GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary - July 2013

FTSE 100	**6,620**	S&P 500	1,685
Resistance	6,700	Gold	**$1,331**
Support	6,400	GBP/EUR	1.1463
VIX	13.4%	GBP/USD	1.5205

Introduction:

Since our last market commentary, in which we moved to overweight on equities, the FTSE 100 has risen 357 points (5.7%).

Our thoughts on gold (where we stated the previous 15% monthly fall was overdone) were borne out with an even more spectacular recovery of 10.7%. Gold bugs are pointing to the 'Future' prices as evidence that "*a corner has been turned*". Irrespective of its short-term movements, it is not uncommon for wealth managers to recommend all clients hold gold – it has a zero correlation with other assets, making it a useful diversifier of risk. It is also a hedge against inflation and despite all the talk of 'tapering', in reality the FED and the Bank of England will have to keep applying stimulus for several years and that will be very supportive to the gold price.

Our recommendations from last month all rose with Rio Tinto up 9.1%, iShares Emg Mkts Select Dividend up 0.8%, British American Tobacco up 1%, United Utilities up 5.25% and General Accident 8 7/8% Preference Shares rising 3.4%.

Economics:

Things are looking up in the UK with retail sales in July growing at their highest level since January. The feel-good factor from the heat wave and early summer sales have helped boost the high street, following a very weak start to the year. UBS has raised its 2014 UK GDP estimate from 1.2% to 1.8% on the back of increasing domestic demand, driven by an ultra-accommodative central bank that is determined to lift asset prices.

In Asia, many observers are worrying that China's weaker growth is not only set to continue but maybe weaken even further, leading to a so-called "hard landing". Jim O'Neill, former Chairman of Goldman Sachs Asset Management, thinks this is unlikely. According to Mr O'Neill, China's economy is now worth $8.2 trillion, now more than half the size of the US. That means if China grows by 7.5% p.a. - its Q2 rate and what the government is assuming for the rest of the decade - this would be the equivalent of the US

Market Commentary (cont)

growing by 4%. The US has not grown by 4% for many decades, apart from the odd year. So, if China's slowdown is limited to 7.5% p.a., this is still a country that is going to have a massive impact on the world. So, while a slowdown from above the 10% level China has achieved for the best part of the last three decades is notable, from a global perspective, it is not as slow as many people think. If China grows by 7.5% p.a. over the next decade (it has grown closer to 8.5% so far this decade), it will be an economy of over $16 trillion by 2020. We shall discuss how to profit from the emerging markets theme in further detail later in the commentary.

Technical Analysis:

The stock market recovered strongly from its low of 6025 reached in the month. The FTSE 100 has recovered back up above its 200 day moving average, still upward-sloping, which is positive for the long-term. Short-term, the market looks trendless. With the RSI at 62 and ADX at 20 (neutral territory) indicating that it is likely we will have a consolidation in the short term.

Seasonality: *"History doesn't repeat itself, but it does rhyme" - Mark Twain*

August

This month has a good record of following the trend. The FTSE All-Share has risen 90% of time during bull markets with declines of no more than 1%, whereas the market has risen less than 25% of time during bear markets. Being in the throes of a bull market, this is a positive indicator for the markets.

Sell in May and go away; don't come back till St Leger Day

Historically, this is the worst time of the year. Since 1966 to 2009, the FTSE All-Share has returned an average of just 0.7% between May Day and Halloween (it is known as the Halloween effect in the US) compared with 7.8% between Halloween and May Day.

Our pagan ancestors knew this, which is why *Beltane* is a time of festivity (where people look ahead to fertility, plenty and joy) while *Samhain* marks the beginning of the "*darker half*" of the year. In March & April lighter evenings and warmer days cheer us up, which makes us more willing to take risks such as buying shares. So prices rise to high levels, which are difficult to sustain over the summer. In the autumn the darker nights make us more gloomy, with the result that prices fall to low levels from which they recover.

First-Year U.S. Presidential Cycle

The stock market tends to bottom out during the second year of each new presidential term and then recover strongly in the final two years. This is due to each Administration ensuring that the economy is strong by re-election time. Unfortunately, the excessive stoking of the economic fires creates excesses, including over-priced stocks, leading to poor stock market returns in the first two years of the next term.

Market Outlook:

Over the long term *(since 1962), the FTSE All-Share has returned 7.2% per annum and that does not include the average 3.8% dividend yield earned on top. Considering inflation averaged 6.2% over the same period, it is vital that an investor invests in equities in order to preserve the purchasing power of their money. However, markets can be subject to swings in the interim and investors should be mindful of these with a view to protecting their capital.*

Market Commentary (cont)

Our allocation to the stock market moves to equalweight. Following such a strong rally in the stockmarket over the last month, value is more difficult to find and thus, we recommend trading more cautiously, ready to reload should a seasonal pullback occur. This is quite likely this time of year, particularly with traders/investment managers away from their desks and the resultant potential for large moves on low volumes.

Longer term, we remain bullish and will buy the dips when they come along. Citi argues that equities are moving from the worst to best risk-adjusted return asset class. Their recent outperformance vs. bonds will force capital allocators to return to equities in the next 1-2 years, ending their 'exclusive' relationship with the bond market, and, in turn, will drive a further re-rating of the asset class.

J.P.Morgan Cazenove believes that equities will learn to live with higher yields and has moved Europe to Overweight in the regional context, noting that European equities are back to last July's relative lows vs. the US, completely unwinding the post Draghi bounce.

Their rationale for buying Europe is based on:

1) Central bank policies are now decoupling. The FED is in tapering mode, while the ECB and BoE are emphasising "low for longer". The diverging rates backdrop could spill over into currencies – helping earnings and exports.
2) European PMIs are picking up – suggesting EPS downgrades could end.
3) European valuations are attractive again and the region could benefit if "Value" style recovers – it typically works when yields are rising.

They find the sector 'Discretionary' attractive (33% Price-to-Book discount to the US) and have upgraded 'Autos'. They also highlight 'Energy' (28% relative discount) and 'Banks' (37% Price-to-Book discount).

Tweet of The Month:

In July, we tweeted that US companies had bought back more than $1 trillion of their own shares since 2009. This is equivalent to 10% of their average market capitalisation over the period. Here we discuss what this means to shareholders.

Whilst preferring companies that opt to return excess capital to shareholders via dividends, an interesting research note from Citi has recommended tilting an equity portfolio towards those companies carrying out major share buybacks.

Though interest rates have increased over the last few months, they are still paltry by historical standards. Given the large cash piles on company balance sheets, Citi believes that companies will continue to return capital to shareholders via share buybacks.

Research by Citi has found that companies conducting share buybacks have tended to be strong performers. Over the last 13 years, their 'global buybacks' screen has returned 13% p.a. and it is up 25% year-to-date. This screen contains the largest 50 companies from the MSCI Word Index that have reduced their share count by at least 5% in the last 12 months and is the screen is rebalanced monthly.

Market Commentary (cont)

Current stocks in the screen have an average buyback yield of 8.5% and a dividend yield of 1.9%, which amounts to a distribution yield of 10.4%.The most represented sector in the screen is 'Consumer Discretionary' (mostly Media and Retail companies) followed by 'Health Care' and 'Financials'. Out of the 50 stocks in the screen, 45 are from the US. Some familiar companies include:

UK: BSKYB
Netherlands: Phillips
Italy: ENI
US: Yahoo, Goldman Sachs, American Express, Stanley Black and Decker, Pfizer, AT&T, Marriott International, General Motors, Northrop Grumman, Xerox, Oracle & Time Warner Cable

Recommended Investments:

Equities

1) British American Tobacco - 3470p, 15.4x P/E, 4.2% yield
Core defensive stock that has fallen 8.4% from its recent high. BATS' focus on brands and emerging market growth has helped offset tough conditions in mature Western markets. Trading at a discount to global peers, J.P.Morgan Cazenove has a 4102p price target, indicating 18% potential upside.

2) Imperial Tobacco - 2182p, 10.2x PE, 5.3% yield
89% of Imperial's revenues derive from international markets. This makes the translation effect (sterling has weakened significantly in recent months) particularly relevant. A core defensive stock with a well-covered dividend that is cheap on both a technical and fundamental level. Deutsche Bank has a 3000p price target, suggesting 37% upside.

3) iShares Emerging Markets Dividend ETF (SEDY.L) - 1772p
Emerging market equities have reacted poorly to talk of Fed tapering, leaving this low-cost (0.65% p.a.) ETF that tracks emerging market dividend paying companies looking good value on a yield of 4.7%.

The MSCI Emerging Market (EM) benchmark now trades on a P/E of below 10x. Though buying the major equity regions on this valuation has proved to be a good strategy in the past, many investors are still cautious, viewing the region as a value trap. Reasons to stay away include rising current account deficits, GDP downgrades, excess CAPEX, a rising USD and falling commodities. However, Citi believes these concerns are overdone. For example, current accounts have had a mixed relationship with equity performance, commodity prices are falling more for supply reasons, EM GDP is still outperforming Developed Market (DM) GDP and EM economies are now less USD sensitive.

So, what can be the catalyst for a recovery in emerging market stocks, notwithstanding the fact that the buy cheap/sell expensive trade usually works in the long term?

Well, firstly, EM equities have a greater sensitivity to growth than is the case for DM. Less uncertainty about global growth and investors will swing towards more cyclical assets like EM equities.

Second, none of the EM countries are zero-bound in terms of interest rates. Should they feel the need for monetary stimulus, this can be done. Their strong fiscal position also allows further stimulus if needed. EM finance ministers simply have more options than their DM counterparts.

Market Commentary (cont)

Finally, given how negative sentiment is towards the asset class, all it would take is for the data to be less bad and you'd get a re-pricing of risk assets. EM's nominal GDP is 48% higher than pre-crisis but the markets are 1/3 lower. It's tough to find anyone who has a good word to say about this asset class. But that's why it trades on a single digit P/E.

Chart Legend:

red dashed line	20 day moving average	(signifies the short-term direction of the security. prices tend to gyrate around their 20 day m/a)
red line	50 day moving average	(signifies the medium-term direction of the security)
thick red line	200 day moving average	(signifies the long-term direction of the security - whether it is in a bull or bear market)
thick green line	400 day moving average	(signifies the long-term direction of the security - whether it is in a bull or bear market)
blue line	bollinger bands	(an indicator that measures 2 standard deviations away from the 20 day m/a)

Technical Analysis Guide:

RSI (relative strength index) - indicates whether a security is overbought (above 70) or oversold (below 30). Also when the RSI moves above 50 that is considered bullish (or vice versa).

ADX (average directional index) - indicates whether a security is in a trend (above 20) or not in a trend (below 20). For trending markets moving averages work best when considering lines of support/resistance. For non-trending markets Bollinger Bands work best (sell at upper band, buy at lower band).

FTSE 100
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Index
6900
6800
6700
6600
6500
6400
6300
6200
6100
6000
5900
5800
5700
5600
6620.17
b
b
B
B
B
31/7/12
Sep
Oct
Nov
Dec
'13
Feb
Mar
Apr
May
Jun
Jul
7/8/13
14 RSI (simple - Daily)
80
60
40
20
14 ADX (Daily)
40
30
20