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Rallies and recoveries

Global stock markets in the final months of 2013 look set to continue to move to expectations of central bank policies as further signs of recovery emerge across the advanced economies. Last week brought no let-up in this dance between leading central banks and equity markets. The developed economies are recording growth in varying degrees of strength – with the UK and US ahead of the eurozone and Japan - while their central banks continue to look to assist these steps of recovery. And, despite lingering concerns over valuations, there is an air of optimism around the world's equity markets.

The upbeat tone of global equities was given a further fillip last week following the appearance before the Senate banking committee of Janet Yellen, the White House's nominee to replace US Federal Reserve chairman Ben Bernanke in January. Yellen indicated that she will continue the pace of the $85 billion-a-month asset purchase scheme when she takes up her role at the start of next year. She made it clear to US senators that her aim is to ensure that central bank policy promotes a strong economic recovery and sustains the recent momentum of financial markets through the continued use of quantitative easing (QE).

US equities have sustained their upward trajectory amid these encouraging signs. The S&P 500 index on Friday rose by 0.42% and closed the week at a new record high of 1,798 points. After gaining a further 1.2% over the five-day period, the index has advanced by 23% since the start of 2013 and 33% over the last year. As well as reflecting the confidence the markets have in Yellen and her ability to continue QE and to steer the US economic recovery, the progress on Wall Street was also a measure of the vitality of corporate America.

Exxon Mobil was one of the significant share price gains on Wall Street last week after American investment veteran Warren Buffett added a $3.45 billion stake to his holdings in the US energy giant. Buffett's move lifted ExxonMobil shares by 1.3% on Friday to $94. Exxon Mobil shares have underperformed in recent years, rising 8% over the last 12 months compared to the increases of 17% and 35% enjoyed respectively by rivals Chevron and ConocoPhillips. However, with oil and gas production levels growing, Buffett's investment group Berkshire Hathaway has expanded its holdings in Exxon Mobil to the sixth largest position in its portfolio, which includes blue-chips such as American Express, Coca-Cola, IBM, Wells Fargo and Procter & Gamble.

Berkshire's regulatory filing on Thursday also disclosed that Buffett had reduced his stake in UK pharmaceutical giant GlaxoSmithKline, which closed at 1,615p on Friday, around 11% below its 52-week high of 1,816p at the end of May. GlaxoSmithKline had lost 1% on Tuesday and another 1.4% on Wednesday after a late-stage trial of an experimental heart drug failed to deliver the benefits needed to launch the product.

In London, the FTSE 100 index ended the week with a gain on Friday of 0.4% to close at 6,693 points, although the index over the week was down 0.2%. The FTSE 100 earlier on Wednesday had sustained its sharpest fall for three months, dipping by 1.4% amid concerns that UK interest rates could rise sooner than expected. However, the index has gained 18% over the last year, and is only 2.6% below its 52-week high of 6,876 points reached in May. Analysts at Credit Suisse were positive about the prospects for Royal Dutch Shell, despite underperforming the FTSE 100 by 13% over the last year as it faced rising costs and falling earnings. With $15 billion of disposals lined up, Credit Suisse noted that proceeds from this exercise would provide for "the most secure dividend in the market". Shell gained 1% on Friday and closed at 2,095p.

Market optimism that strong central bank policy can steer economic recovery and keep financial markets buoyant underpinned a positive week for the FTSEurofirst 300 index, which gained 0.3% on Friday and was up 0.2% over the week to close at 1,298 points. The FTSEurofirst is up 20% over the last year, and is 1.4% off its 52-week high of 1,316 points reached in early November. Meanwhile, the Nikkei 225 Average index rose 2% on Friday to 15,166 points, which was a 7.7% gain over the five-day period – its best weekly performance in four years amid strong earnings from financials. The Japanese index has gained 72% over the last year and 42% since the start of the year, and is now only 5% shy of its 52-week high of 15,942 reached in May.

Yellen's appearance before the Senate, and the prospect that QE will continue at its present rate, also lifted the price of government bonds and pushed down yields. The ten-year US Treasury yield was down 3 basis points over the week to 2.7%, with UK ten-year gilts at a similar level. Meanwhile, the ten-year German bond yield was 5bp lower following the European Central Bank's recent interest rate cut and expectations of further action amid the slower-than-expected eurozone third-quarter growth, down to 0.1% from 0.3%.

Reluctant bulls

Despite the lingering concerns in markets over when the era of easy money will begin to end, investors continue to favour equities which is the best performing asset class so far in 2013. With the MSCI World index up 18% so far this year, Wall Street and European stocks continue to make good gains – with last week no exception to the upward momentum. And retail investors have figured prominently in this strong run as corporates increase dividends and buy back shares, and shareholders reinvest their rewards.

Investors have also regained confidence in the global economic outlook after last month's stand-off in Washington over the US debt ceiling, according to the Bank of America Merrill Lynch (BofA) fund manager survey for November. The BofA found that 67% of respondents now expect the world's economy to strengthen over the next 12 months, which is up 13% more than October. Investors were also asked what the likeliest triggers for the global economy would be to attain "escape velocity" growth in 2014. Bank lending growth among the G7 nations and Chinese and Asian growth are the missing catalysts for further gains, the survey suggested.

Investors increased their equity allocations slightly during the month with the biggest shift into emerging markets equities. Strong overweight positions in eurozone and Japanese stocks were moderated slightly. Europe is undervalued compared to the US, according to the survey; while cash holdings rose by 4.6%.

"Investors remain reluctant bulls. Who would have thought all-time highs in US stock prices would coincide with high cash levels?" asked Michael Hartnett, chief investment strategist at BofA Merrill Lynch Global Research. "Conviction is still low in Europe. More portfolio managers expect earnings per share to grow, but fewer see it reaching double-digit levels," added John Bilton, European investment strategist at BofA.

Yellen softly

Following Yellen's remarks last week, the start to tapering is unlikely to occur until 2014. Yellen told senators that the gains for equities on the back of QE were robust and these were not "bubble-like conditions". Her stance should give further impetus to the S&P 500 index, although some in the market argue that Wall Street's recent rally could begin to lose pace. However, the impetus of QE that has helped power the market in 2013 looks like it will remain in place. "For the US the message is clear – QE will continue and the Fed sees no risk of 'irrational exuberance' developing in financial markets," said Chris Iggo of fund manager AXA Framlington.

The S&P 500 hit a record high on Wednesday following Yellen's remarks. Moreover, Bernanke's nominated successor in a nuanced presentation emphasised that a strong recovery would "ultimately enable the Fed to reduce its monetary accommodation and reliance on unconventional policy tools such as asset purchases". The use of the word "ultimately" suggests that Yellen wants to have the flexibility to ease off the Fed's asset-buying programme gently and is in no hurry to taper QE as the conditions of economic recovery begin to set in.

But, as Yellen pointed out to the Senate, the US economy and labour market are still performing “far short” of their potential, requiring a continuation of loose monetary policy to support growth. However, US growth remains well ahead of the eurozone and Japan. Data last week showed that growth in the eurozone faltered in the third quarter, expanding 0.1% after a 0.3% expansion in the second quarter. Japan’s annualised real growth between July and September halved from the previous quarter to 1.9% in spite of a weaker yen.

Escape velocity?

In contrast, the UK economy could reach escape velocity sooner than expected, according to the Bank of England. The UK’s central bank said that the British economy is recovering so quickly that it could potentially bring forward the timing of a rise in UK interest rates. The Bank expects the 7% jobless rate, which is the point at which it will reassess its policy stance, to be reached much earlier than it previously forecast. Latest unemployment figures indicate a fall to 7.6% in the three months to September. The Bank believes the threshold could be reached by the second half of 2015, compared to the previous assumption of mid-2016.

Azad Zangana, an economist with fund manager Schroders, noted that the change in guidance suggests the Bank will “begin considering raising interest rates over a year earlier than it thought only three months ago”. However, the Bank views current market forecasts that interest rates will rise by mid-2015 as “too aggressive”, he said. “Keeping interest rates on hold until the end of 2016 would, on the other hand, be too late,” he added.

However, the Bank appeared to be turning more hawkish, although it remains non-committal over its 7% unemployment rate threshold. Schroders brought forward its forecast for the interest rate rise to the start of 2016 from the end of that year. The fund manager added it was not confident enough in the sustainability of the recovery to forecast tightening policy in 2015, especially due to the UK’s lacklustre productivity growth. “The UK’s recovery has considerable momentum going into 2014, but whether the debt-fuelled housing recovery translates into anything more than a short-term rebound in demand is questionable,” it added.

Hard yards

Investors who have stuck with equities have achieved good returns since 2007. “For all the bad news it has been a good time to be an investor,” observed BlackRock’s head of strategic asset allocation Richard Urwin at a recent presentation at the fund manager’s London offices. And, with the equity markets powering on in 2013 amid talk of shifts in monetary policy, there are concerns that the rally has reached a peak. However, Urwin argued that equities still have further to go, although the pace of the momentum may begin to slow in 2014.

Although value investments are now less common with UK equities at fair value and US stock more expensive, Urwin said that equities are not on extended valuations. Moreover, equities can rise further given modest earnings growth, low bond yields and loose monetary policy. “But the period of exceptional returns is now behind us,” he noted. In these tougher conditions for equities, dividend yield will become a more important component of equity returns, he argued.

Stock selection is also becoming more important as the markets make the more challenging steps in a mature, momentum-driven stock market, Urwin added. In these conditions, he said that a diversified portfolio of growth assets should continue to outperform government bonds. There are investment risks from deflation and budget deficits to recession in China, the break-up of the eurozone and the lingering concern of another banking crisis. But these conditions are still conducive for equity investors with valuations still not challenged and the market taking a conservative rather than euphoric approach. “The macro background is supportive with growth moderate, low inflation and low interest rates,” he added. “And the risks are known and better priced.”

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