MARKET BULLETIN

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ST. JAMES'S PLACE
WEALTH MANAGEMENT

Russian roulette

Emerging markets have had a torrid start to 2014 as money shifts back to the developed markets, and central bankers from Ankara to Buenos Aires and New Delhi struggle to keep control of local currencies and their wider economy. Financial volatility in emerging markets has come with civil unrest on the streets of cities from Argentina to Thailand and Venezuela. But it is in Kiev and across Ukraine where political differences and developments have outpaced deteriorating financial conditions – and protest has spilled into violence, the overthrow of government and, now, the spectre of a civil and regional war as Russia's military seizes installations in the southern autonomous region of Crimea and amasses on Ukraine's borders.

The international community has condemned President Vladimir Putin's move on the majority ethnic Russian peninsula, and the Ukraine's new Prime Minister Arseniy Yatseniuk has accused the Kremlin of declaring war on his country after sanctioning the use of troops to protect Russians and its Black Sea fleet. Moscow's stock exchange lost 10% during early trading on Monday, and the rouble plunged to a record low against the euro and the dollar. Russia's central bank raised its benchmark interest rate by 1.5% to 7% in response to the currency slide, and said it was responding to heightened levels of volatility in financial markets. Ukraine's sovereign bonds last week had plunged amid the violence that preceded the weekend's military developments, as Russia extended a promise to pay $2 billion of a $15 billion aid package to counter the drift of Kiev towards a trade deal with the European Union. Ukraine needs around $25 billion soon to refinance debt and pay other bills for goods and services. However, the scope for immediate economic contagion from any default in the Ukraine remains limited.

Global markets opened after the weekend's military developments in a state of nervousness with investors looking to perceived safe-haven assets. The pan-European FTSEurofirst 300 index was down 1.6% by mid-morning, while London's FTSE 100 index fell 1.5%. Companies with exposure in the region were among the worst hit, including steelmakers and miners, with resource stocks taking the biggest toll in London and European financials with exposure to the Ukraine also losing ground. S&P 500 futures pointed to a 0.8% drop at the open of trading in New York, after the US index finished last month at a record high. And Japan's Nikkei 225 fell 1.3%. Commodities advanced to their highest level in almost six months amid fears that energy and agricultural supplies could be disrupted. In Europe, yields on the 10-year German Bund fell marginally and were at 1.6%; the corresponding UK gilts eased slightly to 2.7%.

Investors are right to have concerns over the geopolitical developments for the former Soviet Union countries. Britain's foreign secretary, William Hague, told the BBC that the developing situation was "the biggest crisis in Europe in the 21st century" – and others see Russia's moves as the most dangerous since the fall of Communism. But there is an inherent risk in the broad category labelled 'emerging markets'. Russia, for many, has remained an intriguing investment proposition with low valuations, but one complicated by those risks seen across emerging markets – from issues of the rule of law to corporate governance and corruption.

As one of the casualties of the emerging-market sell-off, the rouble this year had already hit a low against the euro. And, with uncertainty over gas prices, a slowdown of Russian growth will further frustrate a lack of state and private sector investment. Fund manager Richard Oldfield of Oldfield Partners, who holds Russian oil giant Lukoil, is succinct about his exposure. "We are well aware of the risks of investments in Russia," he reflects. The emerging Russo-Ukrainian crisis is evidence that the world remains a risky place. The escalating tensions and risk of military conflict could continue to boost safe haven assets. As the diplomatic clamour intensifies and markets necessarily respond to the events, we will keep close contact with our fund managers and monitor events and assess their implication for our investors.

Anglo-German affinities

While Germany and Europe looked east to the unfolding military crisis in the Ukraine, earlier in the week Chancellor Angela Merkel's visit to the UK focused attention on Anglo-German affinities (and some antipathies). The political vision of Merkel and Prime Minister David Cameron may differ over Europe, but they share the experience of an economic recovery – even if each has characteristics the other could do with to balance their respective economies. The UK has consumer spending driven by a buoyant housing market; Germany has net trade growth built on long-term business investment.

The strength of the German economy and its companies has helped to drive the steady rise of the FTSEurofirst 300 index, which ended the week up 0.4% at 1,348 points and only five points off its 52-week high set in late January. Stuart Mitchell of fund manager S. W. Mitchell Capital has taken a consistently positive stance on the depth of quality available in the bloc's leading economy, Germany. Mitchell has increased his German holdings with new positions in Commerzbank, power utility RWE and digital multimedia group Axel Springer. The move has lifted his European fund's German exposure to 12.4% from 7.2% at the end of January.

Moreover, Mitchell points to Commerzbank's restructuring since the financial crisis, its success in doubling market share to 8% in the mortgage market and reduction of costs and non-core assets. "Trading on a half book value, the share appears very attractive," he says. RWE trades on 11x prospective earnings, which he says appears good value. Axel Springer owns successful German media brands such as BILD, Die Welt and news channel N24; and is well ahead in digital media and its €100 million cost-cutting moves over the next three years.

Mitchell believes fears over the strengthening of the euro amid deflation fears are exaggerated. He points to the move of eurozone corporates to diversify production abroad; the trade surplus in the region, helped by German exports; and the steady, if faint, recovery despite the strength of the currency (the eurozone has grown for three consecutive quarters and expanded 0.3% in the final three months of the year). "Germany still has a very significant cost competitive advantage relative to the rest of the developed world," adds Mitchell.

Snow problem

Bulls on Wall Street brushed aside the crisis in Ukraine and further uncertainty about China's currency and economic outlook, and gained confidence in the explanation that the recent poor data was a blip related to extreme weather rather than underlying economic malaise. The S&P 500 index was up 0.3% on Friday to a 52-week high of 1,859 points, gathering 1.65% over the five-day period. The US equity index gained 4.3% through February – compared with a 3.6% dip in the first month of the year – and is up 23% over the last year. New York's equity markets remain bullish about corporate confidence and profit growth, despite talk of over-valuation and flat results from US corporates in recent weeks. However, fund manager Artemis notes that forward revenues, profit margins and earnings are still at record highs, although a price-earnings ratio of just above 15x is tight – and "makes even more important the art and science of stock selection".

In Japan, the Nikkei 225 Stock Average was down 0.6% on Friday to 14,841 points, losing 0.2% over the week and 0.5% through February. However, last Tuesday the index had reached a four-week high after Wall Street had started the week in a positive mood. The Japanese index is 9% down from its 52-week high of 16,320 set at the end of December, but still remains 28% up over the year. The Nikkei last week reacted to poor US corporate news, as well as concern over the People's Bank of China's recent sell-off of the yuan and the continued slowdown of Chinese growth. Fund manager Hugh Young of Aberdeen Asia has not added any new Japanese stocks to his portfolios over the past six months, but believes the country offers some good opportunities, especially in small caps. He continues to find it "very hard to find quality companies in China".

Meanwhile, the US Federal Reserve has continued to reassure that the reduction of quantitative easing (QE) is on a steady course, America's recovery is in hand and the flow of money back into the US markets is not a threat to financial stability. Fed governor Daniel Tarullo last week said that no significant asset bubbles have emerged although valuations in sections of the credit markets, farmland and smaller technology stock look stretched. The Fed's chairwoman Janet Yellen suggested that the weak data did not reflect an underlying change in the US economy, and it would take a "significant change" in the economic outlook to pull back from tapering QE.

The week brings another round of data to monitor US growth prospects – or the extent to which ice storms froze the economy. Fund manager Majedie argues that the weather has had a clear impact on the US and economic growth is likely to stick at around 3% this year. Although Majedie acknowledges concern that there is an over-emphasis on house prices and equity markets, it contends that business conditions are good and the economy is in shape to withstand higher interest rates. And that holds for the UK too. "There is probably just enough of a supporting wind to allow improving companies in the UK and the US to rerate," it adds.

Dividend digging

Business confidence continues to grow among UK companies, which has helped buoy the FTSE 100 index just off its 52-week high of 6,786 set in May. Although the FTSE lost 0.4% in value last week to close at 6,810 points, it still notched its biggest monthly advance since July and is 2% off its record high in 1999. Merger and acquisition (M&A) activity is expected to pick up as activity gathers pace in the US – Bank of America Merrill Lynch estimates US deals will amount to $1.5 trillion this year, which is the strongest since 2007. With corporate UK enjoying the economic recovery, sound balance sheets and low finance costs, fund managers, including Richard Peirson of AXA Framlington, expect more M&A activity in 2014. FTSE 100 stalwart Carphone Warehouse last week revealed that it is in talks for a £3.5 billion merger with retailer Dixons.

Although international mining stocks were unsettled by the poor Chinese economic data at the beginning of the week, the FTSE's miners are also back in favour as a more attractive investment, after sentiment has changed rapidly towards the sector over the first months of 2014. There is concern about the pace of Chinese growth, as was evident last week, but the big diversified miners have started to offer better bottom-up fundamentals. With improved valuations from mining stocks, Adrian Gosden and Adrian Frost of fund manager Artemis have changed their tune in recent months on prospects for mining shares listed in London. The Artemis co-investment managers have recently taken positions in Rio Tinto and Glencore Xstrata.

London miners have been "dreadful performers", Gosden observes. Boardrooms were drawn into high levels of investment, capital expenditure (capex) at three times the rate of depreciation and an "indulgence in corporate transactions", he adds. When commodity values tumbled, drastic measures were needed to protect balance sheets, including the replacement of chief executives. Mining comes with commodity price risks, Gosden adds, but the companies are low-cost producers and, with capex set to drop, offer dividend growth. "We can now see attractively valued assets, generating decent cash flow and producing attractive dividends," he adds.

Five years on…

Thursday marks the fifth anniversary of the UK Bank Rate at its historic low of 0.5%. With inflation on course to ease over the next year or so, there is a strong likelihood that 5 March 2015 will be the sixth anniversary of the 0.5% rate. Markets expect the Bank of England to hold the rate up to the general election in May 2015 at least. Homeowners, businesses and investors have clearly benefited from ultra-low rates, while savers have lost out; consultants McKinsey estimating by around £65 billion since 2009. Amid this almost zero-interest environment, the search for returns will continue and assets such as equities and property will look attractive.

Aberdeen Asia, Artemis, AXA Framlington, Majedie, Oldfield Partners and S. W. Mitchell Capital are fund managers for St. James's Place Wealth Management.