MARKET BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

Monday 4 November 2013

Central banks centre stage

Anticipation of central bank policy once again dominated markets' thoughts in a week which also saw the world's leading banks make an unwelcome return to the spotlight. The actions and events on the other side of the Atlantic were uppermost in investors' minds. The S&P 500 index registered a gain of 4.5% in October despite the 16-day government shutdown that gripped Washington and briefly cast doubt over US credit. Reflecting on the recent procrastinations on Capitol Hill, Hamish Douglass of Magellan Asset Management commented, "US politics never ceases to amaze me but it would be illogical for the US to commit suicide."

Having evidently shrugged off the uncertainty, in part because the shutdown had pushed back expectations of when the Federal Reserve might begin to taper its bond-buying programme, markets towards the end of the week reassessed the widely held view that tapering could be on hold until the spring of 2014. The trigger was the less dovish statement that accompanied the decision of the Fed's policy-setting Open Market Committee to maintain the level of its monthly asset purchases at $85 billion, which appeared to leave the door ajar for it to begin its scaling down before the end of the year.

This view was strengthened by surveys released after the Fed's meeting which showed that US manufacturing grew last month at its fastest level since April 2011, contrary to recent consumer confidence data and forecasts that the partial government shutdown had damaged the economy. Whilst economists will wait for harder data and more signs that the recovery has shrugged off the political disruption, speculation grew that better data are likely to move the Fed towards tapering sooner rather than later, perhaps as soon as its next meeting in December.

Markets will this week be waiting on the release of the delayed third-quarter US GDP figures and October's employment data before embarking on the next round of crystal ball-gazing about what it means for the future of the Fed's QE policy. In the same way as markets responded to last week's Federal Reserve meeting, the anticipation and reaction of short-term market players to central bank announcements will continue to create volatility, which long-term investors would be well advised to continue to ignore. Hamish Douglass commented: "There can be no doubt that QE has had an impact on equity prices and it is equally clear that so too will its withdrawal. When that process begins is the great uncertainty, but in the period of adjustment to a post-QE world, markets and investors can expect some turbulence as we reach cruising altitude. There is no text book that tells us how this is going to end."

The S&P 500 registered a record high during the week, but was unable to maintain it as the stronger-than-expected US manufacturing data was interpreted as bad not good news. It ended the week up just 0.1%. Similar achievements were registered by the FTSEurofirst 300 index, which gained 0.4%, and the FTSE 100, which rose 0.2%. The UK benchmark index benefited from a surge in Vodafone's share price on rumours of a bid from AT&T.

Globe trot

In a similar vein to the US, signs of continuing strength in UK manufacturing came from the latest Markit/CIPS Purchasing Managers' Index, which indicated the sector had continued to grow strongly in October. This, coupled with the latest GDP figures which showed the UK's economy grew by 0.8% between July and September, prompted the CBI to comment that, "The recovery that started in the service sector has

fanned out to manufacturing and construction. The recovery won't be spectacular, just slow and steady, but appears to be more solid and better-rooted." The lobby group said that it still expected interest rates to stay at record lows until 2015.

In the eurozone, news that inflation fell to 0.7% in October – its lowest level since February 2010 and well below the European Central Bank's target rate – prompted speculation that the ECB will cut the refinancing rate by 25 basis points to 0.25% at its December meeting. The pressure on the central bank was also increased by figures showing that the region's unemployment level hit another record high in September.

More positively, Spain officially ended its two-year recession as figures confirmed the country's GDP grew by 0.1% in the July to September period. Improving exports and a boost from tourism supported the growth, echoing recent comments from Stuart Mitchell of S. W. Mitchell Capital: "Tourism is up 20% this year as Spaniards take domestic holidays and other holidaymakers avoid northern Africa and the Middle East. However, coupled with the improving outlook has been a growth in the black economy, which has doubled in size since the start of the crisis. The young have lost their jobs, moved back home and are working 'cash in hand' for their families." Figures last week also confirmed that investors are flooding back into Spanish equity funds, whilst in October European equity funds saw the biggest proportional increase in inflows.

Bad banks

The recent stellar run by many European banks was halted over the past week amid disappointing results and an escalating global probe into alleged rigging of the foreign exchange market. Barclays, UBS, Deutsche Bank and Royal Bank of Scotland were joined by Citigroup and JPMorgan Chase in confirming they were co-operating with regulators, raising concerns about the threat to earnings posed by such investigations and the potential litigation.

Following on the heels of Lloyds Banking Group reporting underlying profit growth of 7% in the third quarter, Royal Bank of Scotland announced a pre-tax loss of £634m in the same period – sharply below analysts' expectations of a £440m profit – and warned of a "substantial" loss for the full year. The bank, which is 81% owned by taxpayers, also announced plans to create an internal 'bad bank', to ring-fence £38 billion of poor-quality assets, rather than split itself into separate so-called good and bad banks. The accelerated sale of Citizens, the US arm of RBS was viewed by many as hasty, albeit necessary given the state of its balance sheet, and likely to be at a disappointing price for shareholders. Shares in RBS had lost 7.5% by the end of the week.

James de Uphaugh of Majedie Asset Management commented, "The 'internal bad bank' is a political solution and relatively small in the context of the balance sheet shrinkage that has taken place since the onset of the financial crisis. Our focus is on the strategic review of the new CEO and financial director, which is due in February 2014 but in the context of tougher capital demands from the regulator. This review's emphasis is likely to be more customer-centric, with a focus on reducing complexity. Whilst we cut our holding earlier in the year, we think the shares are inexpensive at 90% of tangible book value, but the uncertainty over litigation risks will make further share price progress difficult in the near term."

Stuart Mitchell, whose portfolio includes Lloyds, Barclays, BNP Paribas and Banco Santander, commented, "We remain very positive on the European banks. In our view their full recovery potential has not yet been fully discounted. Most importantly, we believe that the largest retail banks should be able to generate 15% plus returns on capital again. Secondly, the regulatory burden is beginning to ease. Finally, very few analysts assume any loan growth which we believe will become increasingly evident as the recovery proceeds."

Too much cash

In another attack on the banking world, the Financial Conduct Authority confirmed last week that banks will face an investigation into 'teaser' savings rates that are set at a competitive level to attract customers, but then cut only months later. Recent figures estimate that £400 billion is languishing in deposit accounts paying less than 1% interest. It could mean that savers are missing out on around £10 billion of extra interest a year.

The head of the FCA, Martin Wheatley, had previously given an insight into the regulator's thinking on the customer inertia that contributes to this problem when he said: "The smart consumer switches at the end of that year to a new teaser rate. What do most people do? Nothing – they stay in these products like a frog boiled in water."

Bank of England figures last week showed that the average interest rate paid on a new savings account is 1.71% – a level that has never been lower – against an inflation figure of 2.7%. The gap between interest earned on deposits and the increase in living costs is as wide now as in the 1970s. According to research by consumer group Which?, 1,562 of the 1,952 savings accounts in the UK are closed to new business and 40% of these accounts now pay less than 0.5%. Furthermore, one in five of the closed accounts now pays less than 0.1%.

The challenges that savers face, and more particularly those saving for retirement, were underlined in a new study from BlackRock which looked at financial needs and investment behaviours amongst a broad range of people, both nationally and internationally. A focus on short-term needs rather than long-term goals remains a major obstacle to a more secure financial future. Those surveyed spend more time planning their next holiday or researching their next car purchase than thinking about their retirement.

In an uncertain world, despite the record-low returns on offer, cash remains a 'comfort blanket' for many, accounting for 68% of their assets. For many savers, the small chance of a big loss is clearly much scarier than a big chance of a small loss – such as the drop in real income when, as now, deposit rates are lower than inflation. Cash is an important element of a balanced investment strategy and the amount of money held in more liquid assets must allow investors to sleep well at night, but 'rainy day' savings should not be confused with long-term investment planning.

Magellan Asset Management, S. W. Mitchell Capital, Majedie Asset Management and BlackRock manage funds on behalf of St. James's Place.

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