# MARKET BULLETIN

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ST. JAMES'S PLACE
WEALTH MANAGEMENT

## Olympian test

The path to global economic recovery was always going to be far from straightforward. With a phenomenal year for developed market equities behind them, investors approached 2014 with confidence of further gains – if not at the pace enjoyed in 2013 – and a steady improvement for the world's leading economies. But for the last month this optimism for global growth has been tested. The US Federal Reserve's move to start to unwind its asset-purchase scheme has exposed the fragile financial condition of a number of nations in the emerging markets. A spate of unexpectedly weak US economic data and further evidence of a slowdown of China's economy have stirred unease too. And fears of deflation linger over the eurozone and Japan.

Abandoning optimism for gloom only six weeks into the year seems unnecessary. The nuances of US economic data – whether exceeding or falling short of expectations – will continue to jolt and nudge markets, while steps to recovery are made from month to month. The US is driving the global recovery and, with confidence high among its households and consumers, the consensus is that it is on course for growth of around 3–4% in 2014. Meanwhile, China's economy is in a slowdown but this does not look like a dramatic slump or 'hard landing'. And, with positive corporate and economic signs in the Japan and the eurozone, there is evidence that underlying growth, if at a pace slower than hoped, can defeat the fears of deflation.

Certainly, emerging markets face a tough test in the end stages of US quantitative easing (QE). Investors have pulled more than $12 billion from emerging market funds over the past two weeks, which is the largest outflow since January 2008, according to fund manager Artemis. Although emerging markets that have relied on inflows to finance growth are vulnerable as the Fed tapers its QE programme, many of these nations are in better financial condition than a decade or more ago. Artemis notes that emerging markets now hold non-gold reserves in the region of $8 trillion, of which China accounts for around half. And even the more troubled economies hold substantial reserves: Russia ($470 billion), Brazil ($356 billion), India ($275 billion), Turkey ($129 billion), South Africa ($45 billion) and Argentina ($28 billion). Investors are right to feel cautious, but it is overly gloomy to view the present challenges as a repeat of the emerging market financial crisis of 1997.

## Winter wobble?

Uncertainty last week hung over developed markets as disappointing US economic data added to concerns that the recovery in the world's biggest economy was wobbling. Non-farm payrolls rose less than expected by 113,000 in January, although it was an improvement on December's 75,000 new jobs. However, the US unemployment rate was down from 6.7% to 6.6%, and only just off the Fed's 6.5% threshold to review interest rates. Market fears seem overdone that recent US jobs data will affect Fed plans to scale down QE.

The US economy experienced steady growth through 2013 – although it has been hit by the unusually harsh winter weather – and the consensus is that this growth will continue this year. Federal Reserve Bank of Philadelphia president Charles Plosser has predicted a 3% growth figure for 2014 and an unemployment rate down to 6.2% by the end of the year – and that could warrant a quicker pace of tapering. Markets will look to Janet Yellen's appearance this week before Congress for further insight into where the Fed goes next with QE.

There is an expectation that the Federal Open Market Committee (FOMC) will revise its forward guidance to signal it does not intend to raise interest rates until 2015. The problem for the Fed, however, is that guidance shifts could fan market uncertainty. The first two asset-purchase cuts, which have slowed the monthly acquisitions to $65 billion, were greeted with relative calm by markets which had priced in the taper when the Fed first hinted a retreat last May. The FOMC is expected to continue to taper by $10 billion increments.

### It's the weather…

Unease on Wall Street took its toll on the S&P 500 index at the start of last week with a 2.3% dip – its biggest one-day fall since June – after the Institute of Supply Management's monthly survey of US manufacturing identified a sharp drop in activity. The index gained 1% last Friday and ended the week up 0.3% to 1,797 points as investors warmed to the explanation that the weak data reflected the severe US weather. Investors early in the week sought safety in government bonds, and ten-year Treasury yields ended the week at 2.68%. These fluctuations underline the role bonds can play as an insurance policy in a well-diversified portfolio.

The FTSEurofirst 300 index gained 0.8% on Friday and was up 0.7% over the week to 1,300 points, as global investors favoured European equities. Eurozone data last week also pointed to some strengthening, if modest, of the region's economy. However, unease persists over the threat of deflation, although the European Central Bank (ECB) dismissed the risk as it held interest rates at 0.25%. "We have to dispense with this idea of deflation," ECB president Mario Draghi said. "The question is: is there deflation? The answer is no."

In Tokyo, the Nikkei 225 Stock Average enjoyed a 2.2% rise on Friday to end the week at 14,462 points; but over the five-day period it lost 3%, which was its fifth successive weekly decline. The Japanese index has had a lacklustre start to the year after its 57% surge in 2013, despite broadly positive corporate earnings. With its exposure to the wider Asian region, the Nikkei has felt the knock-on effect of turmoil in emerging markets and investor uncertainty over how far and how fast Chinese economic growth will slow down.

The highly international FTSE 100 index is also exposed to these global themes of the end of QE and its effect on the emerging markets, and the fears of a Chinese hard landing. However, it was the City's miners – which are particularly exposed to the pace of China's growth – that helped drive the index up 0.9% over the week to 6,572 points, with the UK mining sector up 2% this year after a 16% drop in 2013. London's big mining story is whether Glencore Xstrata will sell a Peruvian copper mine to a China Minmetals-led consortium. The potential $6 billion sale, which would rank as one of the biggest overseas acquisitions for a Chinese company, would allow Glencore to pay down debt and fund a share buy-back or special dividend.

### Cash questions

Amid all the hopes for the US economy, corporate America's capital expenditure (capex) remains weak. In 2013, capex levels were held back by uncertainty over the US economy and shareholder reticence. Deloitte, the professional services firm, estimates that the 975 non-financial members of the S&P Global 1200 index held $3.2 trillion at the end of 2012, compared to $1.95 trillion in 2008. Fund manager Schroders has warned that low capex could cause trouble for the US economy in the absence of easy monetary policy.

However, weak capex often results in more cash to shareholders. Schroders' research shows that companies focused on share repurchases, balance sheet repair and dividends significantly outperformed those with higher capex since 2011. "Companies are increasingly run for cash, an outcome which may suit shareholders today, but is likely to be at the expense of weaker productivity and growth tomorrow," Schroders noted.

But a Bank of America Merrill Lynch monthly survey of fund managers found that 67% believe companies are under-investing. Schroders believes that investors are becoming more positive towards companies that invest. Post-QE stagnation is not a threat for the US, and an upswing of capital equipment orders is likely in 2014. The signs that businesses are finally investing their cash piles will provide a further support to global growth.

### Commercial break

In the UK, the steady economic recovery has underpinned a revival of the commercial property market over the second half of 2013. Fund manager Orchard Street is also confident about the UK commercial property sector as the UK economic recovery looks to grow at its strongest pace since 2007.

The development of online retail in the UK has also had a positive effect for commercial property. Last year brought further reorganisation of supply chains to meet the demands of next-day deliveries, with more logistic operators locating on the edge of big city centres to ensure orders arrive with buyers on time. This has pushed up demand for scarce land amid limited development activity in and around London. Schroders also notes an increase in the regional office market with a shortage of quality stock placing upward pressure on rents.

Orchard Street observes that the UK recovery has brought increased tenant demand, rents and capital values for the UK commercial property market. Researchers Property Market Analysis and IPD have forecast that the commercial property market in 2014 can deliver total returns of 10.1% with 5.4% from income returns and 4.7% from capital growth. Chris Bartram at Orchard Street notes an upturn in the occupier markets, which is "good news for rents and values of well selected investment property".

## World city

The commercial property boom comes alongside a rapid rise in London residential property prices. House values in the capital are now at an average of 11 times individual Londoners' income, according to Ernst & Young's ITEM Club. London house prices rose 12% last year compared to 4% in the rest of the UK, according to the Office for National Statistics. The ITEM Club has warned of "bubble-like conditions" in the capital.

Escalating values in London are, in part, a ripple effect of global economic developments. London's luxury property market is a well-established haven for international money in search of stability, as it was in the wake of the eurozone crisis and the Arab Spring. Estate agent Knight Frank notes a surge in enquiries from wealthy investors from countries such as Argentina, Brazil, Ukraine and Turkey; while Savills reports that around £7 billion of international money was spent on luxury London homes in 2013. Nigel Ridge of fund manager BlackRock observes that overseas buyers now account for half of London real estate sales over £2 million.

Chancellor George Osborne said in December he would impose capital gains tax on foreign property investors to allay fears that wealthy foreign buyers are driving a property bubble. Even free-market champions Civitas have advocated tighter curbs on global investors based on an Australian scheme that requires overseas buyers to show that their investment will add to existing housing stock. In the meantime, London remains one of the most attractive property destinations for global money, if increasingly unaffordable for its inhabitants.

## Carney's choice

Meanwhile, as the UK economic recovery strengthens and unemployment falls, investors have started to price in the first Bank of England interest rate increase for 2015. This is despite Bank governor Mark Carney's insistence that the recovery has some way to run before he starts to normalise interest rates. Carney is also expected to update his forward guidance in this week's quarterly Inflation Report after unemployment fell to 7.1% last month – just off the existing 7% threshold for reconsidering interest rates.

Mortgage borrowers have also been locking into cheap fixed rates in anticipation of rises next year, prompting lenders last week to increase the price of their five-year fixed mortgages. Carney last month said that he did not view rising mortgage approvals and sales from previous low levels as a threat, and will not want to threaten the household confidence that is driving much of the recovery with too early a rise in interest rates. Long-suffering cash savers may have to wait a while longer for interest rates to return to any meaningful level.

*Artemis, BlackRock, Orchard Street and Schroders are fund managers for St. James's Place Wealth Management.*