MARKET BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

Monday 30 September 2013

Watching and waiting

Last week saw markets unsettled as politics returned to centre stage on both sides of the Atlantic.

The FTSE 100 suffered its first weekly loss since August, whilst still registering a rise of around 1.6% so far in September and a total of 4.8% to date in the third quarter of 2013, with one trading day to go. The year-to-date gain is over 10%. Attention has shifted to the US once again as Republicans and Democrats debate the country's fiscal policy. Concerns over the lack of progress in Washington's budget negotiations unsettled equity markets worldwide. Politics were also at the fore in the eurozone after Angela Merkel's re-election in Germany, and as Italy's coalition government felt the strain, driving up borrowing costs in Rome.

The decision by Silvio Berlusconi to pull his ministers out of the five-month-old Italian coalition government caused yet more angst in European financial markets. Italy's government had been on the brink of collapse since Mr Berlusconi lost his final appeal against a conviction for tax fraud on 1 August, raising the likelihood of him being banned from public office next month anyway. With Italy in danger of failing to meet its 3% budget deficit target for 2013, the European Union and the International Monetary Fund have repeatedly warned that political stability is a must in order to drag the country out of its longest post-war recession.

In the US, the lack of an immediate solution to debt ceiling negotiations has increased worries that a partial government shutdown could be on the cards within 24 hours, with the added overhanging problem that the US government could default on its debts later in October. A serious battle is brewing over whether the debt level will be allowed to increase before the Treasury runs out of money on 17 October, and it is not entirely evident if, and when, any sort of agreement will be reached. Certainly, it is difficult to be very confident when both parties seem to have little common ground at present: equity investors need to be prepared for added volatility in the coming weeks.

From midnight tonight, parts of the US government may close down for the first time since 1996 unless Congress finds a way out of this latest stand-off. All non-essential staff could be placed on unpaid leave and many agencies will close down their services. Over the weekend, the Republican-controlled House of Representatives did vote to renew funding for the government until December, but maintained the caveat that it should result in a one-year delay in the implementation of 'Obamacare'. The health reform, deeply unpopular with Republicans, is due to take effect early in 2014.

Economists at Goldman Sachs have estimated that a government shutdown would cost the US economy $8 billion per week based on the similar event in the 1990s. With each side blaming the other, today is likely to be a long day of debates in the US.

Will they deliver?

Within hours of order books opening, Royal Mail reportedly had already received enough orders for its shares on offer. The government is pushing the flotation through by 15 October, before industrial action by up to 100,000 postal workers can begin on 23 October. The shares will be sold at between 260p and 330p each, valuing the company at between £2.6 billion and £3.3 billion. Up to 70% of Royal Mail will be sold during the initial public offering, the largest of its type since the 1980s, which has been predominantly aimed at institutional investors and includes a grant of free shares to its staff. It is thought this will bring up to £2 billion for the government, which will retain a 30% stake in the business.

Members of the public will have to apply for a minimum commitment of at least £750 if they wish to take part, and the initial information states that the stock will pay a dividend of at least 6.1% in its first 12 months. It is thought that private investors will own up to 15% of the company despite the privatisation being aimed primarily at the City, though there is no guarantee that potential investors will receive all of the shares for which they apply. Much of the weekend press reported that retail stockbrokers have received a deluge of enquiries and unexpectedly high demand. This has surprised the government as the process is taking place without huge promotional campaigns such as those seen during the privatisations of BT or British Gas.

Whilst at this point it is impossible to know whether the shares will prove to be a good long-term investment, there are clear risks attached to buying shares immediately, especially given that investors will not even know the price at which they are buying. The aforementioned industrial action, where postal workers are looking to strike over pay, pensions and the privatisation, also casts an ominous shadow over proceedings. History shows that such action by any workforce can affect a share price significantly. As always, our belief is to leave it to professional investment managers to weigh up the risk and return potential.

This is just one way in which the government is looking to raise money in addition to the continued sale of Lloyds Banking Group. News also broke at the weekend that plans are afoot to restructure RBS so that the taxpayers' stake can be sold at a profit, splitting the bank's balance sheet into 'good' and 'bad' assets. The bank is currently 81% owned by the UK taxpayer with the report by UBS suggesting that the 'good' assets would be sold to existing shareholders at around 540p, having been purchased by the government at 500p. The 'bad' assets would remain on the UK balance sheet and be wound down in the same way as the current holdings in Northern Rock and Bradford & Bingley. The debate over the separation comes ahead of Ross McEwan taking over as chief executive from Stephen Hester this week. Mr Hester was known to be against splitting up the bank and had reportedly clashed with the chancellor, George Osborne, over his views on the future of RBS.

Energy rows

The Labour leader, Ed Miliband, took the business world by surprise this week by stating his party would freeze gas and electricity bills for every home and business in the UK for 20 months if they win the 2015 election. During his speech at their party conference, he also said the big energy firms would be split up and governed by a new tougher regulator to give consumers "a fairer deal", saying the move will save average households £120 a year and businesses £1,800 a year but cost the energy companies up to £4.5 billion.

Labour says the energy giants have been overcharging customers to the tune of £3.9 billion since 2010 by not passing on reductions in wholesale prices to consumers. The party denies that the policy is a return to discredited price controls of the 1970s, arguing it is a temporary measure aimed at helping consumers while the party sets up a new regulator, which would force firms to openly sell their wholesale energy in a pooled market. The speech also included other proposals such as the confiscation of land from house-builders, raising the minimum wage and putting up Corporation Tax.

RWE npower, one of the big six energy firms targeted by Labour, unsurprisingly criticised the measures immediately. "In reality, there are three main factors that influence prices – fixing inefficient housing stock, the investment required to replace the UK's energy infrastructure, and the cost of buying energy on the global market," said chief executive Paul Massara. Another firm, SSE, said bills were rising because of "well-intentioned" government initiatives such as green taxes, not fuel costs. Chief executive Alistair Phillips-Davies said: "Instead of price freezes which will lead to unsustainable loss-making retail businesses, the Labour Party should put policy costs into general taxation, taking them off energy bills."

Centrica's share price fell around 5% on the news, and nearly 10% by the end of the week, although the shares did become ex-dividend. SSE's price also decreased a similar amount. Centrica even took the step of warning international investors about the threat to its profits. The company, which owns British Gas, is in the process of raising up to £6.2 billion on money markets as part of its normal funding operations. On Friday, it published a prospectus for the loan programme which included a last-minute warning to potential investors about Ed Miliband's speech. Ironically, if investors were to shy away from Centrica, this would affect the construction of new power plants in the UK for which the company would be unable to pay.

Of course, none of this will please shareholders, especially given that politicians will be looking to reduce the profits of private companies. This brings uncertainty to future revenues, and indeed future dividend payments. The most vocal shareholder was Neil Woodford of Invesco Perpetual, manager of some of the largest UK equity income funds. He said that Labour plans for a price cap on energy bills would damage the investment case for the UK and block the billions of pounds of new money the government admits it needs.

"Here we have a serious politician, standing up and saying what he said which I think at a stroke torpedoed any chance that any of that investment will happen between now and the next election. If Centrica and SSE cannot make any money supplying electricity to the retail market then they won't supply it. The lights will go off, the economy will shut down.

"This policy is economic vandalism at a time when this country needs all the help it can get. It is insane, not least it is also fundamentally dishonest to suggest to the electorate that electricity and gas prices are where they are because of profiteering by the companies. The margins have stayed the same; the return on capital has stayed the same. There have been umpteen investigations into the retail energy market by Ofgem over the last 10 years. But at no stage did any investigation highlight cartel activity or price fixing activity. There is no evidence of profiteering. What we have had in the last 10 years – not least when Ed Miliband was energy secretary – is any number of policies that have been specifically designed to raise prices such as the carbon price floor or massive renewable policies," Mr. Woodford said.

Of course, political risk is just one of the factors to be considered with stock market investments. The outcome of the next election, and the nature of any response from the Conservatives, are equal unknowns and serve to reinforce the importance of a well-diversified investment strategy.

Neil Woodford also manages funds for St. James's Place.