



MARKET BULLETIN



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WEALTH MANAGEMENT

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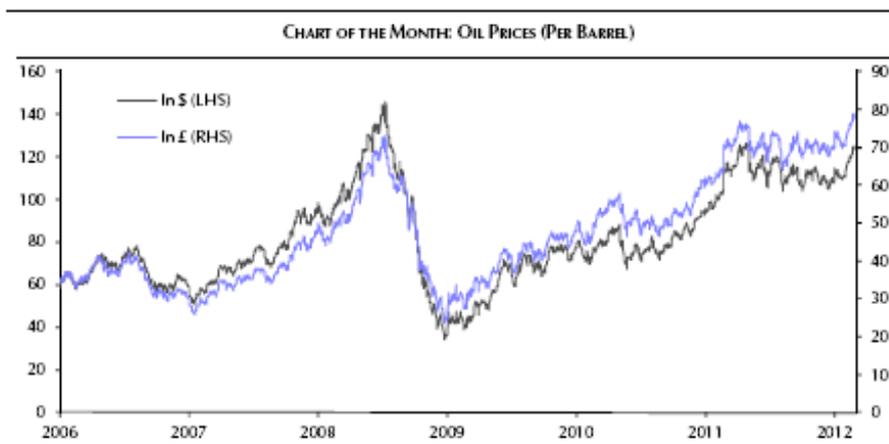
Market Eye

- **Markets consolidate after bull run**
- **Oil prices rise on growing geopolitical tensions**

Global financial markets had plenty to occupy them last week but the final outcome was pretty straightforward: the US dollar was up, oil continued its seemingly inexorable rise and high-quality bond yields were mostly unchanged. As for equities, they took a breather. After a remarkable bull run from their lows last October, share indices in the US, Europe and Asia paused for breath; consolidating gains which, for most, amount to 20% plus. In the eurozone, gains have been even stronger, unsurprising given the huge fallout last year and that bearishness in the region's markets has dropped quite sharply as investors begin to selectively rebuild their exposure.

As explained in our narrative last week, there have been three key reasons why sentiment in global markets has improved so significantly this year. First is the 'shock and awe' power of the European Central Bank's cheap three-year loans to banks, together with better-than-expected economic data from Germany and France. Second is the similarly better-than-expected data for the US economy, where unemployment has fallen to 8.3% from the 10% witnessed at the recession lows, and much improved industrial activity. Last is the belief that China has slain the inflation dragon for now, allowing it to relax monetary controls and stimulate its burgeoning economy. As investors re-shape their thinking about the outlook, the mood has improved markedly, causing markets to play catch-up. The flow of data and news last week re-affirmed the position for the most part but one or two aspects kept the markets from becoming complacent.

Over in the commodity markets, the price of crude oil continued to rise, amid rising geopolitical tensions and a positive outlook for future demand, as the global economy continues to grow apace. At one point the price of a barrel of Brent crude touched \$128.50, before ending the week at \$127.52 – up another 1% on the week. The chart below illustrates how the oil price has rallied in recent weeks, hitting new highs in sterling and euro terms with all the ramifications for inflation and consumer spending. It is an indicator that will be watched closely by policymakers and markets alike over the coming weeks.



Source: Capital Economics, March 2012

The ECB's 'Bazooka'

- **Banks rush to secure more cheap money**

As expected, the ECB injected another huge shot of adrenalin into the eurozone financial system in its second tranche of LTRO (longer-term refinancing operations), totalling some €530 billion. This time, some 800 banks rushed to take advantage of the Bank's cheap (it costs them only 1% p.a.) three-year loan deal – much more than the 500 plus that participated last time. As expected, Italian and Spanish banks dominated the take-up, accounting for almost half the funds on offer. Last December the two countries accounted for 46% of LTRO which, given their respective cash-flow requirements, comes as no surprise: Italy's Intesa Sanpaolo and Spain's Bankia took 10% between them, with Dexia and UniCredit not far behind. One surprise was that Lloyds Banking Group took €13 billion, the largest take-up by a non-eurozone institution. The other real surprise was that half of the 800 banks involved were German.

So despite some criticism from the Bundesbank, Mario Draghi's latest cash tonic remains widely popular as it has given banks much-needed time to begin to repair their balance sheets and bolster their capital ratios: the European Banking Authority is currently assessing banks' plans to do so by June. Further confidence in banks is essential to address another vital component of the money markets, a return to a healthy level of inter-bank lending. As with LTRO1, there is wide expectation that some of the new liquidity will be recycled by banks buying higher-yielding government bonds in what is known as 'carry trade'. Last year's first tranche enabled Spanish and Italian banks to borrow at 1% and then to use some of the funds to buy their own sovereign bonds which were yielding between 6 and 7%. Since LTRO1 the yield on Spanish and Italian ten-year debt has fallen dramatically to near 5%, taking pressure off their respective governments and giving the banks a healthy profit. But there is still work to be done in the eurozone as last week demonstrated; Portugal is struggling to reduce its deficit and Spain told eurozone leaders that it would not meet its target to cut its budget deficit to 4.4% of GDP this year.

Such was the success of the ECB's boost it meant that, refreshingly, for once, Greece hardly had a mention. So has the eurozone crisis finally been resolved? Almost certainly not, but what has been bought is time: it has enabled the Germans to further implement their plans for full fiscal integration of eurozone members. On Friday, European leaders approved new rules to curb government borrowing and allow them to claim that the emergency measures had settled financial markets and that the worst of the crisis was over. Some were more ebullient than others, but Nicolas Sarkozy said:

*“We have not exited the economic crisis but we are turning the page.
The strategy we put in place is bearing fruit.”*

So will this mean the end of cheap money? There are some in the markets who believe that more may be needed and there might be an LTRO 3 – citing the Bank of England's recent decision to embark on QE3 for the UK. Indeed, Ben Bernanke disappointed the markets last week by not providing direction on the prospects of more US-style QE.

Bernanke Cautious

- **No news on further QE**
- **Gold falls as markets are jolted**

The craving on the part of investors for more stimulus is not, as suggested above, something peculiar to the eurozone: all eyes were on US Federal Reserve chairman, Ben Bernanke, last week as he delivered his periodic testimony to Congress on the health of the economy. Mr Bernanke struck a downbeat tone on the health of the American economy, in spite of the upward revision of growth in the fourth quarter of 2011 from 2.8% to 3.0%. In his speech he said that the labour market was doing better but went on to say that the fundamentals supporting consumer spending – a crucial component of growth – continued to be weak. His comments coincided with data from the Bureau of Economic Analysis which showed that most of last quarter's growth

came from an inventory build-up. Whilst the Fed chairman was silent about another round of quantitative easing he did, in true form, couch his comments in such a way that they left the door open to possible further stimulus, saying, "... it will be especially important to evaluate incoming information to assess the underlying pace of economic recovery".

The absence of any hints on more Fed easing gave markets a jolt: gold promptly fell almost 3%. The yield on 10-year US Treasuries rose modestly; leaving all the running to the dollar, which rose 1% against the euro. In the currency markets, some traders believe the dollar will continue its rally unless there are signs that Mr Bernanke does indeed intend to boost the economy with a further round of QE. Although Fed officials expect inflation to stay low into next year, their chairman did comment on rising oil prices, saying it would impact temporarily on both inflation and consumers' purchasing power. Despite Mr Bernanke's failure to drop any hints of more QE, bond investors believe the lingering possibility of further monetary easing is likely to keep a bear market in bonds at bay for now. Analysts believe that interest rates could remain at effectively zero for the foreseeable future and the Fed's 'Twist' programme is keeping yields ultra-low. That in turn makes equities attractive, which probably helps explain why the S&P 500 Index has managed to hit a new, post-crisis, high in recent weeks.

Property Boost

- **Divergence in prime and secondary markets**
- **Attractive rental income opportunities**

Last week there was news that Britain's construction sector enjoyed its best month for almost a year in February, as work on housing and commercial projects increased – according to a survey from Markit, which publishes the Purchasing Managers' Index. Whilst clearly good news for the economy, from an investment perspective there are opportunities too; particularly in the commercial sector – which is often overshadowed by its residential neighbour, despite its clear advantage of a proven track record of consistency in income generation over the medium to long term. Whilst the buy-to-let sector is reviving, it comes with the specific risk of not offering diversification to the typical investor, unlike the commercial sector which is very broadly diversified. Given ultra-low cash returns available to savers – with no prospect of any immediate change – it is worth considering why, as part of an overall diversified portfolio, commercial property might be included.

Phillip Rodger is a property expert with Orchard Street Investment Management and he explains why, since the financial crisis, commercial property is once again offering good opportunities for longer-term investors.

"As a starting point, it is important to realise that we currently have a two-speed market: prime property versus secondary. The market as a whole comprises retail, offices and industrial or warehousing and there are currently very clear divergences. The secondary part of the market – property that is viewed as poorly situated, is configured in the wrong way and carries high tenant risk – suffered heavy losses during 2008 and has not recovered. Indeed, we have noticed that this part of the market is actually reversing again as lenders begin to foreclose. Whilst high rents are attractive – it is quite possible to pick up properties yielding anything from 8–12% – there are significant risks attached. A rental stream of £28 per square foot falls sharply by the time you have had to offer a three-year rent-free period to a tenant, giving a much lower longer-term sustainable yield.

"For this reason we continue to work in the prime part of the market which has recovered strongly post-crisis. There has been an ongoing flight to quality by overseas investors which has boosted capital values but, of course, reduced yields too. We have concentrated on larger, multi-occupied properties: these are easier to manage, and reduce the risk of tenant default or failure impacting in the same way as if they were sole tenancy. This part of the market, particularly retail, is offering some good opportunities because, overall, supply is tight; there is little new office or retail building going on, so the risk of tenants fleeing to new-builds is slight. The retail side is very interesting as most developments are old and need upgrading; despite the internet, people still want to go shopping in the traditional way. We spend a lot of time visiting properties and assessing asset management opportunities, such as reconfiguration to increase the number of tenants, upgrading and development come to mind, as this can help capital values over a 2 to 3-year period.

“Of course the greatest attraction of quality commercial property is the income stream; and currently yields are very attractive.”

“The part of the market we are interested in yields around 6.5% gross and, as leases contain upward-only rent reviews, there is an element of protection from inflation. Crucial is the security of income and, as a matter of course, we credit-rate tenants – 99.9% of rents due in January were paid compared to around 84% for the market as a whole. Your portfolio has a higher, weighted, unexpired lease term than the broad market, which again means reduced risk and enhances capital values. Where we are today is that your portfolios have yields between 6.5 and 7.2% gross and own high-quality assets which are actively managed. Property has a good long-term track record of delivering consistent flows of income; which in the current low-return environment become even more valuable for investors.”

Orchard Street Investment Management manages funds for St. James’s Place.

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