



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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Blink and you miss it

- The S&P 500 Index stands at its highest point since April 2011
- Downgrades fail to make significant impact

Global equities resumed their upward path last week as investors put to one side the worries over Greece and took heart from further signs of a brightening outlook for the US economy. Fourth-quarter eurozone data was not necessarily encouraging, but a string of US data on employment and manufacturing fuelled the equity rally further. The US market was unsurprisingly the most buoyant as the S&P 500 Index closed in on a post-financial crisis high, having risen more than 8% since the start of the year. The Dow Jones Industrial Average hit a four-year high on Friday, while the technology-heavy NASDAQ stands at its highest level for a decade. In the UK, the FTSE 100 closed the week above 5,900, joining in with the widespread optimism.

In currency markets, the euro and the pound showed little response to credit-rating cuts by Moody's to several eurozone countries; or to the threat of a downgrade to several other sovereigns, including the UK, and to many leading financial institutions. Both currencies showed little reaction to the pessimism of the ratings agencies, showing more evidence of the increased risk appetite of investors relative to the gloomy sentiment of 2011.

Some commentators are arguing the rally has been solely as a result of the European Central Bank's (ECB) €500 billion long-term refinancing operation (LTRO) on 22 December. By demonstrating for the first time that the ECB would commit to a form of quantitative easing, they argue that it has reduced the risk of the 'armageddon' scenario many feared from August onwards. With more LTRO activity likely, the risk of contagion across the financial system seems to have been reduced, at least for now. Elsewhere in the world, the Bank of Japan jumped on the liquidity bandwagon as it announced its own asset-purchasing programme, which is weakening the Japanese yen and resulting in the export-heavy Nikkei 225 hitting a six-month high.

Dan O'Keefe of Artisan Partners, co-manager of the St. James's Place Global Managed funds, is one such expert who believes that the European Central Bank has been the key to the turnaround, reporting, "The ECB is now effectively engaged in its own version of quantitative easing, buying large chunks of troubled sovereign bonds. This is reducing funding pressure on the most troubled European sovereigns, which is having knock-on benefits for bank funding. As a result, stocks in Europe and around the world have rallied. The more leveraged businesses such as banks have led the recovery.

"The market has swung from pessimism in 2011 to optimism so far in 2012.

The turn came suddenly and quickly, showing once again how futile it is to try to time the market based on prevailing sentiment. We remain focused on executing our strategy with consistency, even as the market gyrates around us."

Greek talks stall

- Eurozone debate continues, but markets move forward
- Strong words from France amid German reluctance

The relative strength of recent market performance masked another week of twists and turns in the ongoing Greek saga, which saw the prospect of a 'disorderly' default by Athens increasing in the minds of many. While the general view is that the second bailout and the terms of private sector involvement would most likely be

agreed today, enabling Greece to receive the next round of funding by the 20 March deadline, last week drew people's attention to further hurdles that could arise.

Angela Merkel of Germany, Italy's Mario Monti and Lucas Papademos of Greece held a conference call ahead of the weekend discussing a range of contentious issues. Should private investors take a bigger hit? Should the rest of the eurozone have tighter controls over Greece's fiscal policies? How tight should Greece's austerity measures be? There are still many uncertainties over details but the progress made over the last 4 months has led traders to believe that, somehow, there will be a solution. Francois Fillon, France's prime minister, berated those with doubts over rescuing the Greeks.

“We must do absolutely everything we can to avoid a default in Greece. Now that we have a commitment from the Greek government, the Europeans must now honour their own commitments. Such talk is totally irresponsible.”

European leaders have repeatedly warned that there was no guarantee they would reach an agreement, and reports that the German government was split over whether to allow Greece to default would have deeply disturbed markets only a matter of months ago. The markets' sanguine response reflects belief that eurozone finance ministers will choose to rescue Greece rather than rock the fragile global economy further. With the aforementioned American markets soaring, the German and French equity markets also continue to be strong along with Spain and Italy. Nevertheless we still question how, even with a second bailout package agreed, Greece will be able to withstand a prolonged period of austerity (remembering it is already four years into a recession). Without the economic growth Greece and the wider eurozone desperately needs, it is difficult to envisage how the country will return to a path of recovery. The threat of default remains high, with the bigger question occupying commentators and politicians being whether Greece could still remain part of the euro.

Over the past few weeks, the cost of borrowing in the eurozone has also dropped sharply, with AAA-rated euro-denominated corporate bonds falling from an average 3.8% at the beginning of the year to 3.4% now. Sovereign bonds have seen similar drops, with Italian bonds seeing the biggest fall from 6.9% to 5.6%. Some of these changes are hugely significant, and seem to have happened in the blink of an eye.

Iranian oil embargo

- Iran reacts to the EU oil embargo by restricting supply to the EU
- Prices spike but this is likely to be a short-term issue

Back in January, the long-running stand-off between Iran and the West over Tehran's nuclear programme shifted into a more unpredictable phase after Europe decided to impose an oil embargo on the Islamic republic. The EU decided no further oil contracts could be struck between the member states and Iran, with existing oil delivery deals only being allowed to run until July. Several countries shared reservations about the move, with Greece the trickiest problem since it imports Iranian oil on very favourable conditions. Reaction from Iran finally came last week, as official sources said on Wednesday that the Iranian government had cut off oil exports to six of the European Union countries in response to the sanctions. The pro-government channel Press TV interrupted its usual broadcast to report that the measure affects the Netherlands, Spain, Italy, France, Greece and Portugal, amongst which are nations that most depend on Iranian energy. Of the 2.2 million barrels of oil Iran exports a day; around 18% is bound for European markets, according to the U.S. Energy Information Administration. Iran has also threatened to close the Strait of Hormuz waterway if the oil embargo goes ahead, a move that would choke off global oil supplies and send international tensions soaring.

This announcement was followed on Sunday by news that Tehran would stop supplying oil to the UK and France. A spokesman for the oil ministry, Ali Reza Nikzad Rahbar, was reported as saying on the ministry's website that Iran would “sell our oil to new customers”.

The price of Brent crude, the benchmark for oil prices in Europe, has been steadily rising over the past few weeks as investors grow increasingly worried about Iran's nuclear ambitions, with the US, UK and Europe all imposing sanctions to restrict Iran's ability to sell oil. Prices for Brent crude oil rose to their highest level since April 2011 on fears that Iran might halt shipments of oil to Europe, spiking to \$119.53 per barrel immediately

following the reports. However, economists generally do not believe this to be a long-term problem. Julian Jessop, Chief Global Economist at Capital Economics, believes this increase in prices will be short-lived for three main reasons.

“This development is not a complete surprise, because with the EU embargo announced last month but in force from July, the countries involved have already had some time to find alternative sources, with Saudi Arabia and Libya keen to meet any shortfall.”

“Secondly, the six countries targeted by Iran are likely to require less oil this year anyway because of weakness in their economies. The impact of the Iranian ban may simply be to ensure that the burden of weaker EU demand is felt by Iran rather than by other oil exporters. Thirdly, Iran will still need some customers for oil and US pressure to boycott Iran is having little effect in the larger markets in Asia. China and India, in particular, are taking advantage of their much stronger bargaining positions to insist on lower prices for imports of Iranian oil, which will help offset any upward pressure on global oil prices from EU countries seeking alternative supplies.”

Inflation falls further

The official measure of inflation, the Consumer Prices Index (CPI) fell sharply last month to a 14-month low of 3.6% from 4.2% in December, according to the Office for National Statistics. The Retail Prices Index, which includes mortgage payments, also fell from 4.8% to 3.9%. The main reason for the severity of the drop-off is that the VAT rise from January 2011 is no longer skewing the data, while stable petrol prices and a fall in energy bills have also helped pull inflation down. The Bank of England expects inflation to keep falling throughout the year, but other commentators disagree, arguing that while the falling utility prices are welcome, they can't be relied upon to stay that way.

Whatever lies ahead, it's clear that, as with anything investment-related, it is hugely difficult to predict the short-term and any asset class that traditionally protects against inflation remains helpful. Diversification of risk is still key.

The week ahead

- Greek discussions continue, with compromises to be made
- US housing data should dictate the market sentiment

The Greece situation is the key issue that will determine the tone for the week ahead. If all goes to plan in the early meetings, then Greece could provide a formal bond offer to creditors by Wednesday, with the exchanges completed by the bond maturities on 20 March. This requires European leaders to agree the latest austerity proposals from Greece, private creditors to accept the offer without legal consequences, and the International Monetary Fund to agree a proposal that is highly likely not to reduce the debt ratio to 120% of GDP by 2020. At least it is a step in the right direction.

In the US, the country from which the rest of the world takes its lead, the economic releases focus on housing, with existing home sales expected to show a fourth successive monthly rise and new home sales expected to show an upward move for the first time in over a year. In the UK, the second estimate of the Quarter 4 GDP data is released on Friday, but it is unlikely to be revised significantly either way. Meanwhile, the minutes from the most recent meeting of the Monetary Policy Committee will be important to gauge the appetite for further quantitative easing beyond the £325 billion already pumped into the UK economy.

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