# Quarterly Newsletter / Spring 2014

**Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.**

After last year's see-saw stock market performance – better than expected results for the developed economies, but worse for emerging markets and commodities, in particular gold – stock markets have proved rather lacklustre in the first quarter of 2014.

In a nutshell: indices like the Dow Jones, S&P 500, FTSE 100 and Eurostoxx 50 have scarcely moved more than a couple of percentage points in either direction. Japan, buoyed last year by the Bank of Japan's huge quantitative easing programme, has had a disappointing first quarter, with the Nikkei Dow registering a negative 9%. On the other hand, gold miners have seen quite a recovery over the same time: the FTSE Gold Mines index is up 11.3%, and the Gold Mines indices for the regions EMEA and Asia Pacific are up a staggering 27% and 25% respectively.

Lacklustre performances in stock markets usually suggest that not much has been happening, but that was not the case. Markets always seem to find something to cheer or fret over, often simultaneously.

The American market hinted that it might continue where it had left off in 2013 but, no sooner had the S&P 500 index reached an all-time high in February, than analysts began agonising over the level of margin debt outstanding on the New York stock exchange. Margin debt levels are often seen as an indicator of investor sentiment – they tend to rise in times of good prospects in the stock market and quite often peak as the market itself peaks as well. A month ago, the margin debt had risen by 20% in the preceding twelve months to stand at US$451bn. To put this in context, at the peak of the 2007 pre-crisis market, it had only been US$381bn. Ignoring the fact that margin calls can be the result of either short or long positions, the pessimists took this as a sure sign that the market, particularly in technology and biotech stocks, was overbought and heading for a downturn.

In the event, nothing much happened and markets have remained relatively flat, the S&P 500 having recovered from a modest fall to post a new all-time high on 1st April. Let's hope that particular date isn't a bad omen: April Fools' Day, no less!

Even the concerns over the US Federal Reserve's less than flattering annual report or the steadily deteriorating situation in the Ukraine seemingly did little to dent broader market confidence. Given the potentially destabilising impact of the situation in the Crimea, a flat market could be viewed as remarkably upbeat!

The sentiment in the developed and emerging markets of Asia has not been quite so positive. Having seen some of the poorest performing markets in 2013, the region continued to show weakness whenever the US hinted at tapering despite the potentially offsetting effects of massive monetary intervention being pursued by Shinzo Abe's government in Japan. Currencies and markets were hit in January and remain down some 2% or so at the end of the quarter (9% in the case of the Nikkei 225 in Japan as mentioned above). That said, the BSE Sensex in India has registered an all-time high in March and recent trading in emerging markets has been a lot more positive with a nine-day winning streak at the end of March offsetting much of the earlier underperformance.

Whilst the long term prognosis for the Asian region remains intact, worries over the possible slowdown in China have seen investors seek security in the perceived stability of the traditional developed markets of America and Europe. Of course, the sustainability of the US economic recovery remains an issue, not helped by the often confusing employment statistics.

Bizarrely, it could be argued that mainland Europe offers investors the prospect of good returns if and when the market eventually is being re-rated. The crisis of 2008 hit markets worldwide simultaneously but, just as the recovery began to take hold elsewhere, the Eurozone was plunged into a secondary trauma which seemed to presage the imminent breakup of the single currency.

Whereas the US has returned to pre-crisis levels of output, the Eurozone recovery has effectively been pushed back by eighteen months or so, but there are clear signs – such as the return of a functioning bond market – that the worst of the macro threats have receded for the present and that there is, finally, the possibility that the region will recover its lost ground. As one fund manager put it, “Europe is solvent again.”

However harsh the human consequences and despite the ongoing levels of unemployment in the peripheral countries, Europe appears to be slowly getting back into a ‘normal’ cyclical economic pattern. Productivity and capital expenditure have improved considerably as a result of the strict austerity measures forced upon the weaker economies by the Troika – the European Commission, the European Central Bank and the International Monetary Fund – and this will eventually enable the region to grow out of its debt problems.

Whilst we would not advocate investing in a ‘Greek Opportunities’ fund, there are plenty of sound companies in the region that will enable good, stock picking fund managers to benefit from the anticipated market re-rating and, for this reason, we are gradually increasing the European exposure in portfolios where we deem it appropriate for clients.

Now that the region is seemingly returning to more ‘normal’ conditions, analysts can start worrying about the fragility of the French economy and the susceptibility of German exporters to a downturn in China. Without such worries, to inject a note of caution, the market could rapidly become frothy and the opportunity to benefit from a Eurozone recovery would be lost!

Long-term readers of our Newsletter will be aware that we have been heavily critical of both European politicians and bureaucrats, and the fact that things have improved somewhat recently has not changed our way of thinking about the inherent Eurozone problems. We agree with the rather cynical view that the Eurozone is a triumph of political rhetoric and perception over economic reality.

George Soros, in a recent speech he gave in London, put it even better when he said, “*The ‘tragedy’ lies in the EU’s transformation from a generally benign, even noble, endeavour in which countries gave up a little sovereignty in return for international harmony, into a spiteful and fast-disintegrating economic mess in which the union is run by and in the interests of its creditors*.”

The European Parliament elections in four weeks’ time will be interesting. Election turnout in the UK for European elections has always been on the low side, the highest turnout being registered in 2004 when 38.5% of the electorate bothered to vote, but the controversial Mr. Farage and his UK Independence Party may well change that. Of course, one cannot read too much into the outcome, as many voters will use the opportunity to register a protest vote against either the coalition or the traditional parties in general, particularly in light of yet more revelations about MP expenses scandals.

Another election is less than five months away, and that one is of particular relevance to us all as it is about Scotland's secession from the UK. On 18 September, the Scottish electorate will decide whether it wants to stay in the union or become an independent country. Over recent years, the polls suggested that the Scots did not really have the appetite for going it alone, but that has changed dramatically this year, with the latest polls showing a narrowing of the gap to some 2 or 3%.

This change in mood has resulted in more vociferous action among the unionist "Better Together" movement: an independent Scotland cannot keep sterling as its currency, say George Osborne, Ed Balls and Danny Alexander, and Standard Life threatened moving its operation out of Scotland. Even prominent Scottish politicians like Gordon Brown and Alistair Darling came out in support of a 'no' vote which is hardly surprising as an independent Scotland would do serious damage to Labour's general election prospects. Labour currently hold 41 seats north of the border, compared to the Tories' 1.

Alex Salmond might not be every Englishman's cup of tea, but he is an outstandingly able and clever politician, and it would be foolish to underestimate him. He paints a picture of a Scotland ruled by their own parliament for the benefit of their own people rather than being forever subjugated by Westminster.

All sorts of questions remain: what would happen to the UK's armed forces, particularly as the Scottish Government has already announced that the nuclear submarines would have to leave the Clyde in case of a 'yes' vote? Would Scotland join the EU, or its currency? What about the economy, particularly after the oil in the North Sea runs out? Alex Salmond has promised to cut corporation tax by 3%, but the Institute for Fiscal Studies doubts whether Scotland could sustain lower taxes. One major headache is the fact that Scotland's private sector accounts for less than half the economy – not a good point to start from if you want to lower taxation...

It will be fascinating to watch developments up to the referendum date. The UK economy currently is the fastest growing of not just European but also all the G7 countries, and inflation has dropped to 1.6%, well below its 2% target rate. This will make it more difficult for the 'yes' supporters to fully embrace Alex Salmond's vision, and it will certainly give them food for thought.

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