



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Market Eye

As financial markets approached the close on Friday, they had enjoyed a positive week, with investors buoyed by a generally good flow of economic news, but mainly drawing comfort from the fact that two key bond auctions went better than expected. Last week, two of the eurozone's troubled nations, Spain and Italy, received a welcome boost when they enjoyed healthy demand for their debt. The two countries managed to sell more than €26 billion of government debt at sharply lower costs than at previous auctions, helping to ease tensions in the markets. The yield on Italy's and Spain's benchmark ten-year bonds fell to around 6.5% and 5.0%, respectively, and the decline in the yields helped ease some concerns over near-term funding issues. 2012 is a key year for the likes of Italy which has to roll over more than €126 billion of sovereign debt at the lowest cost possible. Earlier in the week the country's new prime minister, Mario Monti, gave vent to his frustration with other EU policymakers (and the markets) over their failure to give credit to the recent reforms, saying, "It is a problem that despite our sacrifices we do not experience any kind of concession by the EU, for example in the form of a cut in interest rates."

The flow of economic news, particularly from the US, also helped assuage nerves. The world's largest economy continued to expand slightly at the end of 2011 thanks to robust Christmas spending, according to the US Federal Reserve, following the release of its latest 'Beige Book' report. US data has mainly surprised on the upside since the low point seen last summer and explains why US equities broadly ended the year in positive territory. Economists are expecting the country to grow by about 2.5% this year, which contrasts sharply with expectations for much of the EU to contract in the first quarter as a result of the ongoing sovereign debt crisis. And, once more, it was worries over this that, at the last minute, pulled the rug from under the markets. Shares gave up some of their gains following reports of imminent downgrades of at least two countries – France and Austria – by rating agency Standard & Poor's. Following the close of EU markets on Friday, S&P said France was being downgraded by one notch, to AA+; although France still has a top AAA rating from the other two main ratings agencies, Moody's and Fitch. S&P also cut its ratings for Italy, Spain, Cyprus, Portugal, Austria, Slovakia, Slovenia and Malta. Credit ratings are used by banks and investors to decide how much money to lend to particular borrowers and they influence underlying bond yields.

The ratings downgrade by S&P also had an impact on the euro. The single currency, which has been under pressure since the outbreak of the eurozone debt crisis, was trading at 97.12 against the Japanese yen and at \$1.26 against the US dollar in Asian trading today. The euro has fallen 19% against the yen since May last year and that does not bode well for Japanese exporters who rely heavily on demand from the eurozone region. It has also fallen against the US dollar. Analysts said the continued weakness and volatility in the single currency was also denting investor sentiment. Of course, the flip side of this is that a weaker euro will help the eurozone's exporters compete better and thus potentially boost GDP – much as it has for the UK following sterling's near 25% devaluation during the Lehman crisis.

For good measure, the eurozone's biggest problem state, Greece, also threw a spanner in the works as a result of talks over its debt restructuring breaking down on Friday, making it increasingly likely that Athens will suffer a full-scale default. International lenders have taken a tough stance over this issue and said that the latest offer from Greece failed to spread the burden of losses to include private as well as international lenders. Nevertheless, by the end of the week most major equity indices still closed with gains, reflecting a certain degree of *sangfroid* amongst investors and showing that much of the news was expected and already priced into equity values.

What will this mean for the Eurozone?

Last week's events demonstrate how tortuous the path to a final resolution is going to be. But despite investors' worries, the final outcome could be far more positive and it is worth reflecting on how, ultimately, the eurozone might emerge from its current crisis. Last week, Cato Stonex of THS Partners gave an insight into how events looked from a fund manager's perspective. This week he discusses why Europe could present a huge opportunity. "We are still in the middle of Europe's transformation towards greater competitiveness through deeper integration. The problems of a general Western financial collapse have been exacerbated by specific European policy errors or confusions. The degree of rigidity experienced in trying to get the 17 members of the eurozone, or even Germany and France, as its natural leaders, to agree common measures, is testimony to the scale of the barriers facing the whole process. Nevertheless, Europe's difficulties should not be overstated. In comparison with the rest of the OECD, its sovereign debt and deficits are not so problematic, with government debt to GDP of around 85% vs. 100% for the United States and over 230% for Japan.

"But of course in order to reach the long term, you need to survive the short term. In this case that means preventing a cardiac arrest of Europe's banking system through the deterioration in the valuation of the sovereign debt held by its members. The European Stability Mechanism, essentially a European International Monetary Fund, will have €500 billion of deployable capital, making it the largest institution of its kind in the world. To these resources must be added the newly agreed additional contributions made by EU members to the IMF which amount to €150 billion. More significant than all this, though, the President of the European Central Bank (ECB), Signor Draghi, has confirmed his readiness "to do whatever it takes" and provide unlimited liquidity to eurozone financial institutions, by greatly liberalising the assets they can pledge as collateral for loans and by extending the maturities available to three years. This is all in addition to the facilities already available which allow European banks to buy government bonds and repo them at the ECB at the current 1%, and thus earn healthy margins. Draghi's clear intention is to have the ECB gain the initiative over European government bond yields, without compromising its independence, and stay within its mandate. Importantly, the ECB has plenty of firepower, so far owning less than 2.5% of all issued European government bonds, while the Fed and BoE have purchased nearly 18% of the Treasury and 30% of the gilt markets, respectively.

"But there is also, surely, the point that the crisis itself has made a repetition much less likely. Just as the Asian banking crisis inoculated the region's financial system, to a significant degree, from the fallout of the Lehman's crash, so, now, the European sovereign debt crisis may pave the way for the EU to become an area of relative fiscal probity. Indeed, one might say that what is remarkable is that there has not been more disruption and protest in the affected countries. Perhaps what is really important is that the crisis has brought home to Europeans, at every level, the hard truth about their position in today's world. This vastly increases the chances that they will rise to the challenge. Europe's problem used to be complacency – that is no longer possible. Further measures will be necessary to promote growth and democracy. The Germans are ready to entertain, for example, tax breaks to private sector investments in deficit countries. They are even prepared to envisage, after clear progress has been made on cutting excessive deficits and the ratification of a new EU treaty, the introduction of eurobonds. Ultimately, we believe that Europe has a fair chance to come out at the other end of this crisis in much better shape than any other great region of the world. To the fundamental renewal possible in creating a truly integrated Continental-scale economy must be added the underlying geopolitical strengths which the Europeans enjoy: their location adjacent to Russia and Asia, as well as to the Middle East and Africa, their distance from the new prime zone of tension and rivalry of the Pacific; and their relative immunity from water and food scarcity and the other challenges of climate change and runaway population growth."

THS Partners manages funds for St. James's Place.

Coupons Count

The starting point for any investor, to use a well-known adage, is to "buy low and sell high". Of course, investing is never as simple as it appears but, as the chart below illustrates, for those investors willing to take a medium- to long-term view, European equities are cheap – particularly against US stocks, as shown – and are therefore likely

to offer more upside than other asset classes which have been in huge demand as a result of the sovereign debt crisis, namely German, UK and US bonds.

Exhibit: Trailing P/E for the US and the EMU



Source: Datastream as of 19 December 2012, using aggregates for EMU data and S&P500 for USA.

To illustrate the earlier point, Berlin last week sold €3.9 billion of six-month money at an average real yield of minus 0.01%. In other words, investors are now so nervous they will actually pay for the privilege of lending to Germany. Even taking a longer view and looking at bonds maturing in ten years, the story is the same: yields on German Bunds, UK gilts and US Treasuries are below 2.0% gross and, if one adjusts for inflation, investors are guaranteed a negative real return. It is a similar story for cash, as we know; and, with the UK economy struggling, it is unlikely that interest rates are going to rise soon. Indeed, the Bank of England confirmed that once again borrowing costs are to remain at 0.5% and, in the market, expectations from the likes of Citibank are that interest rates may not actually start to rise until 2016. Against this backdrop, those of a longer-term disposition will find the FTSE All-Share Index, with an historic yield of 3.4%, net of basic rate tax, more rewarding.

The yield from some of the UK's largest corporations is, in many cases, significantly more, with blue chips having a reputation as a 'safe haven' during difficult times and the case for dividend investing looking intact. The empirical evidence is clear that dividend-paying stocks do well. For example, a study of British stocks from 1955–1988 by Capel-Cure Myers showed 6.3% of excess annual investment return between the top decile of dividend payers and the broad market. Longer-term data corroborates the importance of income, with re-invested dividends accounting for around 80% of the 'total return' from UK equities. Today, as a result of investors' risk appetite being at such low levels, share valuations in the UK (and Europe as mentioned) are as depressed as they have been for 20 years and thus offer potential for prices to recover. In other words, equity markets have been pricing into share prices over recent months the strong likelihood of Greece defaulting with all its associated ramifications for the eurozone. In response to the events of last week, European markets have reacted very calmly this morning, implying that the 'news' came as no surprise. This doesn't mean to say that prices can't fall, but the argument for investing in equities over the long term looks increasingly attractive. Many equity income funds are offering starting yields in excess of 4.0% (net of basic rate tax) which means that investors are, in the meantime, being paid quite handsomely for their patience. As ever, though, the skill is to diversify across a number of different asset classes to help reduce the risk inherent in investing.