MARKET BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

Monday 10 March 2014

Beijing not Moscow

'It will hurt you more than it will hurt us' was the tenor of much of the reaction from Western powers and markets to Russia's stealthy intervention in Crimea and designs on Ukraine. European Central Bank (ECB) president Mario Draghi declared the eurozone an "island of stability" and its recovery would remain in place despite the crisis to the east. And, as the European Union pledged an €11 billion aid package for Kiev, Draghi warned that an escalation of events would have a severe impact, primarily on the Russian economy. Of course, the other place that will suffer is Ukraine, which ousted President Viktor Yanukovych partly in response to the mess in which his government mired the nation's shrinking economy. Other former Warsaw Pact nations now look to Berlin and Brussels, rather than Moscow, for trade and security. Certainly, economic sanctions against the Kremlin could drive up commodity prices and cause problems for the nascent European recovery. But, beneath Vladimir Putin's realpolitik and ambitions in the former Soviet Union territories, the Russian economy and its governance remains frail and flawed, and its wealth squandered in the hands of a few.

As the crisis in Ukraine smouldered through the week, developed markets remained focused on their preoccupation with US data, monetary policy and Chinese growth. The US Federal Reserve meets on 18 March to assess the state of the US economy after the big freeze, and whether or not to press ahead with another $10 billion reduction of the monthly asset-purchase scheme. Meanwhile, Premier Li Keqiang promised China's National People's Congress last week to deliver growth of 7.5% in 2014, contain inflation and tackle financial risks. China's credit-fuelled infrastructure and real estate boom continue to underpin much of this growth, and the authorities have acknowledged the risk this poses – even if they are yet to shift the economy to a more sustainable model. Li pledged to steer "the giant ship of China's economy" and his success is arguably of more significance for the global economy than Moscow's designs in Crimea and the former Soviet Union. As global emerging market fund manager First State observes "20th century Kremlinologists have been superseded by Sinologists in the 21st century". This is the Chinese not the Russian century.

Crimean war?

The Crimean crisis fanned investor concerns around eurozone companies with Russian trade links, including European financials, car makers and food & beverage companies, and exerted general pressure on stocks and shares in Europe. Consequently, the pan-European FTSEurofirst 300 index took a 1.6% tumble over the week to 1,327 points; with 1.3% lost on Friday amid the renewed uncertainty over Russian intentions, and whether or not the crisis in the Crimea would escalate into armed conflict. Meanwhile, investor nerves over the situation in Ukraine ensured a flight to quality and European bonds earlier in the week, although yields on German bonds ended the week static at 1.66% as the ECB held its benchmark interest rate at 0.25%.

US equities ended the week at record highs as the latest employment report offered some reassurance over the health of the US economy. Mixed economic data in recent months have raised concerns over the shape of the US recovery, but its severe winter has been blamed for the slowdown. The S&P 500 index gained 0.8% over the week. It hit a 52-week intraday high of 1,884 points on Friday, although it rested down slightly to 1,873. US Treasury yields also climbed to a six-week high of 2.79% on the brighter employment news. Uncertainty over the underlying conditions of the US and Chinese economies has also buffeted the Nikkei 225 Stock Average over the last month; but last week it gained 2.9% as the weakening yen boosted sentiment towards its international trade-oriented companies.

Meanwhile, developments in other emerging markets rumbled through the highly international markets in London. The FTSE 100 index fell 1.4% during the week to 6,713 points; with a 1.1% loss sustained on Friday as concerns rose for mining stocks after Chinese authorities allowed the country's first outright default of a domestic corporate bond since the market was established in the early 1990s. The failure of a Shanghai manufacturer to pay out interest on a security sold two years ago has raised concern that this could presage further defaults on Chinese corporate debt. Meanwhile, a new South African law to restrict exports of minerals deemed as nationally strategic also added to the pressure on the FTSE's prominent miners.

Five years on…

Last week also brought the fifth anniversary of the start of quantitative easing (QE) and the historic low 0.5% interest rate. Save Our Savers held a mock funeral outside the Bank of England to mourn "our dearly departed savings". But the Bank's decision to create money to buy bonds in March 2009 aimed to pull the UK into recovery rather than to target savers. The Bank has wanted households to spend more rather than to save more. If it had not pursued QE, both the economy and savers would have been hit. Global consultancy McKinsey last year suggested that UK households had lost $110 billion of net interest income overall and that the winner was the UK government with a $120 billion gain.

But the picture is too reductive. The Bank printed £375 billion of new money to purchase government bonds. The exercise as a means to stabilise the economy looks to have worked, with the British Chambers of Commerce now expecting the UK economy to exceed its pre-recession peak this summer. Consumer and business confidence and orders have improved. There are still concerns that the extraordinary experiment in monetary policy looks more permanent than temporary. And when and if the Bank does decide to make its withdrawal from QE, it is well aware that it will be a delicate operation to control any disruption to the economy in the process.

And the pain of lower interest rates has come with the gain of higher asset prices from equities and bonds to pensions and homes. The Bank has argued that the benefits that QE has brought to financial assets outweigh the value lost on deposits. But the financial crisis hit all aspects of the UK economy and to apportion blame for the plight of some on financial policy seems to gloss this reality. For example, although pensioners as a group have been hit, the young have been hurt with falling pay levels. Certainly, small savers are vulnerable. But QE has allowed for recovery which is to the benefit of all.

'Portable property'

The commercial property sector has also gathered strength from Britain's wider recovery and the growth in confidence in UK boardrooms. Chris Bartram of fund manager Orchard Street observes a strong shift in sentiment in the commercial property market in the second half of 2013 as the UK's economic news improved. "There is still plenty of caution," says Bartram. "But if you take a glass half full rather than half empty perspective, the sentiment is upbeat." Orchard Street reports that UK commercial property activity hit a historic record high in the fourth quarter of 2013 with £21 billion of deals, far exceeding the £16.4 billion recorded in the fourth quarter of 2007 before the onset of the financial crisis.

The transactions also reflect an increased level of overseas money attracted to London as an international investment haven. The UK's status as a stable political, legal and financial destination and the strong returns and growth from the London commercial property market continued to underpin this growth last year, as the then-weak pound helped attract Asian investors. Yet, despite a subsequent appreciation of sterling and high valuations, the difficulties in the emerging markets have brought renewed interest from global investors. Bartram says that investor enthusiasm has also spilled to the edges of London. The property fund manager expects total returns in 2014 on a similar level to last year and to exceed 10%.

Bartram observes that there is an "indiscriminate" element to investments in both the residential and commercial markets that is interested in safety rather than returns. Knight Frank reports that, in recent months, there has been a surge of interest from emerging markets such as Argentina, Brazil, Ukraine and Turkey, and that this has fanned out into Greater London. Fund manager George Luckraft of AXA Framlington notes that the recovery in residential prices, which has been dominated by London and the South-East, is now spreading to the whole country. With the sheer volume of global cash ready to park in the top end of the capital's property market, the consensus is that the pressure on price can only increase – and that is not a bubble but caused by genuine demand.

Building Britain

UK house prices in February edged up 9.4% from a year earlier, which is the biggest annual rise since May 2010, according to Nationwide. Demand continues to outstrip the supply of properties, in particular the pace at which the UK's construction industry can deliver newbuilds. And UK housebuilder profits have grown handsomely in this boom market. Investors are reaping gains, with each of the big builders – Barratt Developments, Persimmon and Taylor Wimpey – announcing significant dividend payment pledges to shareholders over the next few years. Fund manager George Luckraft of AXA Framlington comments: "Housebuilding shares have been strong with the majority beginning to distribute capital back to shareholders in the form of substantial dividends."

Luckraft points to other housing-related stocks that have benefited from the house price surge. Shares in UK builders' merchants, for example, have made gains, with Topps Tiles up by over 100% in the past year. "Profits need to exceed forecasts to justify the rises and this is probable if the historic linkage between mortgage approvals and revenue continues," adds Luckraft. There is an argument that the pace of the rise in house prices and consumer confidence will force the Bank to begin to raise interest rates sooner rather than later. Luckraft believes the Bank is more likely to push the UK's banking sector to tighten its lending criteria before it embarks on rate rises. "This will moderate the housing market while still trying to foster the recovery," adds Luckraft.

Record low interest rates, easier access to mortgages and growing consumer confidence continue to exert this upward pressure on UK house prices. The British Bankers' Association has reported that mortgage lending by its members was 38% higher in January than a year ago. But, despite fears of a housing bubble, prices remain 3% below their 2007 peaks. The Bank's Monetary Policy Committee member David Miles maintains that house prices are not rising at an unsustainable level and that net mortgage lending remains lower than "you might expect in a well-functioning market".

Tax-efficient investing

The monetary policy that has underpinned the boom in the UK property market remains, as anticipated, unchanged for another month. Rates on savings accounts have dwindled to near-zero levels. The consensus is that borrowers and businesses have gained at the expense of savers. But amid this jeremiad, it is worth noting that, as the tax year-end deadline for unused ISA allowances looms, investors have gained in this environment, too.

Clearly, QE and persistent inflation have eroded savings – although inflation has begun to fall below the government 2% target and give a little more hope for real returns. However, the Bank is not expected to raise interest rates before 2015. With the UK's higher earners among the most taxed in the world, according to PricewaterhouseCoopers, a tax break such as the annual ISA allowance is an opportunity that is worth taking and maximising.

AXA Framlington, First State and Orchard Street are fund managers for St. James's Place Wealth Management.