



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

Monday 2 April 2012

Investors see best first quarter in 14 years

- Best start to the year for US equities since 1998
- Japanese equities see their largest quarterly gain in 24 years

The first quarter of 2012 will be reflected on as a positive one. Investors have been less fearful of a global financial collapse triggered by Europe, concentrating instead on the steady stream of better-than-expected economic data. The FTSE 100 Index closed the first three months of 2012 ahead by around 3.5%, erasing almost two-thirds of the losses suffered in 2011, while similar advances were seen in France, Germany, Japan and the United States. US stocks gave investors their best first-quarter returns since 1998, while the Nikkei 225 Index had its strongest quarter in 24 years, rising more than 19% in local terms.

In contrast, the past week was relatively muted as economic data disappointed analysts. Ben Bernanke, chairman of the Federal Reserve, amplified investor doubts by expressing worries over whether the recent falls in US employment were sustainable, calling for a continued role for expansive monetary policies to support the economy. Such was the bluntness of the speech that talk of a further round of quantitative easing quickly returned to the markets. In general, markets were sceptical about such a move, prompting analysts to question whether indices have got ahead of themselves in recent times.

In Europe, where so much of the focus has been lately, Friday saw an increase to the region's bailout fund to €700 billion. Alongside this positive news, Spain announced tough spending cuts and tax increases designed to save €27 billion immediately. Clearly there is a long way to go before the hangover of eurozone concerns is lifted from the markets, but the first quarter suggests that investors are increasingly looking at long-term fundamentals rather than reacting to short-term sentiment.

There may be a sense of déjà vu as the optimism shown in the first quarter was remarkably similar to that felt by investors at the beginning of 2011. Are we heading for a repeat of last year? Keith Wade, chief economist at Schroder Investment Management, does not think so. "In 2011, the increased optimism about the world economy in the first quarter had evaporated by the middle of the year, bringing a sharp decline in equity markets. The recent rise in oil price is also an echo of that period and may well herald a period of softer activity. However, there are some key differences. The commodity shock is not as great as last year as oil prices have not risen as rapidly. Furthermore, policymakers have acted to support growth, with the European Central Bank in particular reducing the tail risks through the provision of unlimited-term liquidity to the banks. Greece has also received a second bailout."

"The market is cautious, but this is a better basis for the markets to withstand anything that the global economy has in store, especially compared to a year ago."

"Equity markets have made a strong start to the year, headlined by the S&P 500 Index returning in excess of 12% in local terms, the seventh-largest first-quarter gain since 1928. Germany has seen gains in excess of 20%, while the MSCI World Index is at levels last seen before the summer collapse of 2011. Despite the rally in equity markets, government bond yields have remained low. This marks a distinct break from behaviour in 2011, when equities and bond yields were locked together, but any correlation has broken down for now. It must be remembered that, last year, the slowdown could be accounted for by two major occurrences. The earthquake and subsequent tsunami in Japan disrupted supply chains and manufacturing around the world,

while oil price increases during the Arab Spring helped to bring the global economy to a virtual standstill during the summer. We acknowledge that risks remain, but investors should recognise the crucial progress made in the last 12 months.”

The most austere budget in Spanish democratic history

- €27 billion of Spanish spending cuts
- No change to public worker pensions and VAT

Spain last week unveiled a budget described by Cristobal Montoro, the country's finance minister, as “the most austere budget in Spanish democratic history”, cutting €27 billion in spending. However, the measures failed to win over the doubters, falling short of the €34 billion required to reduce Spain's deficit to 5.3% of Gross Domestic Product. The conservative Popular Party government approved the draft budget on Friday, with spending cuts across all ministries averaging 16.9% and a further freeze on all public worker salaries. Contrary to expectations and to the surprise of other eurozone members, pensions will remain indexed to inflation and there was no rise in VAT, disappointing the markets. Shares in British banks fell – their total exposure to Spanish debt is estimated at around €52 billion. Barclays and Lloyds were affected most significantly. The situation threatened to overshadow the eurozone decision to increase its bailout fund to €700 billion, a move welcomed by the International Monetary Fund.

The Spanish austerity measures came 24 hours after a general strike saw more than a million people take to the streets in protest at the expected spending cuts. There will be public relief at the lack of changes to pensions and VAT, especially after the government had insisted changes were essential. Instead, perhaps as a reaction to the strikes, the government changed course and announced a 7% increase in utility bills in a bid to reduce energy subsidies that continue to be a burden on Spain's debt levels.

Economists have already estimated that, as a result of the cuts, 3% will be wiped from Spanish economic growth this year alone, sending unemployment to crisis levels. It is feared that one in three people will be unemployed by the end of 2013 under the new measures, raising fears over how effective these actions can be. However, speaking from Copenhagen at a meeting of eurozone finance ministers, Luis de Guindos, Spain's economy minister, said he was confident the budget would reassure the rest of Europe. He predicted, “Spain is going to stop being a problem, especially for the Spanish people but also for the European Union. We would expect the rest of the eurozone to understand perfectly the effort that the Spanish government is making.”

More details of the Spanish budget will emerge on Tuesday, risking further protests, while the European Central Bank will also discuss the situation at its monthly meeting.

Is Japan primed for recovery?

- Positive sentiment building for the future of Japan
- Change in culture for Japan's banking sector

For many years, Japan has been considered a stay-away area for investors, especially with the country's main stock exchange standing at a quarter of its level of twenty years ago. At its peak in December 1989, the Nikkei 225 Index stood at 38,957. Today, it stands a shade over 10,000. However, with a debt-free banking sector, lean companies, a massive post-disaster spending programme and a sharp change in culture at the Bank of Japan, evidence is stacking up that it may well be an area of interest for the right investor.

Experts such as Andrew Green of GAM, manager of the St. James's Place GAM Managed fund, and Richard Oldfield of Oldfield Partners, manager of the St. James's Place High Octane fund, have said that Japanese companies were in good shape prior to the earthquake and tsunami in March 2011. Both portfolios hold around 25% in Japanese companies. While the events themselves were tragic, the government committed to a massive rebuilding budget, meaning it is one of the few mature economies looking to expand its spending. In addition, February saw a watershed announcement by the Bank of Japan, when it set itself an inflation target of 1% and pledged a limited amount of quantitative easing. The punitive amount of 1% may not sound excessive to the

Western world, but to the historically conservative banking sector in Japan, it is significant that it has bowed to government pressure. Japan has lived with deflation for 20 years, requiring companies to become more efficient to survive by trimming margins and cutting costs. Companies that have experienced those problems tend to be well-positioned once the economy grows, or inflation returns. Historically, inflation is a positive sign for equity markets, as revenues and margins begin to rise, with consumers bearing the brunt of the price increases. With the largest electronic goods industry in the world, and the second-largest automobile industry, corporate Japan could benefit significantly from the expected increase in prices.

Andrew Green recently reported, “Following a year of extreme pessimism shaped by investors’ flight to safety, markets generally have started 2012 with a more confident tone. Our overweight stance in Japan has had a positive impact on returns; and we were encouraged to find the market stabilise despite currency headwinds and in some cases disappointing quarterly results. In particular, we find Japanese banks undervalued in the context of their strong capital positions relative to their western counterparts, which should enable them to deliver shareholder value through more rapid overseas growth.”

Those who invested in Japan in recent times and saw their hopes dashed, could be forgiven for believing this to be another false dawn. Company fundamentals have often looked favourable but led to disappointment, which is perhaps why Japan often forms less than 10% of a diversified global portfolio of equities for a medium-risk investor. However, the potential of the world’s third-largest economy cannot be overlooked over the long term, whilst accepting that investment in the region is likely to remain a higher-risk option.

Time almost up for ISA investment

The end of the tax year 2011/12 is upon us, meaning investors have until midnight on Thursday 5 April to use their full tax-free ISA allowance of £10,680. It is not possible to roll over unused allowances. The ISA allowance will increase to £11,280 (£5,640 into a cash ISA) on 6 April. Of course the favourable tax treatment of ISAs may not be maintained in the future.