Quarterly Newsletter
Winter 2013/2014

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

If market indices are deemed to be reliable indicators, then 2013 was a very positive period with America's S&P 500 Index breaching several all-time highs and finishing some 29% ahead for the year. Even in the UK, where early in the year we were worrying about a "triple dip" recession, the FTSE-100 Index managed a gain of 14%.

The general tone on news flow through the year would hardly seem to support this rosy outcome – previous issues of the Newsletter have highlighted the ongoing problems within the EU, fears for a slowdown in China's economic performance and the political stalemate in the US which culminated in a government shutdown in October. In addition, there has been political sabre-rattling or, in some cases outright conflict whilst, on the business front, earnings have become increasingly soft.

So what could explain the near complacency evidenced by the VIX Index in Chicago? This index tracks the cost of insuring against a fall in the S&P 500 Index – in effect it is an indicator of market nervousness or lack thereof. The index began the year at 18 and has spent the majority of 2013 in the 12-13 range. When you consider that the index reached 80 during 2008 in the weeks following the collapse of Lehman Brothers, the seeming indifference to current risks seems puzzling. Some have argued that it shows 'risk habituation' on the part of market players who seem to now regard an occasional crisis as the new norm. Witness the muted impact on the S&P when the US failed to reach agreement on its debt.

In light of this determination to see potential, 2013 was a dire year for assets which are traditionally viewed as 'safe havens' when things get tough. The UK All Gilt Index fell 7% over the year whilst the gold price fell a massive 30% to end at around $1,200 per ounce. And let us not forget how a few words can rapidly undermine confidence – Chairman of the Federal Reserve Ben Bernanke's suggestion that it would soon be time to taper the quantitative easing programme (which surely means the crisis has passed?) undermined currencies and led to a massive sell off in both bond and equity markets in Asia and the Emerging Markets, a sell off which has yet to be recouped. The year has very much favoured developed markets.

There is some genuine reason behind this positive viewpoint, of course. The Abe government in Japan was given a mandate in the Upper House election to press on with the reform programme which is essential for the success of the so-called "Three Arrows" policy (quantitative easing on massive scale, huge infrastructure investment and boosting capacity and productivity) which seeks to stimulate inflation (!) and job creation. The consequent weakening of the Yen saw Tokyo stock markets boom and the Nikkei posted eye watering gains of 56% in local currency terms. It has not been a smooth upward trajectory, though: the Nikkei fell 20% in sixteen trading sessions during June as investors became nervous of shorting the currency and driving equities ever higher. It was a short lived panic, however, before the market calmed down and resumed its progress.

In addition, Europe continues to muddle through and there have been encouraging signs at the periphery as bond yields fell back towards more "normal" levels in Spain and Italy. In America, the world did not come to an end when parts of the government temporarily shut down – those in the Tea Party will probably say that this proves government is not needed! The American economy, helped by the improvement in the housing market, seems likely to secure a steady recovery despite stubbornly high unemployment figures.

In the UK, recent data also is encouraging. For the first time since November 2009, inflation has come down to the government-set target of 2%, and the upward revision of the UK growth prospects probably signals that, whilst there will always be something to fret over, the worst may have passed – for now, that is!

Indeed, the UK looks like staging the strongest economic recovery in the developed works, and following this week's unemployment figures, there is even talk of raising interest rates. Shortly after taking over as Governor of the Bank of England last July, Mark Carney stated that interest rates were unlikely to rise in the short term, citing a threshold of unemployment down at 7% before considering a hike in rates. He thought this would occur in 2015, and even he must be surprised by what has been happening. In August, unemployment stood at 7.8% but the figure has fallen dramatically since then, down to the current 7.1%. We are always a little sceptical when looking at unemployment figures – apart from being backward-looking, they have been "massaged" by the governments of the day for ages. Currently, the opposition would claim that many of these "new" jobs are part-time, the trade unions would point out the fact that they are not evenly spread across the country and UKIP would probably argue that they represent low paid jobs taken up by an influx of foreign workers.

Nevertheless, there is some broad strengthening in the labour market, but we don't think that the Monetary Policy Committee of the Bank of England will be in any rush to raise interest rates – the risks of derailing the frail recovery are too great. We continue to believe that both interest rates and inflation will remain on the low side for some time to come, which will please both central bankers (who want to see a broader and more substantial recovery) and borrowers, even though savers will hate these unrealistically low interest rates.

Clients have long been commenting about their difficulties in obtaining any sensible returns on cash deposits, and that is unlikely to change in the foreseeable future. Cash ISAs – often seen as an attractive way of keeping some cash in a tax-free environment – have offered particularly poor returns in recent times. Banks and Building Societies offer a baffling array of Cash ISA's, and some of them offer laughable rates: according to Money Mail, the worst three are Barclays, Halifax and Santander, who all have Cash ISA offering, wait for it, 0.1% per annum! In other words, had you invested £5,000 in one of these a year ago, you would now be £5 better off. Mind you, it is tax exempt…

Fixed interest instruments, such as corporate or strategic bond funds, fortunately offer an attractive and reasonably low risk alternative. Yields are around the 4% mark, and debentures with a good credit rating can provide a relatively safe haven if equity markets were to "throw a wobbly". There are a number of question marks hanging over the markets – a geopolitical crisis, severe problems in the Eurozone or a messy unravelling of quantitative easing in America, for example – and given the somewhat stretched equity valuations, a correction of sorts is entirely possible.

Interestingly, market commentators are remaining quite upbeat. The yearly predictions among major financial institutions about the outlook for the FTSE-100 expect the index to go up. It finished 2013 standing at 6,751 and the forecasts for the end of 2014 range between 7,000 and 8,000. That equates to uplifts of between 3.7% and 18.5%.

So, what else can we expect this coming year? In America, we will see a change at the Federal Reserve when Ben Bernanke hands over the helm to his successor, Janet Yellen - the first time we have a lady in charge of the Fed. She currently is the Vice-Chairman of the institution, having previously been in charge of the Federal Reserve Bank of San Francisco. She has an impressive CV and is seen by many as adopting a "dovish" stance regarding inflation, which means that unemployment is her main concern. It will not be an easy tenure of office, as we can expect another round of political infighting when the question of the US debt ceiling raises its ugly head again later this year. The Tea Party extremists are already sharpening their knives! Talking of the political landscape in the US, *The Washington Post* last October had an interesting piece on the subject. It stated that back in 1982, there were 344 Members whose voting records fell between the most conservative Democrat and the most liberal Republican. Some 30 years later, there were only 11. Therefore, in 1982, the centrists comprised 80% of the House, whereas now they make up less than 3%.

Europe, as already mentioned, also gives reasons for concern. Martin Wolf, the chief economic commentator at the *Financial Times,* predicts that the eurozone will collapse. He likens the stance of EU politicians to that of being so terrified of the consequences of an implosion that they are prepared to continue living in what effectively is a masochists' paradise.

Bizarrely, just as the much troubled periphery nations show slight signs of improvement, some of the core eurozone countries are themselves struggling more and more. France is a good case in point, with M. Hollande's popularity rating plumbing new depths, quite apart from his latest problems surrounding his somewhat complicated private life. However, even the Netherlands' economy is having a tough time, having been the worst performer of the core eurozone countries for the last two years. Its housing bubble has burst – the UK should take note! – with house prices falling by some 20% from their highs, which is particularly unwelcome as personal indebtedness is at a record high. Having lost its triple AAA status last November, there only remain three eurozone countries, Germany, Finland and Luxembourg as members of that exclusive club.

Putting our head above the parapet, we think the best stock market performance this year is likely to come from, in geographical terms, the US, Japan, China and, rather strangely, Europe. The FTSE-100 also should fare well.

Talking of the FTSE-100, congratulations were in order at the beginning of the year as it turned 30. The FTSE-100 was born on 3rd January 1984 and had a happy and relatively gentle childhood apart from a brief bout of illness (Black Monday in October 1987). However, like many youngsters in their late teens, it showed signs of irrational exuberance (according to Fed Chairman Alan Greenspan) and suffered a major setback, mainly due to becoming rather too obsessed with all kinds of new technology gadgetry. It then reverted to tried and traditional values and recovered well until, like many other 23-year-olds, it got into severe financial difficulties. Overspending on borrowed money and making some rash investment decisions led to a severe cash crisis, and credit was virtually impossible to obtain. The 30-year-old now has recovered again and, hopefully, will flourish in future!

To put this tongue-in-cheek analogy into context, had you invested £1,000 on 03/01/1984 in the FTSE-100 and spent all the income (dividends) in the meantime, on 03/01/2014 you would have been worth £6,724. Had you put the same £1,000 into a Building Society and spent all the income from that, you would still only have £1,000.

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