ST. JAMES'S PLACE
WEALTH MANAGEMENT

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The developed world order

Almost a month into the New Year, and many of the big themes that fund managers identified for 2014 are already looming large for global markets and investors. As the US and UK economic recoveries strengthen, a world awash in easy money has exposed the rickety state of a number of emerging markets. And, as global business leaders and political elites ended their week of talks at the World Economic Forum in Davos, the big questions for the global economy remain in the balance. Will the US manage an orderly retreat from ultra-loose monetary policy? How will the emerging market nations fare in this new financial order? What does a slowdown of China's economic growth hold? And when will interest rates in the UK and the US begin to rise?

Markets this week await the US Federal Reserve's next reduction of its monthly asset purchases. The expected statement on Wednesday, at the farewell meeting of outgoing Fed chairman Ben Bernanke, comes amid mounting political uncertainty in a number of emerging market nations, including Turkey, Thailand and Ukraine. Speculation was also rife last week that Argentina, after a week in which the peso lost 18% of its value against the dollar, is running out of foreign reserves. The flight of capital into the US and developed markets is set to continue amid these turbulent conditions.

As Bernanke makes way for his successor and current vice chair, Janet Yellen, the US central bank looks set to stick to its policy of ultra-low interest rates and a gradual exit from its stimulus programme. The Fed is expected to make a further $10 billion reduction of the monthly bond-purchase scheme to $65 billion. Markets will be looking to see if the Fed will alter the forward guidance it gives markets on when it will start to increase interest rates – with some expecting the 6.5% unemployment threshold to be lowered.

The Bank of England's policy on forward guidance was also the focus of market speculation last week as the UK's unemployment rate continues to fall at a faster speed than was anticipated. Britain's jobless rate is now close to the 7% level at which the Bank has said it would consider an increase in interest rates. As in the US, the pace of the economic recovery and the creation of new jobs is faster than the UK's central bank predicted last August, prompting its governor Mark Carney to hint that he could abandon his policy of linking interest rates with unemployment.

Peso problems

But the shock development for global equity and currency markets last week was the turmoil that has overtaken Argentina's peso. The Buenos Aires government on Friday attempted to shore up confidence with a relaxation of capital controls to allow Argentines to buy US dollars, together with a reduction of the tax rate on these purchases. Fears are afoot of a further rise of inflation in Argentina and financial contagion across the Latin American region and other emerging markets. The developments have prompted comparisons with the country's $100 billion sovereign default in 2002, as well as the 1997 Asian financial crisis that followed the collapse of the Thai baht.

Argentina's currency woes had a ripple effect across global equities and emerging markets. The currencies of Turkey, Brazil, South Africa, India and Russia tumbled in value against the dollar. The reaction highlighted the challenges that emerging markets face as the US pursues its policy to taper its bond purchases and money continues to flow back to the US. Fund manager Schroders' emerging markets economist, Craig Botham, said that the slide in value of Argentina's peso had heightened investor nerves about the wider Latin American

region and that people are pulling out while "they reassess what is going on". There are understandable concerns that the fate of Argentina's currency could be mirrored in other emerging markets, but the problems faced by the Buenos Aires government are widely viewed as a result of domestic economic mismanagement. (It's a criticism also levelled at Ukraine and Venezuela.) With a large current account deficit and not enough foreign currency reserves, Argentina allowed domestic inflation to spiral to 25%, which drove many of its citizens to exchange pesos for dollars. A government move to limit currency exchanges created a black market for dollars and a further undermining of confidence in the peso.

Other emerging market countries that have lived beyond their means and could face difficulties ahead include Turkey, South Africa, Indonesia, Thailand, Chile and Peru. The US's gradual unwinding of its monetary stimulus programme will be a challenge for these economies, as they readjust to a world without the large capital inflows experienced in recent years. But the recovery of the world's largest economy, the US, and America's return to more normal financial conditions has ultimately to be good for the rest of the world.

Latin lessons

Argentina's financial problems and concerns about other emerging market economies set in motion a sell-off of equities. In New York, the S&P 500 index took a sharp 2.1% fall on Friday to 1,790 points, its largest one-day drop since June. The US equities index lost 1.8% over the week, reflecting the nervousness around the outlook for emerging markets and an uninspiring round of US corporate quarterly earnings. Yields on ten-year Treasuries also fell five basis points to 2.73%.

European shares also suffered as a result of Argentina's currency problems, with Spanish stocks that have links to Latin America hit particularly hard. The FTSEurofirst 300 index fell 2.4% on Friday – which was its largest one-day fall in seven months – and ended the week at 1,301 points, which was 3.3% down over the five-day period. In Tokyo, the Nikkei 225 Stock Average fell by 1.9% on Friday to rest at 15,392 points, which was a one-month low for the index. The Nikkei lost 2.2% over the week amid the concerns that disappointing economic figures from its main trade partner, China, would have a knock-on effect on Japanese earnings. There was talk again last week in global markets that China's economy may endure a hard landing. The MSCI Emerging Markets index was down 1.3% on Friday, taking its fall since the start of the year to 5.3%.

Amid the market uncertainty, gold reached a two-month high of $1,272 an ounce on Friday before ending the session at $1,267, which was a rise of $14 on the week. Meanwhile, the ten-year US Treasury yield was down four basis points (bps) to 2.7% on Friday, declining ten bps over the week. Ten-year German government bonds lost four bps to 1.66%, which was a near six-month low, and fell ten bps over the week.

Eighties child

The FTSE 100 index passed a milestone at the start of the month – its 30th anniversary. The index was launched in January 1984 at a start point of 1,000 points, replacing the FT30 as the main indicator for the performance of companies listed on the London Stock Exchange. Only 30 of the original members remain and, of these, only 19 have remained continually in the index. At the end of 2013, it closed at 6,750 points.

Meanwhile, the FTSE 100 also took a dive last week and closed on Friday at its lowest point since the middle of December. The index lost 2.4% during the week and ended at 6,664 points, with the pressure particularly on stocks that are exposed to the emerging markets. Richard Peirson of fund manager AXA Framlington points out that 70% of the earnings in the FTSE 100 are from outside the UK, and the index offers a way for UK investors to follow global themes. Of course, that means that the ripple effect of US monetary policy on the global economy will be reflected in the performance of stock with emerging market exposure.

And, as global equities specialist John Botham of fund manager Invesco Perpetual points out, the globalised nature of earnings of members of the UK index has weighed on earnings growth. Moreover, with the high concentration of energy and materials sectors stock in the FTSE 100, fund manager Schroders' chief economist Keith Wade notes that a slowdown in Chinese demand for industrial commodities suggests that there are headwinds for the UK market. Fears of a slowdown in China resurfaced last week after the first estimate of

January's HSBC Markit purchasing managers' survey on the manufacturing sector indicated a slowdown in activity. Although China's fourth-quarter growth has ebbed to 7.7%, this is a level that in most parts of the world would be considered miraculous.

Loyalty pay

Meanwhile, dividend payments to shareholders made by UK companies in 2013 have dipped over the past year. Business consultancy Capita's latest quarterly report found that UK dividends in 2013 were £80 billion, which was 1% lower than the previous quarter. This is the first time dividends have declined since 2010, when UK energy group BP cancelled its payouts after the Gulf of Mexico oil spill.

The rapid growth of dividends in 2011 and 2012 trailed off last year amid weakened company profitability and fewer special dividend payments. But, despite the fall in UK company earnings in 2013, dividend payments were not sizeably cut. Rightly, companies view a large dividend reduction as a negative signal for markets. Meanwhile, investors faced with low yields from bonds and cash are placing pressure on boardrooms to reward their loyalty. And UK companies remain cash rich, even when profits are down, with balance sheets in the FTSE 100 alone holding net cash of £73.9 billion, which is six times higher than the £12.2 billion in 2008.

But, with the UK economy in recovery, Capita believes that 2014 could bring both higher dividends and renewed investment activity by cash-rich corporates. More investment can lead to higher profits too, which in turn can generate more dividends. However, Capita warns that some of the more international companies in the FTSE 100 are exposed to less-than-rosy economic conditions and could find it harder to achieve growth than their domestic counterparts. With a special £16.6 billion dividend due from Vodafone after its sale of Verizon Wireless last year, Capita predicts a 27% increase in total dividend payments to £101.1 billion in 2014.

Carney's choice

The big question for the markets, savers and borrowers in the UK is whether Mark Carney will raise interest rates early. Britain's unemployment rate has fallen sharply to 7.1% and, as we noted, almost at the 7% level that should prompt the Bank to contemplate an interest rate rise. When it published its forward guidance in August, the Bank said that unemployment would not drop to 7% until 2016. It now concedes that the UK economy will reach that number this year – and on the present pace it could be within the next few months.

The British economy is now one of the star performers among the developed nations with only the US expected to do better this year. The speed of the UK recovery has also prompted the International Monetary Fund to review its growth figures to 2.4% for 2014. But, despite the difficulties faced by Britain after the financial crisis, its unemployment rate was never at the levels that hit continental Europe or America. The jobless rate has fallen from 7.8% in May last year to its present level for the months of August to October – that's 280,000 more British people in work since the summer. The revival of UK fortunes is looking robust.

But minutes for the Bank's meeting in early January confirmed that Carney does not want to risk this turnaround with an early interest rate rise. And Carney has been emphatic that the 7% marker is not a trigger but a 'way station', or a point at which the UK's economic progress can be reassessed. With inflation down to the Bank's 2% target and wages hardly growing, there is little pressure to take this next step. Carney at Davos last week again told markets that there was "no immediate need to increase interest rates" – and we are inclined to believe him. Savers will have to wait for the Bank's Inflation Report next month to find out the new thinking behind this approach.

AXA Framlington, Invesco Perpetual and Schroders are fund managers for St. James's Place Wealth Management.

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