Blink and you missed it - anyone comparing the value of a diversified portfolio on the 31st October with that on 30th September would have witnessed little change in value. However this masks **one of the most severe market dislocations in recent times** as global markets from the UK to Japan and the US sold off aggressively at the beginning of October only to recover equally quickly by the end of the month. The volatility index (VIX), which was sitting at 16 before the "blip", hit a 3-year high of 26 before gradually retreating back to 14 by the end of the month. The **FTSE 100 fell nearly 6.50% before recovering** to within 1.15% of where it started and **Japan, after a 10% fall, ended the month up more than 3.50%**.

In this month's overview **we dig beneath the surface to examine the catalysts driving the sharp sell-off** and the subsequent recovery that followed, as this should provide some guidance to the likely direction of markets leading up to Christmas.

So why the sudden plummet in equity valuations at the beginning of the month? We think it's mainly because **so much of the bad news** that had been hovering around the markets since January **was suddenly amalgamated into one indigestible lump**. This news included the conflict in Ukraine, the slowdown in China, the end of US Quantitative Easing (QE), contraction in Japanese consumption and the lack of reform amid two of the Eurozone's largest economies not to mention the aggressive proliferation of Ebola in West Africa and its arrival in the US – quite a lot to worry about all at the same time. It could be argued that **the most important of these factors was a combination of the market's realisation that the QE party in the US was finally coming to an end** combined with the **poor data from Germany** that **took everyone by surprise**. With either or both, the mass exodus out of risk assets offered some immediate value for longer term investors.

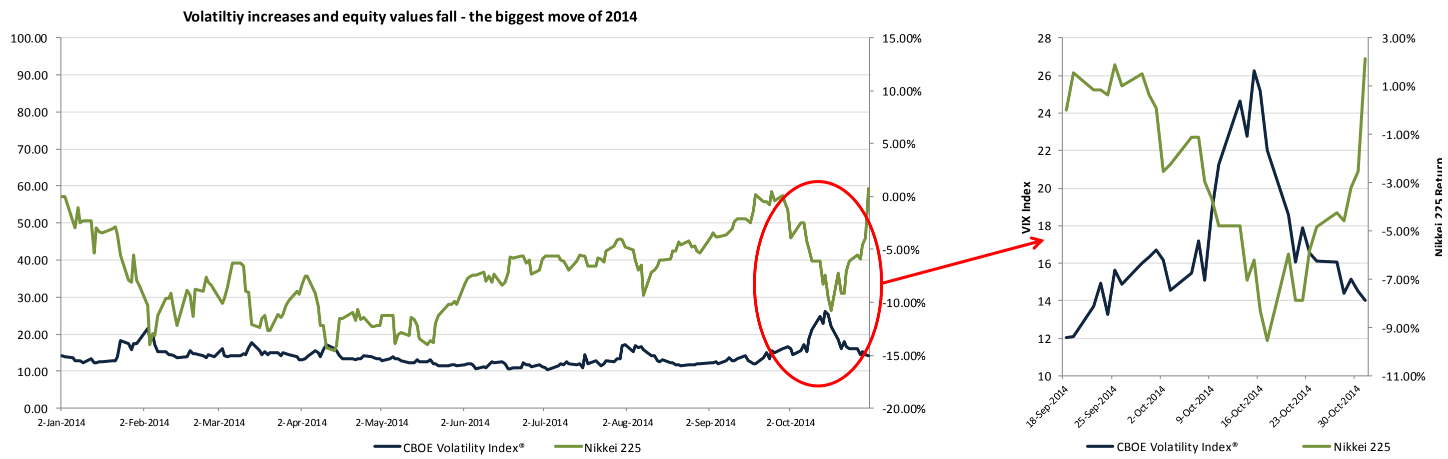
It was with the release of poor 2nd quarter German data this month that investors in Europe's most important economy started to feel the consequences of the Eastern Ukraine conflict first-hand. German exports fell 5.8% in August, marking the biggest drop since the peak of the global financial crisis in January 2009. Lower exports coupled with weak industrial production have led to fears that the linchpin of the European project could be heading for its second consecutive quarter of contraction (a technical recession).

We have been concerned about the prospects for the Eurozone over the last 12 months and the **frailty of the block's most resilient economy** in August only helped to **further enhance our negative bias**. With overall inflation slipping to 0.3% in the Eurozone the concern facing European Central Bank (ECB) president Mario Draghi is one of outright deflation, something his Japanese opposite number has been battling with aggressively ever since the arrival of prime minster Shinzo Abe.

Janet Yellen closes the book on Quantitative Easing

Worrying parallels are being drawn between Japan's deflationary "lost decade" and the situation in the Eurozone at present. Time will tell if such parallels are justified and we sincerely hope not. Whilst **France and Italy continue to breach** their **austerity targets** with no sign of them reeling in their government spending, the **Germans have taken the opposite approach**, adopting tough fiscal austerity with the aim being to balance its budget in 2015. However this stance has proven costly at a time when **in reality the ECB needs these various governments to work together.** Draghi's attempt to offer dirt-cheap lending facilities to Europe's banks has fallen flat, as they have focused more on protecting their own balance sheets than bothering to lend to cash starved small businesses; **not a great sign for growth prospects in the region**.

Another **major factor for the slump** in equity values is the **growing property bubble in China**, which we wrote about in June. Worryingly, local government borrowing is still expanding faster than GDP as China's leaders try obsessively to hit short-term GDP targets. **We feel that this is highly unsustainable** and will only help to weaken China's growth further, which now stands at only a 7.30% when just 4 years ago growth was in excess of 10%.



Adding to the region's woes was the political unrest in Hong Kong. Thousands of protestors gathered for days in the central business district at the end of September and throughout October to express their discontent with Beijing's proposals surrounding the election of Hong Kong's Chief Executive. Although peaceful, many investors feared that the pro-democracy rally would spill over into the Chinese mainland, disrupting commerce and adding to growth fears. The protests also delayed the introduction of the so-called "Stock Connect" (a new agreement between Hong Kong and Shanghai that will enable international investors a new way to access Chinese-listed equities) and this has added to the negative market sentiment.

Japanese markets were pestered by the expectation of worsening growth prospects after the increase in the consumption tax in April and as a result the second quarter saw the world's third largest economy shrink by 7.1% on an annualised basis in GDP terms. Fears were growing that Abe's policy levers were not being pulled hard enough and that this would result in further weakness. The markets reacted accordingly.

Ebola has also played a role in unsettling investors, as epidemics with high mortality rates tend to, bird flu and SARS being obvious comparisons. However awful the humanitarian aspects, the impact on the global economy of such outbreaks does tend to be overstated and this is the case with the Ebola crisis as it currently stands.

Perhaps the biggest concern and in our view the catalyst for all of the other news being amalgamated into one **relates to the end of the US Federal Reserve's (FED) QE programme** that has been helping to support markets for the past three years. As Europe struggles to gain traction and fragile emerging market economies suffer from "hot money" withdrawals not to mention the weaker demand from China, global investors have used cheap money provided by the FED as a security blanket that has finally now been taken away. However, we've known for months that it was going to happen and the withdrawal schedule has been well sign-posted so investors should not have been surprised.

So the news above should certainly give cause to feel pretty miserable because a number of different factors, from geopolitical unrest to major monetary policy shifts have all contributed to very weak sentiment and have rightly spooked investors.

As we suggested whilst the sell-off was in full flow, **we felt that the markets were overreacting**, mainly because most of this bad news has been news for a long time. It should have been no surprise that QE was ending, that Europe is in trouble and that China is slowing down and so we couldn't understand why the markets reacted as if it was hot-off the press.

Therefore **we believe that the rapid recovery in equity prices can partly be put down to the realisation that the sell-off was driven by "hot money"** panic selling at the wrong time; however this isn't the only factor. Firstly **earnings reports** from US corporates for the 2nd quarter **have been strong** (albeit after having been revised downwards as usual) and as the quarterly reporting season gathered pace in the later stages of October and **expectations continued to be surpassed**, investors took a more sanguine view about the prospects for equities in the last two months of the year. By late October, **of 177 S&P 500** companies that had issued third-quarter results, **nearly 70% had beaten expectations** far in excess of the 20-year average of 63%. Ironically, **markets were further boosted by weak US consumer price inflation numbers**, which sparked **encouragement that the FED would maintain its low interest rate policy** for an extended period of time despite the realisation that QE was coming to an end.

The second major catalyst for the rally was triggered by an enormous surprise from Japan. In a bid to reassure the markets about how seriously the Japanese are taking their efforts to kick-start the economy, **the BoJ shocked global investors by announcing a massive expansion of its QE program** on the last day of October. The BoJ has pledged to increase its monetary base by approximately $7.5bn per month at a time when the US has been cutting their stimulus by $10bn per month. **Mr Kuroda cited the tumbling oil price and a tax-hit economy as the major reasons for adding to the stimulus** as the country tries to rid itself of years of deflation. This was perhaps the most important factor in the tremendous rally we have seen in markets since the sell-off. **An additional factor behind the surge in the Nikkei** was the **proposed restructuring of the Government Pension Investment Fund** (GPIF) which plans to double its allocation to domestic equities from 12% currently to 25%. The new structure will help to meet the rising costs of pension pay-outs and was further confirmation that **Shinzo Abe is committed to meeting his inflation targets** as soon as possible.

This **news sent** the **Nikkei index surging almost 5% in one day and helped the S&P 500 in the US to a new record close** as investors once again found their appetite for risk assets. The **US Dollar continued to strengthen** against the Yen and against a basket of commodities, including oil.

These two major factors have pumped life into a flagging stock market and helped to erase fears that Japan is losing its battle with deflation. Investors will now be keeping a watchful eye on Abe's proposal to raise consumption tax for a second time in 2015 to 10%. Such a move could lead to further aggressive stimulus to support risky assets.

We have been supportive of Japan's ambitious monetary policy plans since they were first announced in 2012 and on the back of the renewed stimulus **we have taken the opportunity to add to our desired equity weighting** in the region **and remain positive about the prospects**. **Our European exposure is very low and we are not actively looking to allocate capital to the region.** We still feel that the political environment is not conducive to growth and even if the ECB did decide to increase its stimulus through QE, other markets such as the US and Japan would be direct beneficiaries.

October was a classic example of the markets' tendency to overshoot as an amalgamation of various global events instilled panic in the minds of global investors. As some markets fell as much as 10%, news of improving fundamentals and unexpected stimulus from Japan helped to ease the pain. **All eyes now turn to the US economy to determine whether the excellent jobs data that we have seen of late is sustainable in the long-term. We believe that it is and are positioned accordingly.**