



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

## Equities rally

Global stock-markets shook off early weakness to end the week higher, with the UK's FTSE 100 closing up 3.0% - its highest weekly close since the end of April (source: Lipper). Bearish tones dominated news-flow early in the week when credit rating agency, Moody's, cut Ireland's rating by one level. UK home sellers were faced with the prospect of falling prices for the first time since December as asking prices declined by 0.6% in July according to Rightmove, as the suspension of Home Information Packs led to an increase in the number of homes coming to market. Across the Atlantic, there was similar pessimism in housing when the National Association of Home Builders confidence index fell to its lowest level since April 2009 and housing starts (builds) declined to their lowest level since October.

Amongst the gloomy economic data, corporate earnings have been providing a much needed fillip in recent months. However, it appeared there was little relief in the UK either when the likes of Goldman Sachs, Johnson & Johnson and Cable & Wireless all issued disappointing numbers or downward revisions to forecast earnings. Markets were rocked further by US Chairman of the Federal Reserve, Ben Bernanke's, dour assessment of the recovery prompted a slide on Wall Street. Speaking to the Senate Banking Committee, Bernanke acknowledged the labour market's continued weakness is the "most important problem we have right now" and that the economy faced "unusually uncertain" prospects.

In the second half of the week, markets rebounded with banks and miners leading the way on renewed optimism over the banks stress test and strong metal prices. Corporate earnings also took a turn for the better with Ford Motor, Verizon Communications, SAB Miller, Great Portland Estates and Capita just some of the companies to beat expectations. A wave of merger and acquisition activity emerged in the week, typically a sign that confidence is returning to stock markets, with SSL International accepting a £2.5 billion offer from the consumer products maker Reckitt Benckiser. Canadian institutional investors launched a £2.9 billion approach for Tomkins, and International Power confirmed talks with French utilities company, GDF Suez.

Macro-economic data also showed signs of improvement with German business confidence reaching a three year high in July and the pound receiving a much need boost as UK retail sales rose more than forecast, up 0.7%, according to the Office for National Statistics (ONS). The end of the week saw surprisingly positive GDP figures for the UK, released by the ONS, leaving investors looking towards the outcome of the banks stress test, the results of which were announced after markets closed on Friday.

## Stress, what stress?

The stress test undertaken by the Committee of European Banking Supervisors (CEBS) on 91 of Europe's banks and its results have been met with indifference by a large number of economists, strategists and commentators. Many had called for a more meaningful test with tougher criteria which included exposure to sovereign debt default by a country such as Greece. However, the scenarios of a significant economic downturn including recession, falling property prices and spiking interest rates or another Lehman-style collapse were seen as an opportunity to confirm that banks had strengthened their defences against the foreseen, not the unforeseen. As it was, 84 of the 91 banks passed, but a tougher test may have seen at least 11 more banks, who only just scraped a pass, failing on more stringent criteria. Markets will have a chance to respond today, however with no surprises and the majority of markets having already priced in the expected outcome, it should be nothing more than 'business as usual'.

## Growing or slowing?

Dominating the end of week's financial news was the ONS's release of GDP data showing second quarter growth of 1.1% (double expectations) up from 0.3% in the previous quarter. Terms such as 'remarkable', 'unbelievable' and 'totally unexpected' were commonplace in the media but this does not necessarily mean the economy is about to see

unbounded growth. It should be considered the low base from which this growth has come. **The Sunday Times** pointed out that the savage downturn at the end of 2008 and early 2009, caused by the collapse in world trade, was always going to fuel a short term spike when the situation reversed. What was probably more unexpected was the source of the growth. Whilst manufacturing and services (in particular, business services and finances) contributed to the strong growth, construction provided the greatest contribution as output leapt by 6.6%. This is surprising in light of recent reports that the number of residential properties coming to market has increased dramatically, and the commercial property sector is awash with properties being sold by banks to generate cash. It is difficult to tell if the current level of growth will be maintained, but what is obvious is that the current level of bank lending to businesses, which is contracting at around 6.0% p.a. will need to reverse dramatically or the corporate credit markets must take up the slack, unless businesses have deleveraged to such an extent that their growth is 'self-funded'.

The stronger-than-expected earnings data saw sterling strengthen against both the euro and the dollar, and the price of gilts fall. The latter move was an indication that some investors now see the prospect of inflation as more of an immediate threat. However, the Bank of England needs to keep interest rates low for several years according to the latest Ernst & Young Item Club report. According to **The Sunday Times**, the Item Club forecast, which uses the Treasury's model of the economy, shows that interest rates need to stay low for the next three to four years to counter balance the government's tax rises and spending cuts.

### **No guarantees**

Savers received more bad news this week when government-backed National Savings & Investments closed its popular inflation-beating certificates to new customers and cut interest rates on a number of other key accounts. These 'risk-free' investments were offering tax-free returns of 6% and having invested over £11 billion into these certificates over the last 5 years, investors are uncertain about what their alternatives might be. With interest rates low, deposits and savings bonds may not keep pace, especially when income tax is factored in. So what other opportunities exist? Fund managers have not been slow to remind investors of the other opportunities over the last few days with alternatives ranging from offset mortgages to equities being touted. Neil Woodford, manager of St. James's Place High Income and SJP/Invesco Managed funds, has been reinforcing his view that future growth is likely to be low and that yields from stocks and shares will become more popular. This aligns with his long held view that defensive, high-yielding shares in quality companies will continue to provide investors with a way to stay ahead of inflation.

### **Back shares not property**

**The Sunday Times** reported on a publication by leading accountant, Price Waterhouse Coopers (PWC) that said it expects property to grow by 2% a year over the next 10 years, after inflation, but equities to return an average of 5% a year. PWC's Head of macro-economics, John Hawsworth said: "Our analysis highlights the high degree of uncertainty over future house price prospects, emphasising that housing is a risky asset that is not guaranteed to generate positive real returns in the future, even though this has been the pattern in the past."

This forecast growth of 5% per annum for equities sounds good, although relative to returns of 7.1% seen over the past 30-years (source: Barclays Equity Gilt Study) it may seem relatively slow. This view was reflected by manager of the St. James's Place Property fund, Duncan Owen, who said about the commercial property market, "The UK market is continuing to recover but there is some concern about sustainability in parts of the market. Our projection is for future capital value movement to be flat on average, but it is not a homogenous asset class; prime property prices continue to be driven by low supply and strong demand. Despite capital returns being negligible, income returns from rents are still strong at somewhere between 6.5% and 7.5% and there is potential for growth through active management, our analogy is to buy the worst property on the best street and look to improve it."

Mark Lyttleton, managing director of BlackRock and manager of St. James's Place UK Absolute Return fund, told **The Sunday Times** there were still plenty of opportunities for investors, "Slower growth is better than no growth. Given that companies have cut their costs and are operating very efficiently, it doesn't take a huge growth in the top line to make a material improvement in profitability. So you can still make money, maybe not as quickly as investors might have liked, but I don't think that when interest rates are nearly nothing, people need to make such high returns."