Market Overview January 2014

It has been another good year in the investment markets in 2013, as the continual supply of new money created by quantitative easing by the Central Banks in the US, Japan and the UK has found its way into the investment markets, creating excellent returns for global equity investors.

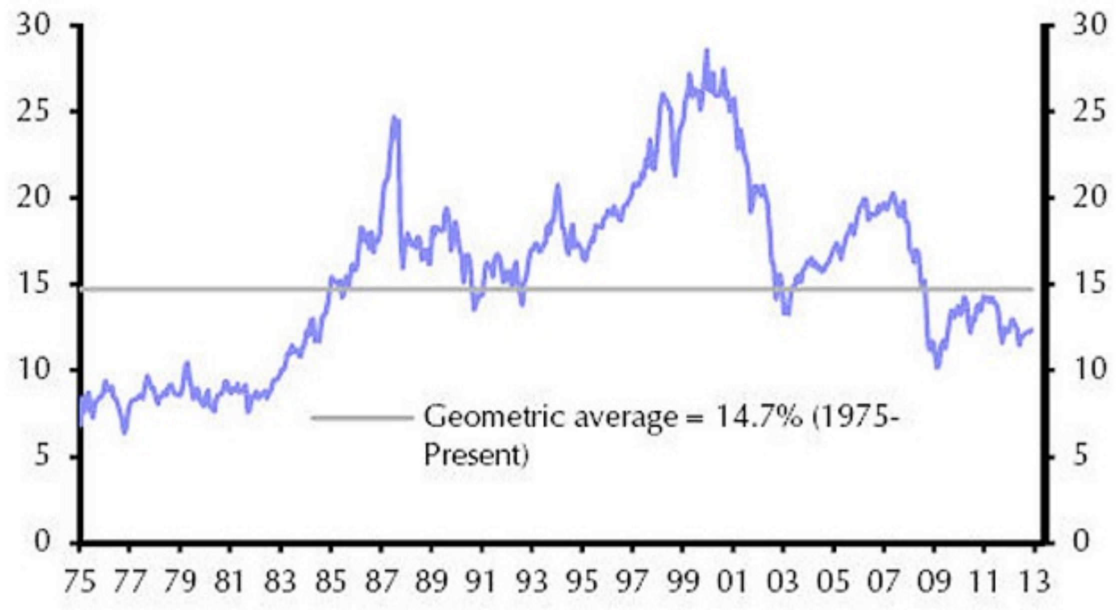
2014 Returns for an average UK Equity Income Fund (blue), Global Equity Markets (orange), the FTSE 100 (green), the Halifax UK Residential Property Market (red) and the UK Fixed Interest market (turquoise)

As you can see from the key below the graph, the average UK Equity Income Fund, commonly used by those saving in the investment markets, was up by 22% last year, if you include reinvested income. The FTSE100 lagged, up 14%, as several poorly performing mining and oil companies affected the Index. House prices, as measured by the Halifax were up by 7.3% on the year, while Nationwide measured the rise in its Index as 8.4%. This is much better than was expected prior to the Governments intervention in the mortgage market.

The graph also shows the average UK Sterling Corporate Bond Fund return (turquoise, down 1%) at the bottom. This marks the end of the bull run we have seen over the last 20 years in the fixed interest markets, as existing fixed interest rates look less attractive when interest rates start to rise. The US starts to reduce the amount of quantitative easing (QE), ie money printing, that it will be doing this month, and no doubt the UK will not be too far behind them. Further down the road, this will undoubtedly mean base interest rates will start to rise, although most forecast that this is unlikely before 2015 in both the US and the UK. In the UK, Bank of England Governor Carney has said that this process will not start until unemployment rates are down to at least 7% (now 7.4%), before it will even be considered.

After several years where equity markets had got cheaper and cheaper, as share prices did not rise to take into account the record profits being achieved by corporate bosses, a large catchup finally occurred in 2012-2013. Now valuations suggest prices are back to more of a historically normal level at last in the developed world markets. One way to gauge whether shares are expensive or cheap is to look at the price-to-earnings (p/e) ratio of a stock market, which compares each company's share price to its earnings, then takes the average for the whole market. At present, the UK market has a p/e of 15.6, below the UK's historical average valuation of 19.1. A more sophisticated version of the p/e is the "cyclically adjusted p/e" or Cape. This uses an average figure for earnings over the previous 10 years. As you can see below, UK share prices also look a little undervalued on this measure, and historically in a bull market they tend to rise quite a bit above average before falling again.

Cyclically adjusted price to earnings ratio (Cape) for the FTSE All Share index



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However, the US continues to lead the global markets, and the same chart for them shows that shares are looking a little expensive there, although US economic prospects are picking up. This has allowed the US Federal Reserve to cut its money printing from $US85 million per month to $US75 million this month, however this is still a substantial amount of money to have sloshing around the system. In normal times this would undoubtedly cause inflation, but with the current relatively slow economic recovery back drop, and the slow down in China, US inflation is only 1.2%. After two years of relative austerity, the US budget deficit is also less than half that seen in 2010, the housing market is recovering strongly, and business and consumer confidence continues to improve. It also has demographics on its side, with a relatively young population, unlike China, Japan and parts of Europe. This allowed the US Dollar to actually rise a little lately, despite the embarrassing brinkmanship on Capitol Hill last year, when the Government effectively closed down for two weeks and sent all their employees home in a fight about the budget deficit. Investors are also taking into account the effect that US cheap shale oil will have on heavy energy users, and the reduced need for reliance on Middle East Oil going forward from here. Next year the US is set to overtake Saudi Arabia to become the world's largest oil producer – a position it last held in 1970. In addition, Chinese economic growth has fallen from about 9% a couple of years ago to about 7.8% pa now, which has allowed US manufacturers to buy raw materials like copper and steel far more cheaply, whereas previously China was buying everything up, and driving prices up for the rest of the world in consequence. Huge wage inflation in China has also meant that US companies have become more competitive, and some jobs have been brought back to both the US and the UK as a result. However, the Chinese economy still plays a very significant role in the global economy, and we should also remember that China has the largest shale gas reserves in the world, so they too will be able to benefit from this energy source going forward from here.

In contrast to the US, some emerging, European and Asian equity market valuations look relatively cheap, after "hot money" from big US investors flowed back to the US upon concerns about the effect the Federal reserves quantitative easing tapering would have on Asia and other emerging markets. The countries most affected were those with large current account deficits, like India, Brazil and Indonesia. This has left some emerging market valuations looking relatively attractive, while emerging market economic growth is still expected to be a robust 5% in 2014 according to the International Monetary Fund forecast.

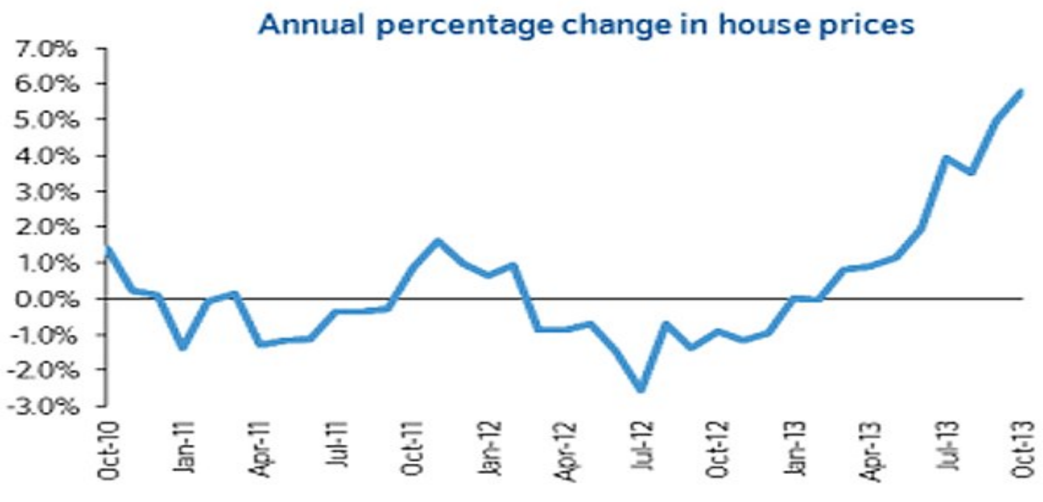
In Europe, the ECB appears to have stabilized the eurozone sovereign debt crisis, with its Outright Monetary Transactions (OMT) programme backstop. There is also some sign of tentative recovery in some of the peripheral economies most hurt by the credit crisis, although, in contrast, the outlook for the large French economy appears to have deteriorated in 2013, and preliminary indications suggest that it may have dipped back into recession in Q4. European unemployment also still stands at 12.1%, compared to 7.4% in the UK and 7% in the US. European youth unemployment is also stuck at 24.2%, rising to 41% in Italy, 57% in Spain, and 58% in Greece, which creates severe economic and social problems of its own, while the banks are behind those in the US and the UK in cleaning up their problems.

In the UK, the stagnant UK residential property market was kick started by the UK Government's "Funding For Lending Scheme" for banks, and more latterly, "Help to

Buy”, which has seen 6,000 applicants for government-backed mortgages in its first three months. The Funding for Lending Scheme, perhaps more aptly called the 'Funding for Votes Scheme' was put into place by the Government to provide cheap money for banks to lend out to businesses, or for those seeking mortgages. One could easily argue that houses are already too expensive, Majedie Asset Management did an interesting piece of work in 2013 comparing UK equity’s price earning ratio of 15.6, with residential property, where they found it is currently a very expensive 35 ie twice as expensive. Nonetheless, the Government has given fresh impetus to those first time buyers who have struggled to get funding during the credit crisis, while banks were using much of their capital to rebuild their balance sheets. The Government also introduced a Help to Buy mortgage guarantee scheme allowing purchasers with very low deposits, to again access mortgage markets provided they had a reasonable salary. However, the number of people actually using these Help to Buy mortgage schemes has been relatively low in comparison to the size of the overall market, which still seems to be driven a lot by cash buyers.

In November, Mark Carney, the new governor of the Bank of England, announced that the Funding for Lending Scheme will in future just be used to support business lending, rather than being used for residential mortgages, as it is still so problematical for small companies to get bank financing. Concerns were also rising that the mortgage lending part of the scheme may be promoting excessive debt for its recipients, which will create problems for them when interest rates do finally rise, and also that this money may lead to another housing price bubble. However, November was still the first month where more money was lent out than repaid, so consumer indebtedness has declined from 170% of household income in 2008 to 140% now.

The Office for Budget Responsibility is forecasting a rise in house prices of 5% for 2014, while Right Move is forecasting 6-8%. Savills is forecasting a 6.5% rise for the UK, and 7% in the East of England, falling to 6% in 2015. The rises in property values, are also finally starting to spread out from the capital and the South East providing a feel good factor for all those who already own their own home.



Source:- Halifax

Looking forward into our crystal ball for 2014, quantitative easing's decline in the US will be one obvious major headwind for the market, which is likely to cause some volatility. In contrast, the fact that the global economy is slowly recovering, inflation remains subdued, and the fact that money is likely to continue to move out of fixed interest markets and cash, should help shore up equity prices. In addition, the UK economy is now growing more quickly than every other major developed economy. It still has a significant way to go to regain its pre crisis production levels, but it looks as though it is heading in the right direction. In addition, the fact that some of the cheap government money provided to the banks for the Funding for Lending scheme will dry up should lead to a small increase in the interest rates offered to retail savers of about 0.3-0.4%, as the banks will have to find the money for mortgages elsewhere again. This is positive news, as bank savers have been doubly squeezed in 2013 by base interest rates that have been at 0.5% for five years now, and the Funding For Lending Scheme. The flip side of this, is that mortgage rates are also likely to rise as well in 2014, as the interest rate that the banks will have to pay retail investors will be higher than the cheap money they currently get from the Government, so to maintain their profit margins, mortgage rates will have to increase.

UK economic growth is also likely to move towards more normal levels in 2014 ie about 2.5-3%pa, similar to that seen in the US, and this is likely to be one of the best growth rates in both Europe and the developed world. This compares to inflation in the UK, which has come down to 2.1%. In conclusion, 2014 looks likely to be a continuation of the gradual climb out of the depths of the credit crisis, with a few glimmers of light on the horizon for a relatively good year.

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