



ST. JAMES'S PLACE  
WEALTH MANAGEMENT

SPECIAL MARKET BULLETIN

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## Volatility reigns

The FTSE 100 began the week at 5,247 and ended 1.4% higher at 5,320. At first glance it appears to have been a relatively benign week. The story was similar in the US where the S&P 500 closed 1.7% lower over the week at 1,179 and the Dow Jones 1.5% lower at 11,269. However, these movements disguise the most dramatic days seen in the market since the 2008 crash.

Global markets fell sharply at the beginning of the week, as the US lost its AAA credit rating for the first time in history, with Standard & Poor's (S&P) downgrading it one notch to AA+ and placing it on negative watch. The agency claimed that the debt ceiling hammered out by Congress the week before did not put the nation on a sustainable fiscal path and in its downgrade note, was highly critical of Washington politicians citing 'political brinkmanship' – evidence, if any was needed, that the current issues are as much political as economic.

**The Financial Times** reported that the downgrade unleashed an extraordinary row between the Obama administration and S&P, with the former questioning the agency's competence and rationale, accusing them not only of numerical incompetence by making a \$2trn mistake in its initial analysis, but also of making an arbitrary decision to downgrade and then changing its arguments to fit the decision made.

Mid-week the Federal Reserve acted more positively in its attempts to tackle the problems by freezing short term interest rates for two years and opening the door to more quantitative easing, a move that sent the dollar and treasury yields sharply lower. The Fed added it would "*continue to assess the economic outlook*" and was prepared to employ its policy tools "*as appropriate*" – a clear hint it would consider further action if deemed necessary. The statement triggered one of the sharpest moves in the Swiss franc in its history; the safe haven currency surged at one point by more than 6% to touch a record high of 0.7085 to the US\$. The Japanese yen strengthened to 76 versus the US\$, just below the level at which the Bank of Japan began its market intervention earlier in the month. The S&P 500 duly raced ahead to its biggest one day gain since March 2009, rising 4.7% by Tuesday's closing bell and paring much of the previous day's steep drop. US treasuries also rallied sharply, indicating that markets were increasing their expectations of loose monetary policy – 10 year treasury yields fell more than 25bps to 2.0346%, a record low (*source: The Financial Times, 10 August 2011*).

The rally started to run out of steam as investors worried about the eurozone crisis turned their attention to France. The French President, Nicolas Sarkozy, gave his finance and budget ministers a week to devise new measures to cut the nation's budget deficit, as shares in the country's banks plummeted in the next round of financial market turmoil. As concern mounted over prospects for growth and the country's ability to meet its debt targets, Mr Sarkozy attempted to reassure markets, already nervous about possible troubles in the French banking system and its high exposure to shaky peripheral European debt. **The Financial Times** highlighted that whilst all three of the main rating agencies reiterated that France's AAA credit rating is stable, investors and analysts believe it could be the next country in line for a downgrade.



Meanwhile in the UK, Sir Mervyn King, Governor of the Bank of England, delivered what many commentators regarded as a rather indecisive speech, signalling that interest rates will remain on hold for much longer than previously anticipated, following the bank's forecast for lower economic growth and inflation over the next two years. In outlining the bank's new forecasts, Mr King emphasised that they did not take account of worst case scenarios from the eurozone debt crisis: *"There are many risks that we feel we cannot sensibly quantify. If you like, these come under the heading of the unimaginable or the unmentionable."* In its quarterly inflation report, the bank reduced its economic growth forecast for 2011 from 1.9% to 1.7%, while the 2012 number was lowered to 2.1% from 2.5%. Inflation, which had been forecast to fall to the bank's 2% target by the end of 2012 after a series of rate increases, is now forecast to fall to the target level without them. Mr King admitted however, that inflation had a "good chance" of touching 5% this year (*source: The Financial Times, 11 August 2011*).

On Wednesday, markets fell sharply again as investors flocked to the usual perceived safe havens, with US and German benchmark 10 year bond yields falling sharply to hit all time lows, and UK 10 year gilt yields falling to a record low of just 2.48%. **The Sunday Telegraph** reported that the recent surge in the gold price, another safe haven, is an indication of investors' lack of faith and confidence in world currencies and equity markets – safe haven buying lifted gold above \$1,800 per ounce for the first time ever.

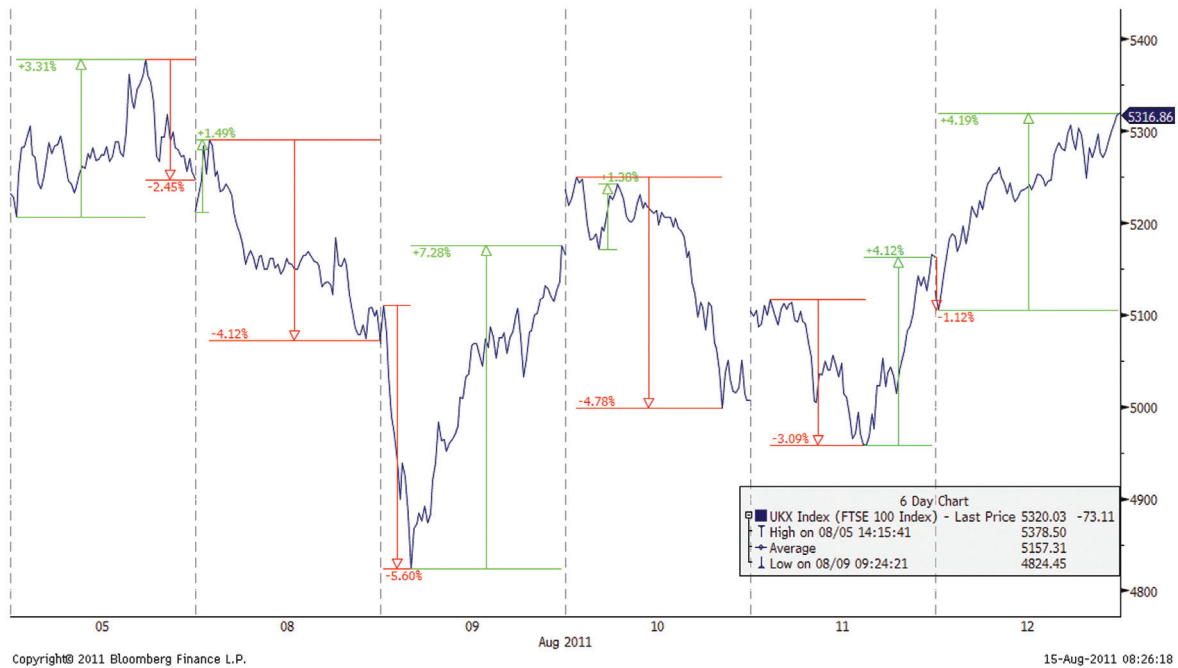
Nevertheless, markets ended the week positively, as France, Spain, Italy and Belgium imposed a ban on short selling of shares in banks and other financial companies. Banking shares led the rally as the European Securities and Markets Authority stated: *"While short selling can be a valid trading strategy, when used in combination with spreading false market rumours the practice is clearly abusive."* The action was taken in an attempt to stabilise markets which subsequently received further boosts after an unexpected decline in US jobless claims and better than estimated corporate earnings eased concerns about the health of the US economy.

## Market timing

So what does all this volatility prove and more importantly, what does it mean for investors?

More than ever, it demonstrates that investors should not attempt to time the ups and downs of market movements. It is understandable that investors are concerned about such short term fluctuations however; the only certainty is that it is impossible to predict how markets will move. It is common for the sharpest falls and the largest gains to be concentrated into short time periods and the events of the past week have put into focus the extreme volatility which can be encountered daily. For example, on Tuesday the FTSE 100 opened at 5,041 and closed at 5,165 representing a change of +2.46% on the day. However, at various points during the day the index had reached a high of 5,176 and a low of 4,824. The maximum percentage intraday gain was +7.28% and the maximum percentage intraday loss was -5.6% demonstrating that investors taking different views on the market would have seen a 13% differential in returns on a single day. The chart below demonstrates the maximum percentage intraday gain and the maximum percentage intraday loss over each day from 5 August. An investor who panicked and sold out of the market at its lowest ebb of 4,824, would have lost out on in excess 10% worth of gains over the remainder of the week.





(source: Bloomberg, 15 August 2011).

Market timing may be two of the most dangerous words in investing, especially for those who are not full time trading professionals. Over time it is not possible for an investor to successfully predict market movements, even more so during times of extreme daily volatility, the like of which we are presently experiencing. Market timing ultimately becomes more of a gamble than a legitimate decision or strategy based on solid grounds, and for the long term investor doing nothing and remaining invested is generally the most prudent strategy.

## Diversification

We have previously discussed the merits of diversification in our market updates and these past weeks have provided further evidence of its importance in an investment portfolio. As referred to above, fixed interest securities and in particular, the government debt of the UK, Germany and somewhat perversely in the midst of their credit downgrade, the US, have stood firm and increased in value during the equity market turmoil, as yields have dropped to historic lows.

With Sir Mervyn King indicating that interest rates will likely remain at historic lows for sometime to come and other commentators even predicting a cut in interest rates to 0.25% over the coming months, the news is desperate for those seeking returns on their deposit accounts. Interest rate futures have seen a big shift in recent months. They now point to autumn 2014 as the likely date for the first rise but these predictions are volatile. Only four months ago they suggested a rate rise was imminent and have shifted rapidly, especially in the last month – and the past week, following the recent market turbulence (source: Bloomberg, 15 August 2011).

Bricks and mortar physical property has also remained steadfast, as demonstrated in the performance of the Association of British Insurers (ABI) UK Direct Property sector which has risen by 1.3% since the beginning of the year, during which the FTSE Allshare fell by 7.64% and the S&P 500 fell by 9.07% (source: FE Analytics, 15 August 2011).

It is important to distinguish between bricks and mortar property and property related securities (which provide access to property by investing in the shares of listed property companies). Whilst property related securities are often easier to buy and sell than bricks and mortar funds because they are traded daily, they can also experience extreme short term volatility in sentiment driven markets. Essentially they are equity based funds with a significant correlation with equities over the short term, even though they have been used as a proxy for property investment for many years.



## Investment opportunity

One investor who hasn't changed his opinion on the outlook for the future, despite the stock market's multi-billion pound drop in value over the past week is Neil Woodford, the Fund Manager of the St. James's Place UK High Income Unit Trust: *"Much of what the market is currently panicking about centres on weak growth and the ongoing sovereign debt crisis. This is not a new surprise to us. We are no more concerned about the macro environment than we have been. We have built our portfolios with these concerns in mind and remain confident that the businesses in which we are invested can survive and prosper in this environment."*

Rather than panicking, Neil, who is one of the UK's most experienced fund managers, believes that the already attractively priced companies that he is invested in now look even more enticing with opportunities for income seeking investors: *"Many of the companies in which we have high levels of confidence have seen their share prices fall dramatically, as on previous occasions, the market is indiscriminate. We believe this provides a very attractive investment opportunity for those prepared to take a longer term perspective, as valuations are, in my opinion, profoundly attractive, particularly in terms of cash flows. We remain very confident in our strategy and portfolio positioning."*

The attraction of dividend yields compared to cash and gilts is clear to see. With the Bank of England base rate likely to remain at its historic low of 0.5% and 10 year gilts yielding 2.5% - a negative real rate of return when accounting for inflation - the FTSE Allshare index yields 3.6% (source: Bloomberg, 15 August 2011). As reported in **The Sunday Telegraph**, since the 1950s equities have typically yielded less than fixed interest securities on the grounds that investors considered the growth potential of share dividends outweighed the extra risk borne by equity investors. In recent times, on the rare occasions when equities have yielded more than government securities, these have been viewed as a potential buy signal for equities particularly in a low interest rate environment. This is a subject we will return to later in the week however, it is understandable to expect investors with a focus on income to be interested in equities paying high dividends with the potential to grow, over cash and government securities where the same level of income can no longer be found.

Investment grade fixed interest securities also offer a solution for the income seeking investor. In the current stock market turmoil, lending money to companies with a more secure credit rating and a low default risk has proved appealing to investors. To demonstrate this point the Investment Management Association (IMA) Sterling Corporate Bond sector has risen by 3.79% since the turn of the year, during which the FTSE Allshare and S&P 500 registered the aforementioned falls (source: FE Analytics, 15 August 2011). With current yields from the asset class of between 5-6%, the attraction is obvious.

## The week ahead

Tuesday sees the release of July's inflation figures and Sir Mervyn King writing his seventh consecutive letter of explanation to George Osborne, Chancellor of the Exchequer, when inflation comes in well in excess of the bank's 2% target – as it almost certainly will.

Experts are predicting that the consumer prices index (CPI) will be 4.3%, a small increase on the 4.2% in June, but more than double target.

The latest minutes from the Monetary Policy Committee are published on Wednesday and retail sales figures are released the following day. These will be viewed with interest, as the market looks for some positive signs on the health and direction of the UK economy.

The week ends with the release of figures on the health of public finances. These are anticipated to prove difficult reading for the Chancellor, as weak economic growth is making it difficult for the Government to hit its target for budget deficit reduction to £122bn this year.

Given the mix of helpful and unhelpful indicators in the week ahead, markets are likely to remain skittish with exaggerated reactions to each piece of economic news – whether positive or negative. Against this background, our advice continues to be; remain calm and rationale, review your portfolio to ensure it is well diversified and look at investment opportunities as they arise.