INVESTMENT NOTE

September 2012

Come back on St. Legers Day

Sell in May and go away, don't come back 'til St. Legers Day

St. Legers Day fell on 15th September this year and is the day on when those of a superstitious nature may supposedly return with confidence. Anyone who's been "away" since 1st May could hardly fail to notice the FTSE 100 chart climbing merrily upwards and accelerating through 5,900. To be fair, this is only a modest 1.6% gain from where the index closed on the 1st May, but is still a significant recovery from the lows in June when there seemed no escape from the insoluble crisis in the eurozone, not to mention all the other concerns casting a gloomy cloud over market sentiment.

There was plenty to consider only a week ago. On the one hand, faintly disappointing job numbers out of the USA had kept cautious markets in check but, on the other hand, the market was already getting to grips with the relatively good news of an apparent policy U-turn by Angela Merkel. In addition, we were starting to ponder the ramifications of an ECB bond-buying program whilst hoping for its ratification by Germany's top court. Other potential banana skins included an uncertain outcome to a close general election in the Netherlands being fought between pro and anti Euro parties and, hogging the newswires, the launch of the new iPhone 5; an event now so big that it has an impact of overall consumption. All of these events passed off to the satisfaction of the stock markets but the biggest question of the week was whether the market would receive a third dose of financial medicine in the form of QE3 dispensed by the Chairman of the Federal Reserve, Ben Bernanke. After much speculation, the medicine was delivered generously.

The stock market, always hungry for more, would've been happy with a statement explaining where the Fed would like to see interest rates or the economy or, on the other hand, an indication of the emphasis the Fed places on unemployment or the long-forgotten issue of inflation. In the end, the market got both.

Their ongoing commitment to keeping interest rates low is now open ended and, for good measure, a target has been identified on the absolute level of employment that the Federal Reserve is trying to achieve. As we have noted before, the emphasis on unemployment has marked a fundamental shift and a bold one at that. Announcing QE3 with an open ended commitment to keep rates low, at a time when deflation is no longer deteriorating, sends a clear signal that some degree of inflation above and beyond the Fed's 2% target will be tolerated for as long as employment remains below target. Furthermore, this target would seem to be related to the long-term job participation rate rather than something cyclical and, therefore, here to stay for a while.

If this is the correct interpretation of the Fed's intentions, then QE3 will be bigger and longer lasting than QE1 and 2. The ramifications resonate beyond the USA – particularly as the EU, UK and others are all undertaking some form of monetary easing themselves. It could mean that the UK equity market rally will continue and that the bounce in UK Gilt yields has only just begun. Today, the UK 10-year Gilt yield is 1.94%, up from 1.46% at the end of August.

The dilemma facing a returning absentee from May will be further complicated by significant geo-political threats which have been steadily building up over the summer: Japan vs China over the Senkaku Islands, escalating austerity protests in Europe, Iranian involvement in Syria with Israel threatening pre-emptive action over nuclear capabilities and large military exercises in Straits of Hormuz with US embassies being attacked around the Middle East. For the TAM International investment team, these known-unknown issues were never as absent as the May seller. We are more concerned about what has changed in the longer term and, in that regard, the QE3 announcement not only gives us greater confidence to buy equities but re-enforces our oft repeated negative view of Gilts.

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