



Keep your eyes on the road

It would appear that the Greek authorities have blinked first and come up with a proposal that will allow the EU to throw in the towel whilst still keeping some degree of self-respect. With the FTSE 100 index down a few hundred points from the high, about 5%, in only a month, we believe this is an opportunity to reiterate the longer term reasons why we think equities will recover from this short term dip.

Stock and bond markets have learned over the last few years to treat good news as bad news and vice versa. Good news on the economy implies an end to QE and, ultimately, rising interest rates which erode the real future value of returns in equities. Conversely, bad news on US employment, or lower than expected inflation, serves to keep interest rate expectations pinned back. In this regard, the negative UK inflation rate in April was sobering. But it has already bounced back to positive territory and both the Bank of England and Chancellor Osborne have been vindicated in their determination to look through this period of “low-flation”, brought about mostly as a result in the fall in oil, and start preparing the ground for rate rises, probably in early 2016.

If this assumption is broadly correct, and if other economic indicators such as unemployment and wage

growth improve in the second half of 2015, then we can expect this to result in higher bond yields as the year progresses. In the meantime, with base rates still pinned at 0.5%, the Gilt yield curve will likely continue to steepen, with longer term interest rates rising, as it has done over the last 6 months; a so-called “bear steepening”.

In a market obsessed with the short term, one can be forgiven for expecting this scenario to be a hostile environment for equities. However, there have been more than a dozen periods since 1980, which technically counted as bear steepening, during which the FTSE All Share did marginally better than during other periods. It wasn't much, about +0.1% per month, but in a world of low returns, it's a more meaningful return than when interest rates were 5.5% back in 2007. This is an important difference from previous periods of rising Gilt yields because it sets the agenda for a honeymoon period whereby the opportunity for equities, supported by the reality of an improving economy, outweighs the impact that implied higher rates has on future earnings.

Furthermore, in absolute terms, nobody expects the Bank of England to raise rates to pre-2008 levels. Markets are expecting no more than two quarter point hikes by the end of 2016, which would bring the base rate up to 1%, still below the end-2016 forecast inflation rate of 1.6% and well below the Bank's target inflation rate of 2%. As such, we would also expect that the Government and Bank of England will be keen to justify rate hikes as a “lifting of emergency measures” and more of a return to normality rather than a concerted effort to curtail rampant inflation which, we believe, will be absent.

In such an environment, good news on the economy could change to being genuinely good news for stocks because, whatever the merits of an improving economy, company earnings will still have to deliver growth in order to support the more elevated valuations to which we have become familiar, particularly in defensive stocks. If investors deem the UK to be sufficiently reflationary and buoyant, something indicative of a steepening yield curve, then they may deem the risk of a move into more equities, and even cyclicals, well worth the risk.

In conclusion, we believe the recent sell off is yet another reflecting weak sentiment as a result of unremittingly negative news headlines for Greece and by extension the eurozone project, political or otherwise. Indeed, the TAM investment team increased exposure to UK equities by buying the Investec UK Alpha Fund and we are confident that the UK stock market will recapture recent highs in the second half of the year.

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