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ST. JAMES'S PLACE
WEALTH MANAGEMENT

Wild horses

Bank of England governor Mark Carney at the weekend addressed the UK economy's 'wild horse' – the housing market boom. Carney dispensed some of his Canadian West straight talk when he identified the "deep, deep structural problems" of the UK property market as the "biggest risk" to the economic recovery. His comments come as the Bank's Financial Policy Committee prepares to unveil next month how it will rein in the housing boom, following its Inflation Report last week that deemed the recovery on track but in need of more support from loose monetary policy. Carney's clear message is that he intends to keep interest rates as a "last line of defence", and on hold, as he uses other measures to tame the housing market and the UK economic recovery sets in.

Markets are also looking to the European Central Bank (ECB) to unveil a package of economic stimulus measures next month, amid fears that the region's recovery has lost momentum. Last week, eurozone data showed that the region's economy expanded by only 0.2% in the first quarter, missing 0.4% forecasts. Meanwhile, market expectations that the ECB will adopt a version of quantitative easing (QE) helped drive the yield on the benchmark ten-year German Bund to its lowest for a year and down over the week by 11bp to 1.3%. As the US Federal Reserve continues its steady retreat from QE, financial markets are proving unruly. Fixed-income investors started 2014 nervous that a global sell-off would accompany the economic recovery and a return to normality for markets. Instead, government bonds have continued to fall and prices rise, with the ten-year US Treasury yield down 10bp to 2.5% and the UK ten-year gilt yield 13bp down on the week to 2.6%.

Peak equity?

Global equities steadied on Friday at the end of a turbulent week in which equities bolted to all-time highs and then retreated amid fears over valuations and a growing aversion to risk. In New York, the S&P 500 index touched 1,900 points on Tuesday, but fell back over the week by 0.4% to close on Friday at 1,877 points. A rally by US technology stocks lifted the benchmark index earlier in the week, including gains by high-growth companies such as Facebook, Twitter, Netflix and Weibo. But US equity markets are entering a new phase after the 2013 rally and as the end of the Fed's asset-buying programme, at the current rate of reduction, approaches later in the year. Richard Oldfield of fund manager Oldfield Partners anticipates that US equities with their high valuations will offer less opportunity and lower returns.

In Tokyo, the Nikkei 225 Stock Average suffered its second weekly drop in a row, with its export-orientated corporates battered as nervous global investors continued to push up the value of the perceived safe-haven yen. The Nikkei fell 0.7% over the week to 14,097 points, despite data showing Japan's economy enjoyed its best quarterly growth in nearly three years of 1.5% over the first three months of the year. However, there are fears that last month's sales tax prompted a consumer buying spree ahead of its introduction on 1 April, and growth could fall back in the second quarter. In Tokyo, investors focused on weak corporate earnings, with electronics giant Sony down 9% over the last two sessions of the week after it announced a ¥125 billion net loss last year.

European equities also powered ahead in the early part of the week, driven by strong company earnings, the prospect of further takeover activity and expectations that ECB president Mario Draghi will opt for QE next month. Strong quarterly results pushed France-headquartered consortium Airbus shares up 4% and German

conglomerate ThyssenKrupp 7% over the week and helped to lift the FTSEurofirst 300 index to a six-year high on Tuesday – which was surpassed two days later by a new high of 1,373 points. The pan-European index closed the week up 0.5% at 1,361 points. The French government's battle with US multinational General Electric and its $13.5 billion deal to buy Alstom's energy business took a fresh turn after Paris took new powers to block foreign takeovers of "strategic" companies.

In London, the FTSE 100 index last week also surged to its highest level since December 1999, reaching an initial peak of 6,873 points on Tuesday powered by house-builder gains amid the UK housing boom. On Thursday, the FTSE 100 hit a new 14-year high of 6,895 points, although investors' nerves about valuations pushed the index down by 0.6% at the end of the session. The FTSE 100 ended the week up 0.6% at 6,856 points. This week, markets will look to see if US pharmaceutical giant Pfizer will drop its takeover attempt on AstraZeneca, after the UK drugs giant declined its offer of £55 per share. AstraZeneca said the new £69 billion offer undervalued the company, which is a view shared by fund manager Neil Woodford. Last week the founder of Woodford Investment Management said that Pfizer's offer was "very distant" from the right price.

Global litmus

The crisis in Ukraine, the threat of a Chinese default and the sluggish global recovery have had a knock-on effect on appetites for risk, with investors holding more cash and reduced equity holdings despite Wall Street and Europe's indices on or near record highs. The Bank of America Merrill Lynch (BoA) monthly survey of fund managers has found that the average cash levels have reached 5% of portfolios – the highest level since June 2012 and up from 4.8% in April. And 22% of those surveyed are taking below normal levels of risk, up from 11% in April; while the proportion overweight in equities has fallen 8% over the month to 37%.

Caution is mixed, however, with measured optimism. Two-thirds of those surveyed at the start of May expect the global economy to strengthen over the coming 12 months, up from 62% in April (although nearly three-quarters predict below-trend growth); while just under half believe that corporate profits will rise over the next year (although a fifth said the growth would be less than 10%). European equities continue to attract interest; while valuation fears have resulted in caution over US equities. "Investors have belief in the economy but with two big questions: Are we on the brink of a disruptive event? And why, at this point in the cycle, isn't this recovery stronger?" asks BoA chief investment strategist Michael Hartnett.

Horse whisperer

While Wall Street is skittish about stock valuations, the US economic recovery and when the Fed will start to raise interest rates; on the other side of the Atlantic, Carney's clear message to UK markets and investors over the last week is that the UK's economic recovery has broadened, inflation remains under control and the record-low base rate will stay in place. While the forecasts for growth for 2015 were raised from 2.7% to 2.9%, Carney emphasised that the economy has "only just begun to head back towards normal".

Carney at the weekend also indicated that the Bank could look to rein in the housing market boom by placing limits on mortgages, including tougher affordability tests on borrowers, higher loan-to-income ratios and a cap on the ratio of a loan's size to the property's value; as well as advising the UK government on changes to the Help to Buy scheme. But the ultimate weapon of a rate rise is one of last resort. Carney's steady but cautious approach to keep in hand a potentially capricious UK economy suggests that the base rate could remain on hold later than many in the market have guessed, and even into the second half of 2015. Britain's straight-talking Albertan central banker has made it clear: he doesn't want this horse to bolt.

Oldfield Partners and Woodford Investment Management are fund managers for St. James's Place Wealth Management.

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