



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Market eye

Investor risk appetite improved sharply last week, enabling major global equity indices to rally strongly – from London to Hong Kong share prices were up anything between 3 and 5% on the week. The rises were fuelled in part by greater optimism over the eurozone – discussed more below – following Slovakia's support for the latest bailout plan and confirmation that Greece would receive its next tranche of bailout funds from the ECB/IMF/EU 'troika'. Investor sentiment remains fragile, though, with ongoing concerns about a possible 'hard landing' for China's economy as a result of slowing Western economic growth. However, there are some signs that the US economy is stabilising after the recent run of poor economic data and hawkish noises from the US Federal Reserve – a retail sales report from the U.S. Census Bureau on Friday showed that for September, consumers' outlays rose the most in any month in seven months. Consumer spending accounts for over 70% of American GDP and so is crucial to any growth revival.

The markets have been paying particular attention to any sign from US policymakers that they may embark on a further round of quantitative easing – colloquially known as 'QE3' – as a way of boosting US growth. The release of the minutes from the Fed's September meeting showed that the prospect of further stimulus is still on the cards if the economy weakens further; this would be in addition to 'Operation Twist' launched last month which is intended to drive longer-term interest rates even lower. As discussed last week, the BoE launched QE2 here in the UK to give growth a much-needed boost – it believes that GDP could be anything up to 0.75% higher as a result. The timing of the latest stimulus is well-judged when looked at in the context of the UK economy slowing significantly. Unemployment rose to its highest level in 17 years, for the three months to August, to stand at 2.57m: equivalent to 8.1% of the workforce. Alongside this, leading economic think tanks such as the Ernst & Young ITEM Club (which uses the Treasury's own economic model) suggest growth will be only 0.9% this year, down from an earlier forecast of 1.4%. So it comes as no surprise that investors remain on a state of alert as they look for signs of stabilisation in the West and continued growth in the emerging world.

EU set to 'shock and awe'

Stock market volatility has been a dominant feature during recent months – research shows that, since mid-July, large (2+%) daily fluctuations have been five times more frequent than usual. October is proving no different. After a short, sharp sell-off at the beginning of the month, global markets have bounced back strongly with many indices up more than 10% from their lows. So what has been the catalyst for the latest move? In some respects it is very simple: investors have become more optimistic that at long last, after weeks of pressure from bond vigilantes and global leaders, eurozone policymakers are about to tackle the debt crisis by putting together a comprehensive and effective package to address the issue. As leading economist Martin Wolf succinctly put it, "The broad consensus of the world's policymakers is that the eurozone must now do the following: divide countries into the insolvent and the illiquid; restructure the debts of the former and provide unlimited, but temporary, support for the latter; and recapitalise the banks, after stress tests that allow for losses on sovereign debt, either from national treasuries or from the European Financial Stability Facility (EFSF)."

So how will the package, to be announced on the 23rd of this month at the EU summit, actually work and, crucially, be funded? The eurozone's current rescue fund stands at €440 billion; large but insufficient to potentially bail out Spain and Italy in a worse-case scenario. To address this key issue, EU officials have focused on an insurance plan which would involve the EFSF guaranteeing 20–40% of losses on (government) bonds for struggling eurozone countries instead of buying them as the ECB currently does. Depending on how large such guarantees are, such a scheme could leverage the EFSF's resources to between €1,000 billion and €2,900 billion. The plan, in effect, means that the EFSF gives its word to guarantee underwriting potential losses but without actually handing over any cash. Not that the plan is without risk: the guarantee will include guarantees from Italy and Spain which could, potentially, mean them guaranteeing themselves; and the markets could shy away from such an idea. For now though, investors feel more comfortable that EU policymakers will be forced to deliver a workable solution – large enough to 'shock and awe' and to enable longer-term structural reform to take place.

Paid to be patient

The events of the last two months or so – the eurozone debt crisis and worries over a 'double-dip' recession in the West – have, unsurprisingly, dominated the markets and investors' thinking. Whilst no-one is suggesting the EU will deliver a panacea in two weeks' time or that US growth will suddenly jump forward, it is clear that policymakers have now grasped the nettle and begun to take action about solving the debt crisis and restoring growth. The sideways movement of global equity markets has reflected investors' frustration with the political paralysis so evident until very recently. But after spending much of the last couple of months on macro, geopolitical issues, it is worth focussing back on the fundamental drivers of investment returns over the longer term. There is one successful aspect of investing that has been lost in all the bad news – the importance of dividends to long-term investment returns. It would be easy to think that, with all the market gyrations of late, even this component had succumbed too: nothing could be further from the truth and international investors are slowing waking up to the opportunities that exist for capturing high levels of quality income.

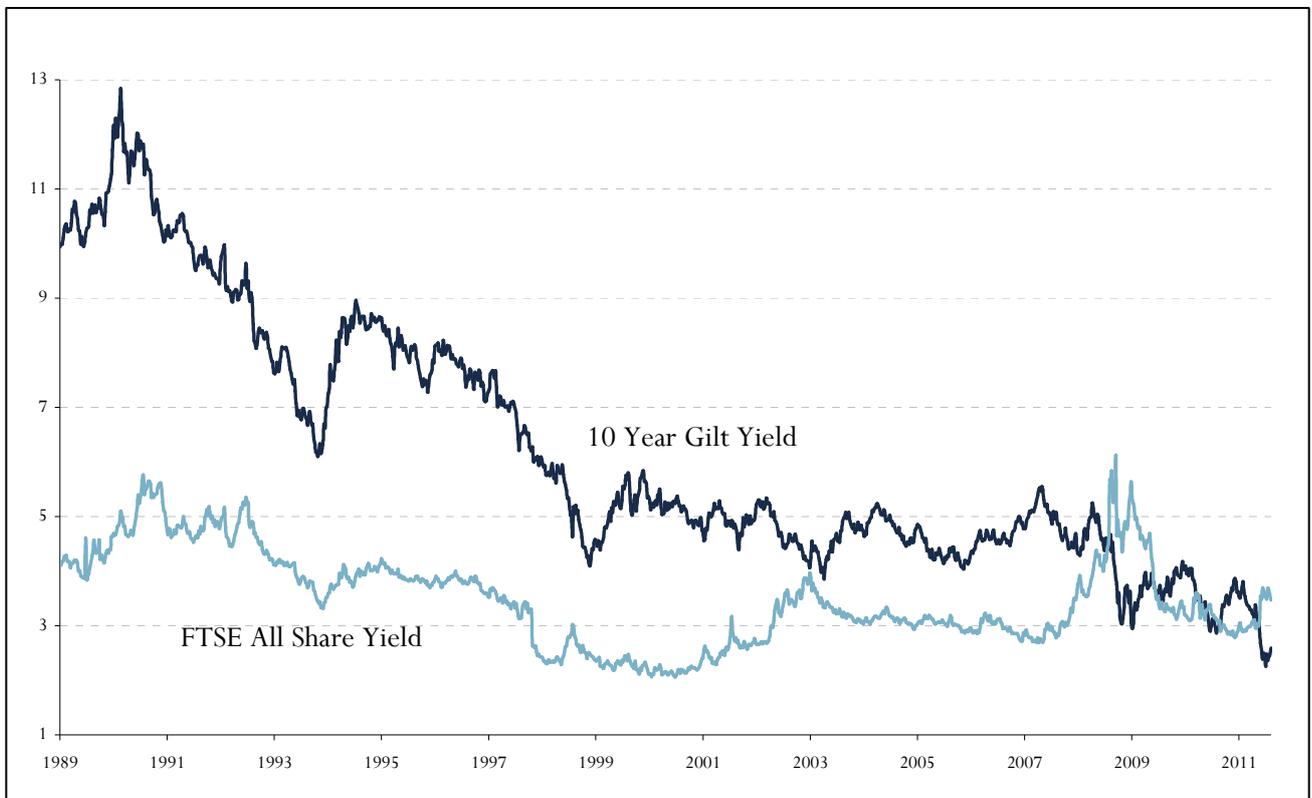
Starting with the basics: dividend income is a fundamental part of real investment because it is about real cash. The amount that a company pays out to shareholders is determined by how much cash it has and is less easy to fudge than, say, explain why it may have missed an earnings target. The other reason to focus on dividends is that they are the most important contributor to total returns from shares, having accounted for almost 90% of total return over the longer term, according to research by Société Générale. The stream of dividends will likely reflect the cash-generative power of the business over time. This in turn means that companies with high, robust and growing dividends tend to be higher-quality companies. The final aspect of dividend income is that it has proven to be an effective way to shield against the effects of inflation: in other words, dividends have grown in real, inflation-adjusted, terms over the long term. By way of example, long-run inflation is 3% (based on the last 100 years) whilst long-run dividend growth has been between 4 and 5% over the same period, meaning investors can hedge against the erosion of their spending power. Another way of looking at it is that income investing can be growth investing in disguise.

Events over recent years have seen share prices fluctuate considerably but dividends have been more stable. It is easy to think that with low economic growth in the West this means that dividends must have suffered too. Clearly there are times when companies have no choice but to cut their dividends to protect their balance sheets – the credit crunch in 2008/9 was a good example but it is exceptional. Since then, companies have concentrated on restoring their financial positions and today businesses have higher than usual levels of 'spare' cash on their balance sheets, giving management the means to return cash to shareholders, either by increasing dividends or via a one-off special dividend. The other aspect of equity income investing is that high-quality companies have robust business models and investors' conviction in these businesses means their shares tend to be less volatile than others over a full market cycle. So, whilst they may not have the racy characteristics of

a growth stock in a rising market, they are likely to weather difficult or turbulent market conditions much better.

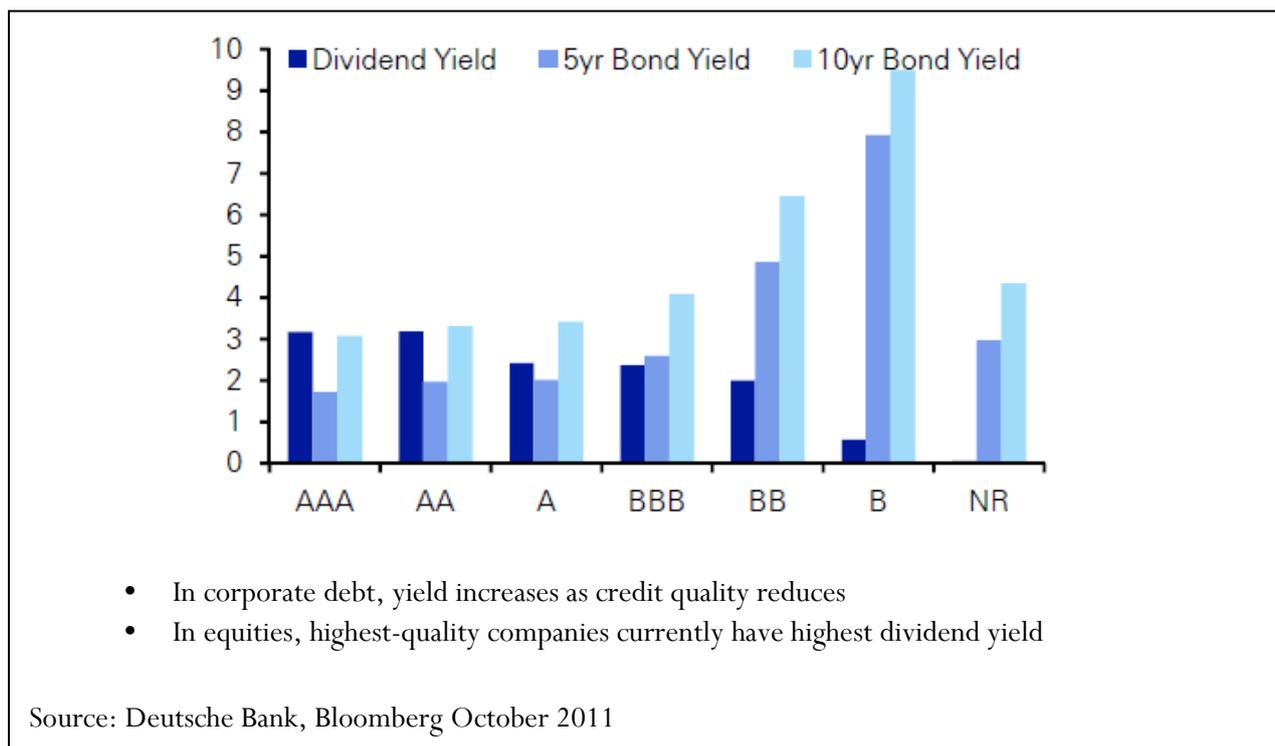
This brings us to the here and now. Is there evidence to support the investing for income (and growth) strategy in current market conditions? Firstly, it is important to compare and contrast and, historically, the yield on a ten-year gilt is used on the basis that it is a 'risk-free' alternative. Investors have taken the view that a gilt should yield more than its higher-risk equity counterpart to reflect the lack of long-term growth from holding a gilt to maturity, and evidence has supported that view. However, on rare (only four times in the last 50 years) occasions, equities have yielded more; but this has coincided with a low point for equity valuations and a rally has ensued. Today the FTSE 100 yields 3.6% (net of basic rate tax) compared with 2.5% (gross) from a ten-year gilt. Furthermore, there has been another unusual twist to events – the yield on many high-quality equities is now greater than the coupon they are paying on their own corporate debt, despite the latter not having the same growth prospects. The two charts below illustrate the points made.

A reversal of fortunes?



Source: Bloomberg. Data to 14/10/11. Past performance is not a guide to future performance.

Bond equity conundrum



The last aspect is to look for current evidence on dividend payouts. Taking the UK, British-based firms have paid out an extra £4.1 billion in dividends in the second quarter of 2011 – up 27% compared to the same period last year. For the first half of the year, dividend payments are up 19% year on year, the fastest increase since 2007 and, encouragingly, growth was broadly spread across most sectors. According to Capita Registrars UK Dividend Monitor, underlying dividend growth for this year will be 10.2% – significantly ahead of inflation. To illustrate the changes taking place, AstraZeneca increased their dividend by 21% at the half-year point; likewise, BAT was up 15% and Centrica 12%. Of course it is a global story, not just confined to the UK: there are companies like US-based Johnson & Johnson which has an astonishing track record of having increased its dividend payment every year, for the last 48 years; a point made by fund manager Richard Oldfield.

“It seems to us at the very least that investors will do better holding Johnson & Johnson or Canon, each currently yielding about 3.5% over the next ten years with a decent prospect that dividends will rise, than 10-year government bonds. Before the last recession there were only five years in the S&P 500’s history when dividends declined and the maximum decline was just 3.3%. So we will continue to have a balance in the portfolio between high-quality companies where their financial characteristics currently appear under-appreciated; that is high returns on equity, brand names, large market shares and relatively un-volatile earnings along with other, often more cyclical, businesses.”

Richard Oldfield manages funds for St. James’s Place.

The final point to consider is the importance of diversification, not just at asset class level but at fund manager level too. Within our range of income portfolios we have consciously put together a number of fund managers who have their own distinctive approach to selecting stocks, knowing that it helps reduce volatility and risk. So it seems to us that, notwithstanding the big picture of which we are all aware, there are some good investment opportunities currently available to investors. Whilst investors are obviously keen to see growth in their portfolios over the medium to long term, the investing for income strategy means that they are, at least, being well-rewarded for their patience in the meantime.