



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

Dodgy Data

In a world of instant communication it is no surprise that the release of economic and financial data can move markets up and down in a matter of minutes. Any investor who watches the markets will have understandably become quite frustrated in recent months as the flow of economic news goes from positive, to negative and often back to positive again. Last week was no exception in some respects – data was mixed throughout and was capped off with what some observers saw as a set of particularly dubious figures from the Halifax. According to the bank, UK house prices suffered their largest one-month fall since records began over 25 years ago – down 3.6%. Unsurprisingly there was scepticism in the market and even the mortgage lender itself cautioned against reading too much into one set of figures, pointing instead to the latest quarterly drop of 0.9% – in line with the Nationwide Building Society's own index. **The Times** came to the conclusion that with some 30% of property transactions being done in cash the house prices indices are becoming increasingly unreliable.

On a more global view, the IMF released some data of its own. This time the message was that any slowdown in the economic recovery would push the UK's debt as a proportion of national income to almost 100% – up from its current level of 77%. To put this in perspective, Ireland's debt ratio is currently 92% and Greece's 130%. The IMF's stress test assumed global growth coming in 1% lower than the expected 4.2% next year. Growth may well have slowed a little but the world is still growing, albeit at different levels. For example, it seems that swingeing government cuts in Ireland mean the country's economy is unlikely to grow at all, whilst Greece's economy is expected to shrink by 2.6%, yet it unveiled a budget last week setting out even deeper spending curbs. Conversely, Germany saw industrial orders surge in August, up by 3.4% as businesses raced ahead – especially the automotive industry. Here in the UK the dominant services sector enjoyed better-than-expected growth in September with the activity index rising to 52.8 (any reading about 50 indicates positive growth). "The survey at least provides some reassurance that the economy is not plunging head first into a renewed contraction," said Vicky Redwood of Capital Economics. Industrial growth rose in August too, along with construction; yet, perplexingly, confidence levels in the sector are now at their lowest for 18 months.

More Yo-Yos

It's a similar story in the world's largest economy too. The US housing market is displaying further signs of stabilisation following the release of data from the National Association of Realtors' index showing pending homes sales rising 4.3% in August. As **The Financial Times** noted, it appears that the property sector is regaining some ground, albeit from a low level. Activity in US services also rose last month with the US Institute for Supply Management saying its index was up to 53.2 from 51.5. But the one number that finally swung it for investors was the US non-farm payrolls figure. Earlier in the week a poor set of US labour market figures caused the dollar and US Treasury bond yields to plumb fresh lows and gold to climb to a record high. According to ADP Employer Services, private payrolls fell by 39,000 in September and set the scene for Friday's employment report which showed that, contrary to expectations, the economy shed 95,000 jobs. To put this in context, **The Financial Times** reckoned that, more than a year into recovery, the economy ought to be creating 300,000 to 400,000 jobs a month if unemployment is to fall from its current level of 9.6%. The paper also pointed out that the loss of 76,000 local government jobs speaks of further pain as the stimulus wears off. And it's not just the unemployed who are likely to stifle increased consumption – America has another six million people working part-time because they cannot find a full-time job.

So the question being asked by most economists – and the White House which faces mid-term elections in November – is why America's recovery is proving so fragile and tenuous. Well, according to a former chairman of the US Federal Reserve, Alan Greenspan, it is fear that is undermining recovery. Writing for **The Financial Times** he pointed out that fixed capital investment (by businesses) has fallen far short of the level that history suggests should have occurred given the surge in corporate profits. Combined with a collapse of long-term illiquid investments (property) by households, this has, in his view, frustrated economic recovery. Mr. Greenspan went on to say that these shortfalls in spending were the result of widespread private-sector anxiety over America's future. This has led to businesses and households responding to the uncertainty by disengaging from those activities. The net result is that households are paying down debt and businesses are hoarding cash – by mid-2010 total liquid assets had risen to \$1,800 billion, the highest share of total assets in half a century. Unsurprisingly, Mr. Greenspan concluded that the greatest unknown was how long it would be before lasting economic growth unfolded.

QE2 Launched

Not by shipping line Cunard, but by the US Federal Reserve and most likely the Bank of England too. As discussed above, the ongoing weakness of economic recovery and uncertainty will, in the eyes of the markets, almost certainly mean that America's central bank will embark on a second round of quantitative easing (QE2 for short) – the so-called printing of *virtual* money in an

effort to pump-prime the economy once more. Having already spent some half a trillion dollars buying bonds (thus keeping interest rates low), Ben Bernanke is being urged to do more – the Fed chairman left the door open to this policy in his most recent testimony to Congress. Economists at ING said they favoured an incremental version with an initial amount of around \$250 billion, with the promise of more if needed. Here in the UK the CBI is calling on the BoE to do likewise by adding another £50bn to its existing QE programme of £200bn. Indeed, Chancellor George Osborne gave himself room for such a move by saying, “If it [the BoE] makes judgements, I would want to basically follow those judgements.” Speaking after a breakfast meeting of G20 member nations, Mr. Osborne also joined the chorus of ministers calling for “market-orientated” exchange rates, amid worries about a possible currency war as countries attempt to devalue their way to export growth.

The link from QE to currency manipulation is a natural follow-through according to economist Liam Halligan of Prosperity Capital Management. Writing in **The Sunday Telegraph**, he said that QE is now being seen as a policy designed to weaken a country’s domestic currency (by increasing the supply) in order to make exports more competitive and lessen the real value of sovereign debt (government bonds) held by creditors overseas. Since expectations by the markets of a second round of QE surfaced in recent weeks the US dollar has fallen significantly – sterling has risen to almost \$1.60 for example – and should therefore help exports. However therein lies the rub. The race for cheaper currencies has just begun – Japan intervened last month in the currency markets for the first time in six years by spending some \$15bn selling yen. China is determined not to lose its competitive edge though as any threat to its economic growth could have serious social implications for its government. So since China’s trading partners can’t get it to increase the value of its currency – it has been dropping in lock-step with the dollar – they have decided to reduce the value of their own currencies in a round of devaluations which could be harmful to the world economy. These international frictions have led the IMF to try and strike a deal but it has failed so far, despite US calls to deal with the issue more forcefully.

Sugar Rush

Against this backdrop financial markets have reacted fairly predictably – the dollar is down, gold is up and yields on quality government bonds are at rock bottom.

Over in the equity markets investors have already made up their minds that central governments will add a further stimulus. “This is now happening through quantitative easing in Japan and will almost certainly happen in the US and down the road also in the UK,” was the view of Danske Bank, clearly shared by many others. Last week global equities rallied smartly in anticipation of more cheap money with the Dow Jones Industrial index closing above the 11,000 mark for the first time since May. It was a similar story elsewhere with nearly all the major shares indices advancing steadily as investors bought up shares across the board. Some well-known investors are extolling the virtue of a ‘Bernanke *put*’ for the stock market – in other words any signs of further weakening will lead to more easing by the Fed thus protecting equities from the risk of losses – effectively an equity *put*. But as **The Financial Times** pointed out, whilst the signs are promising there is no guarantee that QE2 will work.

Solid Optimism

One fund manager whose glass is most definitely half-full is UK equity manager, John Innes of RWC and here he explains why.

“This is a most interesting time in the financial markets. Many participants are still very nervous following the credit crunch and the authorities’ extraordinary response, leaving some fearing deflation and others worried about roaring inflation and some that we will experience both at the same time! Previously I have been pretty gloomy about the UK economy. The situation is still not good but with one very important and positive change for UK companies. After 13 years the UK has an administration that is no longer taxing the private sector to expand a less productive public sector. This must be to the advantage of those investing in UK companies and hopefully will result in a stronger recovery in time.

The most obvious global trend currently is the shift in economic power from the developed to emerging economies. The current exuberance for developed economy [government] bonds does not seem to me the safest route at all for real wealth preservation in this environment, whereas selected equities do give you a genuine route to participate in the increase in global prosperity. So it should be no surprise that the portfolio is positioned for economic recovery and a positive market trend. The equity market is supported by both valuation and liquidity. The philosophy of the fund is supportive as many stocks in the cyclical and financial sectors are still regarded with suspicion and in an investment world where the current fears are dissipated then these stocks should perform well. The cyclical element of the fund is also heavily biased towards emerging economy growth but where share price valuations are low, for example, Xstrata, Cookson, Charter and GKN; but the fund remains cautious on exposure to the UK consumer. So overall I am positive: the UK market is cheap, liquidity is increasing, M&A activity is picking up and share buy-backs are becoming more common. The next few months are looked forward to with optimism.”

John Innes manages the St. James’s Place UK Growth Funds.