



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Summit snowballs

- Davos deliberates decisive eurozone action
- Portugal comes under spotlight as yields hit euro-era highs
- US equities retreat from bull market territory on GDP data

The world's political and business leaders gathered in Davos for their annual wintry jamboree – the World Economic Forum. The number of such gatherings since the summer does foster a nagging sense of summit fatigue and the event was characterised by the usual statements of great intent from politicians. As always, actions will speak louder than words.

Inevitably, eurozone debt reduction was the talk of the town. Discussions during the week and at a European finance ministers' meeting today have focused on plans to bolster the 'firewall' put in place to bail out Greece and other struggling eurozone members. One option being considered is the consolidation of the two rescue funds already in place – the European Stability Mechanism and the European Financial Stability Facility – providing a combined war chest of €770 billion. Pressure is also increasing for public lenders to share the pain of a write-down in the value of Greek bonds. Private lenders have been asked to take a 'haircut' of 50% and the European Central Bank may also be forced to do so to push through a badly needed debt reduction for Greece. Delays in reaching a final agreement have been weighing on the equity markets over the past few days.

As we have stated many times over the past few months, political agreement is the key requirement; a point stressed by both the Chancellor George Osborne and his US counterpart, Tim Geithner. Osborne challenged European leaders to "show us the colour of your money" before the UK was willing to contribute more to the IMF bailout pot, while Geithner opined that:

"Eurozone countries need to convince financial markets that they can respond to any eventuality. All that is required is the political agreement."

After similar action taken by rival ratings agency Standard & Poor's earlier this month, Fitch added fuel to the fire on Friday by downgrading the ratings of six eurozone countries, including Italy and Spain. The news had little initial impact – Italy's 10-year bond yield finished the week below 6%, having been well above 7% earlier this year, while Spain's dipped below 5%. However, there was no respite for Portugal. Draconian austerity measures have failed to reduce its borrowing needs and concerns mounted that the country was heading for a similar fate to Greece, driving its 10-year bond yield to a euro-era high above 15%. Kasia Zatorska at Lombard Street Research commented: "The Portuguese economy is already in the downward debt spiral and once the Greeks have negotiated a reduction in their debt burden – most likely in a disorderly manner – the Portuguese will be tempted to do the same."

The key event of the week was the Federal Reserve's statement that US interest rates would remain "exceptionally low" until late 2014. It also made clear that further asset purchases to boost the economy had not been ruled out. This dovish stance helped counter lingering worries about the eurozone debt crisis and pushed the S&P 500 Index into bull market territory, defined as a 20% rise from the cyclical low it reached last October.

Amongst those announcing fourth-quarter earnings, Apple confirmed a bumper set of results and briefly became the largest US company by market capitalisation as its shares surged 6% on Tuesday. Indeed on Wednesday,

turnover in the company's shares was \$15.5 billion, compared with \$5.2 billion total turnover in the FTSE 100 Index. However, Wall Street failed to maintain the momentum as disappointing US housing and gross domestic product data backed up the Fed's cautious tone. The US economy grew at an annualised rate of 2.8% in the final quarter of 2011; the best showing since early 2010 and stronger than the 1.8% recorded in the third quarter, but short of the 3% most forecasters had expected. The figures confirmed that, despite ambitions to move the US economy away from a reliance on consumers, the current recovery remains highly dependent on their spending, which still accounts for two-thirds of GDP.

From the aforementioned Davos summit, Timothy Geithner, the US Treasury secretary, insisted that the US economy was "in better shape than we could have hoped for", and added that he expected the economy to grow between 2 and 3% this year. The S&P 500 Index ended the week marginally down, by 0.08%, although still on track for its best ever January.

Double-dip doubts

- Muted response to UK recession fears
- Downside risks and upside opportunities remain

In contrast to the positive US numbers, Wednesday saw the release of preliminary figures from the Office for National Statistics (ONS) confirming that the UK economy shrank by 0.2% in the last quarter of 2011 and grew by just 0.9% over the year as a whole. The quarterly fall in GDP was the first since the last three months of 2010, when freezing weather was blamed for a 0.5% drop. This time it was the fault of the warm weather as people turned down the heating, causing a 4.1% drop in electricity and gas production. The figure was not unexpected but worse than had been feared, as most economists had forecast a 0.1% fall in activity. The previous day, the International Monetary Fund (IMF) had cut its growth forecast for the UK economy in 2012 to 0.6% from 1.6%.

That the news came as little surprise was reflected in the phlegmatic response of the markets, which were equally unfazed by the inevitable debate over whether the UK is now halfway towards a double-dip recession, technically defined as two successive quarters of negative growth. The FTSE 100 Index ended the week virtually unmoved, having risen 0.09% but 2.9% up for the year to date. Graeme Leach, the chief economist at the Institute of Directors, said:

"The tightrope walk between recession and recovery continues. We've taken one step towards a double-dip recession, and it's now probably 50-50 as to whether we'll take the second. It's important to stress that the 0.2% fall in GDP is not large and could be reversed as QE2 works through the economy. But even if output does increase in Q1, we'll continue to experience a feel-bad jobless recovery for some time yet. Indeed, the combination of falling output and [Wednesday's] MPC minutes suggest QE2 could be further expanded in February."

Whilst the market has discounted a lot of poor economic news, a further escalation of the crisis, a disorderly default and exit of the euro by Greece would clearly threaten the world economy and global stockmarkets. However, for the first time some are beginning to think the previously unthinkable and reflect on the outcome for markets if economic news does slowly begin to look better and the eurozone avoids imploding. A double-dip recession would be the first for 37 years but what does it mean for investors? In three of the last five recessionary periods the UK stock market has actually risen and the ratio is similar for US recessions and market returns. That said, America, in the shape of the National Bureau of Economic Research, has a different definition of recession: "a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale retail sales".

Whatever the definition, for those with the necessary medium-term time horizon, bad news for the economy can signal a good time to buy into the markets. Albeit with the usual caveats, history shows that the stock market has a knack for discounting future events and will turn up well before an economical recovery is evident. Indeed it will often pick up when the outlook is at its worst, typically rising 6 to 12 months before a rise in GDP.

Analysis by Fidelity shows that an investment made in the FTSE All-Share Index at the end of the last recession – the second quarter of 2009 – would have made 56% in the following two years. The same two-year figures for the 1990s’ and 1980s’ recessions would have been 18% and 30% respectively.

The potential long-term opportunity presented by current equity markets was suggested in analysis by J.P. Morgan, which last week showed that UK stocks are the cheapest in the world compared to their historic averages since 1987. At 9.6 times next year’s earnings (the p/e ratio), shares are 31% below the historic average. This compares with European shares at 9.9 times, 30% below their long-term average; and 12.3 times for US stocks, which is 21% lower. However, the advice for investors remains the same: shares need to be viewed as long-term investments, not quick-win solutions, and a well-diversified portfolio will help cushion the impact of the likely continued volatility in markets.

Don’t forget the dividends

- UK dividend payouts rise to record levels
- Dividends contribute two-thirds of total equity returns
- Many blue-chip companies yielding double the level of cash returns

Further evidence of the disparity between the prevailing macroeconomic concerns and the health of many companies came from Capita Registrars’ report on UK dividends in 2011. British companies handed out a record £67.8 billion in dividends last year; the first rise since the financial crisis took hold in 2008. Reflecting the fact that many companies have strong balance sheets, unlike debt-laden individuals and governments, the payouts represented a 19.4% increase on 2010 and expectations are that this upward trend will continue, with an increase of 11% forecast this year.

Of course, last year’s improvement was from a low base, coming on the back of banks and other companies scrapping dividends in 2009/10 and the suspension of the BP dividend following the Gulf of Mexico disaster.

The slow drip-feed of dividend income is often overlooked by the headline writers who focus on fluctuating share prices, but an oft-quoted fact is that about two-thirds of equity returns are from dividend income. Over the last decade, the FTSE 100 Index is up just 12%, but up 60% including reinvestment of dividends. With the same index currently offering a prospective yield of 4.4%, UK shares present an appealing alternative income stream for those with cash languishing on deposit who are willing to increase their risk levels.

But it is dividend growth that matters as much as the absolute level of income paid. Whilst the UK has long been seen as the traditional source of equity income, the ‘dividend culture’ is well established in many other countries – there are more than 90 companies in the US which have increased their payouts to shareholders every year for at least a quarter of a century. Indeed, of the top 100 global companies based on dividend yield, only 5 are UK companies whereas 45 of them are in Western Europe. Just ten years ago, only 5% of companies in the FTSE World Index yielded over 3%; today 30% of those companies achieve that benchmark. But in these testing times, in order to negotiate the road ahead, it is vital that investors discriminate between high yields that are a function of a company in trouble, whose share price has hit rock bottom, and those paid by cash-generative companies that are, for whatever reason, undervalued.