



RBA Wealth Management

Market Bulletin

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ST. JAMES'S PLACE
Wealth Management

This Bulletin highlights some of the key issues from last weeks press and from time to time includes the views of some of the St. James's Place fund managers.

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An Historic Week

Undeniably, history was made last week. First, of course, was the election of Barack Obama as the first black President of the United States; his charismatic style enabled him to engage with millions of Americans who voted for the first time and deliver a stunning victory for the Democrats, sweeping them into the White House and Capitol Hill. The ramifications of Obama's victory will ultimately be felt across the world, both politically and financially - which we'll discuss later. The other remarkable event was the Bank of England's decision to cut interest rates by a shock 1.5% - taking the markets by surprise and wrong-footing market analysts, economists and experts alike.

The Kindest Cut

The Monetary Policy Committee's decision to cut means interest rates are now at 3%: their lowest level since 1955. The swingeing cut in the cost of borrowing reflected the Bank's deepening concern over the accelerating pace of economic slowdown - evidence of which has been mounting daily. Last week the influential Purchasing Manager Index data released showed a significant decline, with the service sector indicator falling to 42.4 - its lowest level ever recorded. The breakdown highlighted an across-the-board weakening, with new orders and business expectations at record lows, while employment intentions also weakened. Manufacturing production was also disappointing, falling 0.8% in September, meaning the level of output is now 2.3% lower than a year ago. Coupled with this, the Office for National Statistics recently reported that the UK economy shrank for the first time in 16 years, confirming that the UK is on the brink of a recession. The contraction was broad based across both the service and manufacturing sectors. The BoE is charged with the task of keeping inflation down and, whilst still elevated at 5.2%, the sharp decline in commodity prices over recent weeks will ensure that inflation quickly falls back to the 2% target.

Against this backdrop the MPC took decisive action by abandoning its softly, softly approach and instead made the bold move to axe rates, to stave off a severe recession.

In its accompanying statement the Bank gave an insight into the reasons for the decision. "Since mid-September, the global banking system has experienced its most

serious disruption for almost a century. While the measures taken on bank capital, funding and liquidity in several countries, including our own, have begun to ease the situation, the availability of credit to households and businesses is likely to remain restricted for some time. As a consequence, money and credit conditions have tightened sharply. Equity prices have fallen substantially in many countries. In the UK, output fell sharply in the third quarter. Reports by the Bank's regional Agents point to continued severe contraction in the near time . . . economic conditions have also deteriorated in the UK's main export markets. Since the beginning of the year the Committee has set Bank Rate to balance two risks to the inflation outlook, but commodity prices have fallen, with oil prices down by more than half. Inflation should consequently drop back sharply. As a consequence, the Committee has revised down its projected outlook for inflation and judged that a significant reduction in Bank Rate was necessary now in order to meet the 2% target for CPI".

Will the Bank's action be enough asked **The Sunday Times**? The sharp cut in borrowing was welcomed by industry and consumers alike, but Graeme Leach at the Institute of Directors said the Bank would need to go further. "The sooner we get interest rates down the less is the risk of a long and deep recession". The Engineering Employer's Federation voiced what many thought. "People welcomed the boldness of the Bank's move but they also wondered what lay behind it - what do they know that we don't?" The BoE's move co-incided with a move by the ECB to cut rates in the eurozone but for once interest rates ended up higher than those in the UK for the first time since the single currency was introduced in 1999. The ECB cut its bank rate by just 0.5% to 3.25%, but economists are forecasting that the central bank will continue to cut borrowing costs at the most aggressive pace in its history.

Banks Taken to Task

Whilst the immediate reaction to news was positive, Britain's main banks were somewhat reticent about how much of the cut they would pass on to their borrowers, saying that the key LIBOR (London Interbank Offered Rate) had not fallen by the same amount as the base rate cut. LIBOR fell by 1.09% and is the rate banks charge to lend to each other and, since the credit crisis, the difference between base rate and LIBOR has increased dramatically. However, the Chancellor Alistair Darling was clearly in a no-nonsense mood last week and summoned senior executives from all the main banks to a meeting in Downing Street and made it clear the government expected the cuts to be passed on to businesses and households. After their initial reluctance most of the main banks announced that they would, after all, pass the cut on in full by reducing their standard variable rates (SVR) by 1.5% - notable exceptions though were HSBC and Barclays, two banks who have not received any aid from British taxpayers. But as **The Financial Times** pointed out, fewer than 10% of borrowers in the UK are linked to SVRs, with most on tracker-rates and many of these products have been withdrawn and replaced with new, higher margin rates and criteria. But as the press noted, Britain's lenders face losing vital profits because their funding costs remain stubbornly high and as one banker said "We have probably reached a point where banks will find it difficult to pass on any further base rate cuts because of the disconnect between base and LIBOR rates".

Action Stations

"What theory can we use to get us out of the impending slump quickly and reliably?" asked **The Financial Times**. The thoughts of some have turned to John Maynard Keynes, a British economist and financial expert who, as measures of economic control, advocated interest-rate changes (the role of the BoE), public works to ensure full employment and income redistribution to enable the purchasing power of consumers to grow. The latter policies are clearly down to governments and in the UK the Chancellor is considering, *inter alia*, bringing forward public building programmes to boost growth along with possible tax cuts. Evidence of economic slowdown is patently clear – **The Sunday Times** said that British business has shed more than 300,000 jobs over the past three months and the number of companies becoming insolvent jumped by 26% during the third quarter of 2008. So it seems likely that in his forthcoming pre-Budget Report, Alistair Darling will announce an emergency package of tax cuts and public spending, according to **The Financial Times**, which could be worth as much as £15bn. The paper commented that cuts in taxes and increases in tax credits aimed at poorer households are easy to implement quickly and there are also calls from some economists for VAT to be cut to 12.5% to give a boost to the economy.

There is the small issue of funding, of course, and it seems likely that government borrowing is likely to mushroom, with the situation not helped by falling tax revenues as a result of the slowdown. According to the Centre for Economics and Business Research, the Treasury is likely to face an overall City-generated tax "black hole" of more than £10bn and its CEO said "the outlook has deteriorated and I would expect borrowing of around £100-£110bn for 2009/10".

Obama Bounce?

The election of Mr. Obama is timely, although the new President will face innumerable challenges – not least how to fix America's economy. Adding to concerns about a slowdown in the global economy, the International Monetary Fund (IMF) said last week that the world's developed economies are collectively set to endure their first full-year contraction since the Second World War. The IMF said that the toll imposed by the downturn across the West would sap the strength of the world economy and cut growth to 2.2%. As if any more evidence was needed that things are difficult, the latest data from the US showed that 240,000 jobs were lost in October, taking unemployment to its highest level in 14 years. Obama met a team of 17 high level economic advisers last week – including investment guru Warren Buffet – to discuss the economy. The Democrats are calling for another fiscal stimulus package of \$60bn-\$100bn on top of the one given by Bush earlier in the year, but this would need the approval of the President-elect who has yet to set out his fiscal policy. And clearly there is an imperative for swift action if the stock market's reaction is anything to go by: after an initial jump, share prices fell back following the IMF's gloomy prognosis as investors mulled over the outlook for the world's largest economy.

However, looking through the short-term fluctuations in the equity markets, history has shown that on balance, Democrats are better for shares, according to data from **Bloomberg**. Since 1928 the S&P500 index of America's companies has risen by an average of 9.3% in the opening year of the six first-time Democratic presidents, compared to dipping 4.3% in the first year of Republican leaders. US fund managers are looking to buy stocks that will benefit from a Democratic government, so infrastructure companies head the list. On the other hand, sectors to be avoided it seems are medical insurance and pharmaceutical groups, as the new administration is likely to push for lower drug prices and wider access to health insurance. But some believe that UK investors might be better off staying at home because US markets, according to **The Times'** *Tempus* column, look more expensive than the FTSE100 when judged by dividend yield. The Dow Jones gives investors 3.3% while Footsie yields 5%. So for now though, it looks like the jury is out as to whether investors will enjoy an Obama bounce.

Steering Through Choppy Waters

As we all know, financial markets are encountering some of the most challenging conditions for many years and in recent weeks markets have recorded some of their largest daily price swings since the 1930s. It would be surprising if private investors had not been unsettled by these sharp movements and keeping a steady eye on one's long-term investment goals has not been easy in this environment. The volatility is a result of markets coping with the financial crisis and pricing-in the impact of a slowdown in global growth and the likely consequences for corporate earnings. There are two aspects for investors to consider. First, what steps, if any, should they be taking in respect of their existing investments? Secondly, some are asking if now is a good time to invest new money? Taking the first point, faced with a market correction, it is only human to seek a safe haven. Investors instinctively wish to reduce their exposure to a falling market to prevent further losses, but acting on impulse could be expensive in the long-term. As painful as they are, stock market declines remind us that volatility in share prices is the corollary of historically better returns than cash and bonds.

Identifying Opportunity

During these difficult times we have endeavoured to share the opinions of some of our fund managers with readers and last week Andrew Green of GAM, was asked his views on the markets, the economy and where the opportunities lie for the future. Here are his thoughts:

"I think every economic crisis and setback has its own individual elements that differentiate it from other ones. And therefore it is always tempting to say '*it is different this time*'. Obviously there is a degree of severity here, where the very confidence in the banking system is in question and I think it takes a long time for this degree of shock to go away. Therefore it will seem like a long haul over the next few months because the economic news will be poor. But one needs to keep a perspective and valuations in a number of areas are already very, very low.

On the economic front, one is unable to have any certainty yet as to the length and depth of the recession. Clearly, one can buy ahead of that, taking the view that we have seen the worst and that these prices were assuming bankruptcy, but I also think that during the next 3-6 months there will be a whole range of profit warnings coming through from stocks and possibly stocks that we are not expecting them to come from. Therefore one needs to keep some powder dry to take advantage of those situations as and when they occur, picking your way through the landscape, finding the stocks that you want. You see, in a time like this, everyone flees to the high ground and therefore I would say some of the big liquid names may well have seen the best. Whereas the areas where expectation of recovery is nil, those types of shares may hold better value.

So I think it is a very slow gradual move to a more economically sensitive portfolio over the next six months.

Because of my particular style, which is looking at the stocks that have had a long period of underperformance and here I am talking about decades and decades, I am not buying in to any bubbles. The lack of mining stocks in the portfolio is a sign of that and obviously one felt very uncomfortable a year ago when the question was "why don't you have mining stocks?" No one is asking that now of course. I have avoided or at least reduced involvement in Europe and the US in favour of Japan as this market has under performed world markets for approximately two decades. The collapse of the last month or so was predicated almost entirely on the Yen - its dramatic rise caused shares to buckle as Japan assumed a deep recession on the back of a very expensive currency. However, for the UK investor, I had deliberately built in a shock absorber, because obviously exposure to the Yen protected one from the weakness of sterling and so we didn't suffer the full extent of that pain. Also, portfolio selection has also given us a degree of protection because a few months ago I cut the banks back very heavily, despite my hoping for a recovery in Japanese banks to lead the way as globally they were the only banks not involved in all the sub-prime disaster. Therefore they now look, I think, reasonably attractive.

So in that sense, having investments in an area that most people are avoiding, has actually helped us and where I have been able to stay away from sterling, I have by and large done so, as I was concerned that sterling looked topmy a few months ago. The whole portfolio is in areas where stocks have under performed dramatically over the past 30-40 years so in that sense, it is geared to any recovery in Japan as a result of China, which is the customer of Japan. This is a relationship that has been changing over the years and whereas Japan was very dependant on the US in past decades, it is much less so now. As the population in China becomes better off, more sophisticated, Japan has more of the things they want and therefore I think there is a very good outlook. It is not only China but elsewhere in the Asian part of the world which has growing populations, with more money to spend and Japan makes a lot of those things. Added to which I think the balance sheets of most companies in Japan are unleveraged and the yields are on average higher than bonds.

"In the UK, one stock I have bought recently is Lloyds TSB. As I mentioned earlier, I have had no UK banks or US banks for a decade or more but we have at last had a few catalysts. The involvement of Lloyds with HBOS brought about a negative reaction in the share price and led to a sell off in the shares. But I felt that the lifting of the competition rules and the short term pain on HBOS were warranted, as it gives Lloyds a dramatic percentage of the mortgage market. And we can already see in the figures, new mortgages are extremely profitable, because they are calling the shots on pricing.

The controversy surrounding their involvement [with HBOS] was caused by the Government talking about no dividends for 4-5 years. Well, we viewed that as a complete nonsense and a misreading of the situation and indeed Lloyds has now confirmed that they hope, after a year, to be able to begin dividends. So, I felt there were enough negatives to think the bank was starting to be good value.

Overall, whilst in some respects I have arrived a little bit early in one or two areas - such as Japan – and it is still time to remain cautious, the fund is well positioned for the recovery. I don't need to throw every penny at the market to get the benefit of an upturn because the sort of stocks I own are focused on ultimate recovery, but this is not yet reflected in their value”.



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