1st June 2013

Markets have tumbled, fearing that the US might start to withdraw Quantitative Easing. Investors must pray that Mr Bernanke gets his timing right.

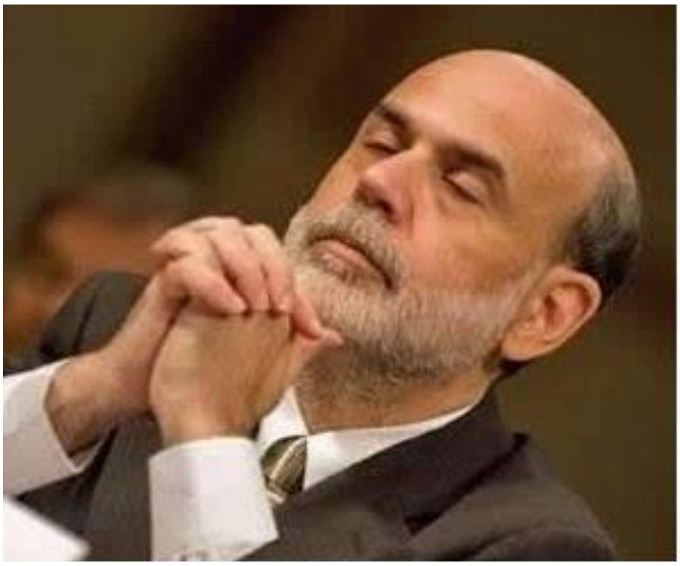
After a prolonged, 4-year equity market rally, with the S&P 500 at an all-time high, the FTSE 100 approaching 7,000 and massive gains in the Japanese equity market since November last year, **Wednesday the 22nd May heralded a short and brutal change of sentiment**. By close of play on Thursday 23rd May, the Nikkei 225 had lost over 7% in one day's trading and it didn't stop there. A week later the Nikkei had fallen by 15.1% whilst the FTSE was down over 5%.

Remarkably, this sudden sharp reaction that has wiped billions of US dollars from the value of world markets can be largely attributed to one speech on the evening of 2nd May, which we will come back to later on. However in order to understand the rationale for this sell-off, we firstly want to re-visit the **2 broad principles that drive stock markets – fundamentals & sentiment**.

Fundamentals can be split into two sub categories – **earnings & global economic conditions**. Analysts' expectations of companies' earnings have been beaten consistently over the last few years. However this "positive earnings surprise" has been driven primarily by companies cutting costs rather than growing revenues. Also **economic conditions have been mixed at best**, with a continuing weak Eurozone (Spanish unemployment, Italian political shambles, Cypriot bailout and Portuguese contagion), faltering emerging market GDP growth (China at 7.7% growth is seen as a huge disappointment) and fears over US "sequestration" (tax increases, spending cuts and a growing debt burden that has been extended to $16.4 trillion). However these fears have been counterbalanced by very strong US growth data of late, including very positive housing market data. Overall though, with corporate cost-cutting and mixed economic conditions, recently the **fundamentals have not been favourable**.

So why have markets been so strong until recently? Partly due to that fact that **sentiment has been very strong**, as investors have sought superior returns from equities whilst bond yields have been declining.

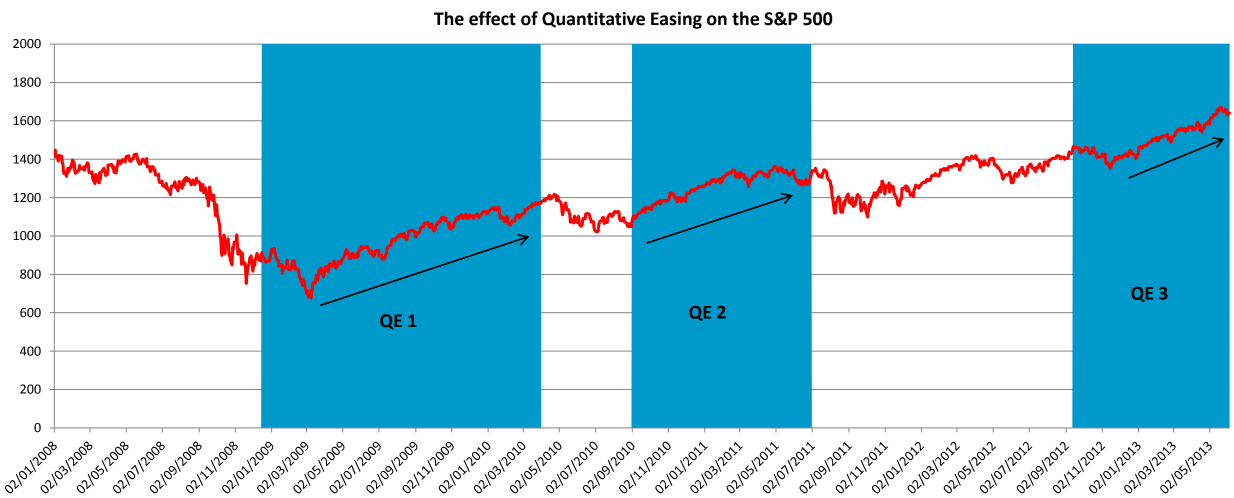
However perhaps the most important variable has been government intervention in the form of **Quantitative Easing** (QE), as this **straddles both fundamentals** (it has major impact on the medium term economic outlook) **and sentiment** (expectations about future QE greatly influence investors' short term instincts). In essence **QE means printing money** and with interest rates pushed as low as they can go, the creation of new money is seen as the last weapon available to central bankers, who are desperate to combat deflation and economic stagnation.



So how does it work? The theory suggests that **as new money is "created", these new dollars are used to buy back debt** originally issued by the government.

The investors selling this debt then use the proceeds to invest in the economy in the form of banks lending more to businesses, companies employing more staff and consumers spending more money. However a by-product of QE is that, rather than spend the money available to them, **many investors squirrel away the proceeds** by buying equities, property and corporate bonds instead – swapping one form of investment for another, thus inflating the prices of these other asset classes. **It is this phenomenon that has been a major factor in some of the more pronounced equity market surges** of the last few years as central banks have pumped more money into the economy and investors in turn pump money into equities and other assets.

The chart below illustrates this impact on the S&P 500 after each major round of QE was announced. Perhaps most interesting of all is that successive rounds of QE have had less and less positive impact on the markets as investors experience "QE fatigue":



So what about the quantum? In the US, QE during rounds 1&2 led the Federal Reserve to buy $1.2 trillion of bonds. QE round 3, started in September 2012, was dubbed "QE Infinity" as the Fed pledged to buy $40bn a month for "as long as it takes", and then subsequently increased this to an eye watering $85bn per month in December 2012. In the UK, the Bank of England has bought £375 billion of Government bonds. More recently in April 2013, the BOJ in Japan announced bond purchases of $1.4 trillion over the next 2 years, on top of an existing $700bn, with the aim of pushing inflation up over 2%. Each of these announcements has heralded an equity market rally with the most marked of these being the Japanese market, which (notwithstanding the recent tumble) has risen a staggering 86% from trough to peak since the aggressive policy U-turn was announced.

Another by-product of **QE** is that it **should boost inflation** because greater money supply should lead to a weaker currency and therefore to more competitive exporters and higher price of imports.

Countries with large deficits relish the thought of inflation (up to a point) as it helps to eat into their debt burdens and for the opposite reason, deflation is every central banker's worst nightmare.

We have laboured the point, but this is with the aim of indicating just **how important QE has been for the equity markets** over the last four years. Markets have become hooked on these injections of cheap liquidity and so when there is even the slightest hint that it might be taken away, the QE junkies start to panic.

With this in mind, May 22nd was an important day because Ben Bernanke delivered his testimony to the Joint Economic Committee on the Fed's expectations about the future for QE.

In that testimony he indicated that the Federal Reserve was "……prepared to increase **or reduce** the pace of asset purchases, depending on the incoming data……." and it was the words "or reduce", combined with minutes from the last Fed meeting suggesting divisions in the camp over increasing or reducing QE, that so spooked the markets.

Ironically, **every piece of good news about the US economy will compound the problem.** US Housing data has been strong of late and there are now very strong signals that the US economy is starting to recover. Whilst this is of course good news, QE junkies panic more because **strong economic data makes it more likely that QE will be cut back**, with the result that good news could actually drag the market lower in the short term and vice versa!

The recent market falls can therefore be attributed directly to the threat that the Federal Reserve will withdraw QE and this in turn demonstrates that in the short term investors' decision making is dominated by "policy intervention" from 3 or 4 large central banks (Federal Reserve, Bank of England, Bank of Japan and the ECB). **Such intervention cannot be predicted but only reacted to** and this makes portfolio decision making challenging.

Our view? Whilst the US economy is recovering, **we can't see QE being terminated yet** because inflation and growth are still relatively benign for now. **However with more positive economic data from the US, stopping or reversing QE will become ever more likely** and whilst this strong data will be supportive over time for equities (and as a result we are happy retaining a longer term positive stance), **we believe that the real risk in client portfolios lies in US government bonds**. This is because with returns at such a low level, investors are not being paid to take the risk that the US will stop QE unexpectedly and whilst this has already been reflected in US treasury prices falling, potentially there is more to come in the weeks ahead.

Market "Stance" - *the chart below illustrates our current general "market stance". Each of the dots on this chart represents a change in this market stance over 5 years or so, although we have only started to officially adopt this strategy since September 2012. Notwithstanding the current fears over the withdrawal of QE, we expect that the longer term outlook for equities remains favourable as the US economy recovers and so our current stance remains* ***NEUTRAL.***