdrawal of support will lead to higher bond yields – with a knock-on effect on equity markets and the economy as a whole if the process gets out of control. The Fed needs to avoid an unruly sell-off at all costs; but as investors wake up to the realisation that extraordinary monetary stimulus cannot last forever, the period of adjustment and uncertainty may will be a difficult one.

Confidence remains high that central banks will continue to provide support until self-sustaining economic recoveries are evident and that the inevitable and eventual withdrawal of stimulus will be managed to reassure investors that economic growth and corporate profits will not be hurt. In the meantime however, investors need to ensure that they are sufficiently diversified to help cushion them against the possibility of more market uncertainty over the coming months.

Eurovision

- OECD cuts eurozone growth forecasts as unemployment hits new high

The eurozone, which is the other elephant in the room, reminded investors of its existence last week. In its twice-yearly Economic Outlook, the OECD again cut its growth forecasts for the region and called on the European Central Bank (ECB) to consider doing more to boost growth. The OECD said the eurozone will shrink by 0.6% this year, a contraction in GDP which is much sharper than the 0.1% drop forecast just six months ago. It blamed continuing austerity measures, weak confidence and tight credit conditions and hinted that the ECB might want to expand quantitative easing as a measure to encourage stronger growth.

The OECD's statement that unemployment in the eurozone would continue to rise before stabilising in 2014 came as figures from the Eurostat agency showed that unemployment rose for the 24th consecutive month to reach a record rate of 12.2% – 18.3 million people. The figures for young people out of work are devastating: 56.4% in Spain, 42.5% in Portugal and 62.5% in Greece. The urgent need to address the issue was acknowledged in a speech by Herman Van Rompuy, President of the European Council, who echoed a plan supported by France and Germany that is to be put to an EU summit in Brussels this month and partly funded with a promise of €6 billion from the EU budget over the next six years.

In the same week, Greece provided an unlikely source of positive news as Jeroen Dijsselbloem, chairman of the Eurogroup, praised the Greek government for persisting in debt-cutting reforms that are beginning to bear fruit. The country certainly isn't fixed yet – the overall unemployment rate is 24% and it has just entered its sixth year of recession – but consumer confidence is at a two-year high, Greek companies have been able to issue debt on capital markets, the government is forecast to run a primary budget surplus this year and a return to economic growth is expected in 2014. Greek 10-year government bond yields are now well below 10%, having peaked at 28%. The much-needed reductions in civil service headcount, the liberalisation of regulated professions, tourism and the retail sector, as well as the crackdown on tax evasion (current annual tax losses are in the region of €30 billion) are all helping tackle the persistent current account deficit. Amongst the other largely unreported and surprising news stories is the fact that the Athens Composite has been the best-performing stock market index in Europe over the past year, having doubled since May 2012.

Clearly, there is still a long way to go and the risks remain considerable but, albeit a small economy, if Greece can present itself as on the path to recovery, having taken the medicine of fiscal austerity, then the reform agenda of the ECB and IMF will be given a boost.

Building blocks for US recovery

- Positive signs from the housing market boost hopes for US economy

The US housing market appears to be on the mend. The number of houses stuck in the foreclosure process is down 24% year-on-year and sales of both new and existing homes are up, as are applications for building permits. The S&P/Case-Shiller Home Price Indices, which survey prices in 20 cities, recorded their 10th consecutive monthly rise and the largest gain in seven years. It is estimated that 1.4 million US homeowners have moved out of negative equity following the 10% rise in house prices in the last 12 months. Inevitably, such gains continue to prompt fears that loose monetary policy is stoking up the next house-price bubble, but analysts at Capital Economics played down fears, commenting, "Talk of a house price bubble seems premature. In relation to incomes, rents or their own past, US home prices still look low. Even after the rapid gains of the past 12–18 months, average US home prices are just three-quarters of their previous peak. Moreover, there are tentative signs that the demand/supply imbalance that has helped to drive prices up so rapidly is starting to ease. We suspect that the demand/supply balance will continue to normalise and that, as a result, the pace of home price gains will moderate in the second half of this year."

Such figures help to explain why the US Conference Board's measure of consumer confidence rose to its highest level since early 2008, suggesting that Americans' attitudes are resilient in the face of government budget cuts and tax hikes hitting workers' pay to the tune of about $700 a year on average. There was also some good news for the country's banks as, for the first time in five years, ratings agency Moody's upgraded its outlook for the US banking industry to stable from negative, where it has been stuck since the height of the financial crisis. Now that the banks have enough capital, the next stage is to find people to lend to, and the signs are that commercial and industrial loan terms are loosening steadily.

The theory and hope is that the housing recovery has the desired powerful accelerator effect. Instead of people having a big mortgage on a cheap house, which has been the biggest drag on the US economy since 2008, higher prices mean that more of them have enough equity in their home to refinance at the lower mortgage rates being offered by the banks, providing them with the funds to start spending more.

Funding for (not) lending

- Fall in bank lending to UK companies suggests the recovery is still some way off

Back in the UK, after six weeks of mostly positive economic data, a third consecutive monthly fall in lending to companies stemmed the flow of good news. Figures from the Bank of England confirmed that net lending to business fell by £3 billion in April, dealing a blow to the government's plan to encourage economic recovery by pumping cheap money into British companies through its Funding for Lending Scheme (FLS). Unsurprisingly, there were two sides to the story; banks blamed a lack of demand and confidence among companies, whilst business leaders suggested lenders were only offering credit to safe bets rather than small, growing companies. "There is clearly low demand for credit with many companies still very wary about borrowing and investing in the current difficult economic environment. Furthermore, many companies are looking to pay down debt," commented Howard Archer of IHS Global Insight.

"So far, rather than providing funding for lending, the FLS still seems to be providing funding for not lending."

Michael Saunders, Citigroup

In contrast, the figures showed the housing market has benefited more from FLS, although the rise in mortgage approvals in April was less than expected and lower than in each month in the final quarter of last year, leading to suggestions that FLS might merely prevent a further fall in mortgage lending, rather than provide a significant boost. Although the Bank of England has said it is too early to determine whether FLS and its recent extension (skewing incentives towards business lending) are working, in the nine months after the scheme was introduced, net lending to households and businesses fell £6.4 billion compared with only £3.7 billion in the nine months before its introduction.

Speculation over the withdrawal of monetary stimulus looks likely to set the market agenda in the short term and may well lead to increased volatility. However, it is clear that economies around the world are not yet on the path to sustainable recovery. In such an environment, investors need to maintain a well-balanced portfolio and avoid the temptation to get too involved with day-to-day market movements.