



Market Bulletin

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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.

QE Too

It seems the Bank of England (BoE) has set a fashion trend in the financial world after its pioneering policy decision to adopt *quantitative easing* (QE) as a means of helping the economy out of its current recessionary slough. Just as the International Monetary Fund warned that more aggressive and concerted efforts were needed to key economies to quell financial market distress if the world is to avoid an even deeper and more prolonged downturn, the US Federal Reserve swiftly obliged by announcing its own QE strategy. Late on Wednesday Ben Bernanke, chairman of the Fed, stunned investors by announcing plans to buy \$300bn of US government debt, plus its intention to double its purchases of mortgage-backed securities issued by housing groups Fannie Mae and Freddie Mac. The aim of the move is to bring down longer-term interest rates and support the housing market – seen as key to kick-starting the ailing American economy.

The need for action – not just in the US but also in Europe and Japan – was put into sharp focus last week as economic data on both sides of the Atlantic illustrated the depth of recession. American jobless claims hit a record 5.47m in the first week of March – the highest since records began in 1967 – bringing the rate of unemployment close to 10%. In the UK, unemployment rose above 2m for the first time in ten years, with the private sector bearing the brunt of the cuts and brings the jobless rate to 6.5%. And, in Japan, the central bank announced the latest in a series of ever more assertive measures to respond to the pressures created by the global financial crisis saying it intended to increase its purchases of Japanese government bonds by a third. The move will help hold down bond yields and increase liquidity in the financial system coincided with the Bank of Japan's announcement to maintain its current 0.1% policy interest rate.

A Few Trillion More

The US Federal Reserve's latest move confirms the view of many economists that Ben Bernanke will do whatever it takes to get some hold of the problem, but as **The Financial Times** observed, it all comes at a price.

The latest announcement will increase the size of the Fed's balance sheet by another \$1,250 billion to about \$3,000bn even before the roll-out of a \$1,000bn

scheme to finance credit markets. Once the latest plan is fully implemented its balance sheet could approach \$4,000bn or \$4 trillion (that's twelve noughts) – nearly a third of the size of the American economy. What concerns economists is that such a swollen balance sheet might make it difficult to manage down the money supply when the economy finally turns up, raising the spectre of higher inflation.

Here in the UK the BoE embarked on the next phase of its QE initiative by unveiling plans to start buying companies' bonds (the first phase involved buying up gilts) in an attempt to ease the credit drought blighting corporate Britain. Corporate bonds are effectively IOUs issued by companies to raise cash – in return investors are paid an agreed rate of interest and receive their capital back on redemption although there are no guarantees attached. The Bank's move is an attempt to increase money supply, but there is no certainty that it will succeed. Indeed as **The Financial Times** pointed out, large investment grade companies appear to be hoarding their cash following a booming global issuance market for corporate debt. Companies have already raised \$353bn worth of bonds this year with UK businesses having raised the equivalent of \$24.95bn whilst facing redemptions of only \$16.88bn. The extra money is being raised for a number of reasons including insurance against uncertainty but also for building up acquisition war-chests.

A Whipping for Wall Street

As the White House endeavours to implement its policies for recovery attention is being diverted to Wall Street following news that the financial giant AIG is to pay out some \$170m in bonuses even though it received billions following its bail-out by the US Treasury. News that employees are to be rewarded has angered US taxpayers and has caused a furore in Congress which as a consequence has led to new legislation taxing bonuses at the rate of 70% where the employee works for a business that has received state aid. The AIG storm has meant that President Obama has been distracted from the pressing need for more detail on his administration's plans for recovery. **The Sunday Telegraph** said that Mr. Obama is poised to unveil a revised trillion-dollar plan aimed at helping America's crippled banking system. Unlike the UK the US administration is reluctant to take large stakes in Wall Street's banks, yet they are in desperate need of fresh capital so the new plan needs to address these issues. Yet even before details are known, some observers are sceptical that it will succeed highlighting the tightrope the President must walk.

But whilst Wall Street is seething, Ben Bernanke's action nevertheless drew the attention back to the

economy and following the announcement of his scheme financial markets were galvanised into action. Yields on US Treasuries fell sharply to 2.5% as the bond market reacted favourably – as the stock market did too with shares heading up sharply. But the dollar headed south as investors reacted negatively, taking the view that the impact on both nominal and real rates was adverse. Also heading up was gold where prices jumped \$58 per ounce to \$948 reflecting the view that ultimately the Fed's policy was inflationary. The following day, as the Fed's move began to sink in, commodity prices were the big winners with the dollar falling further. Hopes that stronger economic growth would boost demand helped push oil over \$52 per barrel and gold continued to rally as expectations for higher inflation drove investors to their perceived haven. So by the end of the week investors' focus had switched from the equity markets – where most of the main indices notched up some gains – to government bonds, commodities and currencies.

Thrifty Squeezed

Falling interest rates may be good news for borrowers but for savers it's created a problem – how to replace the lost interest on their deposits to maintain their lifestyle. **The Sunday Telegraph** mulled over some of the income options currently available to investors and highlighted the pros and cons of both fixed-interest investments and equities. Starting at the lower end of the risk scale the paper explained that gilts – government issued bonds - are attractive because they are deemed to be one of the safest forms of investment. Whilst rates are very low – a ten-year gilt yields around 3% gross – there is the possibility of capital gain when interest rates fall or demand is very high. The BoE's QE policy has been well received in the gilt market with the extra demand pushing up prices. To complement this strategy the paper also discussed corporate bonds which yield more than a gilt to reflect the higher risk. This part of the bond market also has two distinct categories – investment grade (perceived the safest part) and high-yield which is also viewed as having higher risk because there is a greater chance of corporate default. To reflect these differing levels of risk a typical investment-grade corporate bond fund yields c7% gross whilst a higher-yield fund containing a mix of bonds could yield over 10% gross.

Moving up the risk ladder to include share-based assets, investors could add equity-income funds to their portfolio which historically have produced good levels of income as well as capital appreciation over the longer-term. The paper pointed out that whilst dividends are not guaranteed and some companies are cutting payouts because of the recession, a good fund manager will endeavour to identify those companies that are most likely to maintain or even increase their dividends. Last week was a good example that, even in tough times, some businesses continue to look after their investors – the Prudential raised its dividend to shareholders last week by around 11%. One fund manager mentioned was Neil Woodford of Invesco Perpetual who has a strong track record of outperformance and who also manages the St. James's Place UK High Income fund.

Quiet Optimism

One fund manager who has seen many bear markets during his long career in managing money is Richard Pierson of AXA Framlington and here he shares his thoughts on current events. "The markets continue to be very challenging and my aim has been to preserve the position of the portfolio so I have made no material changes to the funds' asset allocation in recent months although with sterling weak the overseas exposure has moved up slightly. I still have high levels of liquidity; cash is about 10% but I have not increased the gilt weighting. I'm not convinced about quantitative easing – on the one hand the BoE is pumping £75bn into buying gilts, but on the other hand we know the government is planning to issue £146bn of new gilts.

The continuing volatility in the markets makes it difficult to make short-term judgements but I do feel that markets will be higher in twelve months time – they are, after all, very cheap. So whilst economic activity remains poor, I think we will see some of the proverbial green shoots later this year which will be positive for equities. In the meantime one needs to be careful – prices are still falling in parts of the market and investors remain very nervous indeed. The actions taken by policymakers are of massive proportion in terms of money being pumped into the system and ultimately this will work as borrowing conditions ease for businesses and consumers but we just don't know how long this will take. Corporations are hoarding cash, banks are maintaining tight lending criteria and earnings visibility is poor but I do think we are now bumping along the bottom.

In terms of the portfolio we have been defensive, preferring to own larger stocks – in this way some of the risk is managed-out. But around 30% of the fund is higher beta – in other words small/medium sized companies who have the capacity to outperform once recovery is underway. Owning any small/medium cap stocks has been a headwind in these markets but I do not intend to remain cautious forever and at some stage I will put more risk back into the portfolios. Within defensive stocks I have been careful not to make any very large sector bets preferring to maintain a neutral weighting although two months ago I did reduce the weighting, in pharmaceutical stocks which had done very well and this has proved to have been a good move as they have since underperformed. I do own some banks and mining companies; sectors where I think there will be a recovery. There have been few hiding places during this crisis and whilst I am still being careful I am now more optimistic than I have been".

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