Gibraltar Asset Management

Stockbrokers & Investment Managers

Market Commentary - November 2013

FTSE 100	**6,655**	S&P 500	1,807
Resistance	6,770	Gold	$1,249
Support	6,505	GBP/EUR	1.2003
VIX	13.0%	GBP/USD	1.6330

Introduction:

Since our last market commentary, in which we moved to equalweight from overweight on equities, the FTSE 100 has fallen 117 points (1.73%).

After reaching multi-year highs, the equity market was simply looked tired. Indeed, various indicators at the beginning of the month predicted this – the bull/bear ratio, director selling, and the gap between sector risk appetite and overall risk appetite had all reached extreme levels associated with marginal market falls.

Last month's stock recommendations were disappointing with Centrica falling 4.2% and HSBC falling 0.3%. We are still bullish on both, which yield 5.3% and 4.6% respectively. On top of this, Deutsche Bank has since put a 430p price target on Centrica (26% potential upside) and Nomura has since placed a 850p price target on HSBC (24% potential upside).

Economics:

The UK's economy is now getting a little hot. With the private sector adding 1,000 jobs a day and the housing market at all-time highs, the Bank of England's move to cool mortgage lending via a change to its Funding for Lending Scheme could be a signal that the Bank has been caught out by the strength of the economy, and may need to tighten monetary policy sooner than thought.

The pound enjoyed a good rally following the announcement as traders bet that interest rates could increase in 2015 and as the market appreciated the BoE's move to head off threats to financial stability from the housing market.

Over in the Eurozone, the picture is not as rosy. Though unemployment rates in most peripheral economies have already reached their peak, the deterioration in the Eurozone labour market as a result of the economic slowdown is spreading to several core European economies where unemployment rates are rising.

Market Commentary (cont)

Over in the US, recent improvement in US payrolls has fuelled speculation that the FED could be looking to taper its large-scale asset purchase (QE) programme sooner rather than later. We shall look at the ramifications of this and what it could mean for the markets later in the commentary.

Technical Analysis:

Last month's analysis (*"we feel that the UK's main index is subject to a short-term correction"*) again proved spot on, falling 1.73%. Looking ahead, the market appears totally trendless from a technical perspective, with the RSI lying at 41 and the ADX at 16. Standing just above the 50-day moving average, there is no reason for any dramatic move in the markets bar one based on fundamental or seasonal factors.

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

Santa Claus Rally

The FTSE All-Share has risen in December 27 of the 32 years from 1980 to 2012. The average monthly gain, including the 6 down years, was 2% and in the up years the average gain was 3.2%. Also, the chance of taking a big hit during December is much less than at other times of the year. Even during bear markets, the size of December's falls - around 0.5% on average - has been pretty modest. The DJIA exhibits similar characteristics. The Santa Claus Rally occurs during the last 5 days of the year (usually on low volume) and officially ends on the second trading session of the new year. There are several reasons for this:
1)Window dressing. For fund managers chasing bonuses, performance is everything and they seek to maximise it at the year end.
2) Seasonality. The 4th quarter has been a great time to be invested in equities and the UK stock market generally. December is also the stock market's strongest month, by quite a margin. Since 1970, the market has achieved positive returns 86% of the time, increasing by an average of 2.6%.
The gains are weighted to the final few weeks of December as trading volumes tail off and traders shut up shop. As liquidity dries up, the only market participants still trading are likely to be buyers of shares. By comparison, the odds of the UK market rising in the first ten days of December are no more than 50:50.

Fourth Quarter

The fourth quarter tends to be a strong one for the stock market. For example, the FTSE 100 rose no fewer than 20 of the 25 years between 1990 and 2005, posting an average gain of 4.5%.

November - April

Delaying re-entering the market from St. Ledgers Day to Halloween has yielded statistically significant outperformance with the FTSE All-Share rising an average 13.4% from Halloween to May Day since 1965. There is a 1-in-2,000 chance of this arising by chance in random data. One explanation for this is that as the nights draw in during winter, we become anxious and depressed, which means share prices fall and expected returns rise. This then leads to a decent winter rise.

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.

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Market Commentary (cont)

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. Therefore, 'strategically', it pays to be in the market. Also, 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 and thus maintain a 'tactical' view.*

Our allocation to the stock market reverts to overweight. The short-term outlook remains very compelling. Technically, the RSI has fallen from an extremely overbought reading of 93% to 41%, a good base from which to move to the upside. The seasonal factors going into Year End are too strong to ignore. We will discuss our outlook for 2014 in greater detail next month but Credit Suisse has outlined the following factors that underpin equities generally:

1) Cheap relative valuations. Equities remain cheap vs bonds and flows are coming into the asset class
2) Excess liquidity
3) Inflation expectations-are set to rise, which are positive for equity multiples
5) Long-term positioning is cautious (retail/institutions have sold ~$200bn of equities since 2009)
5) US EPS growth is set to be 7% in 2014 and European EPS growth is forecast to be 10.5%
6) Global GDP growth is likely to accelerate to 3.8% in 2014

Therefore, even if things don't pan out as expected over the short-term, long-term investors can take comfort that they are swimming with the tide.

Tweet of The Month:

We recently tweeted that FED tapering is on the way perhaps earlier than many think. In this section, we look at QE in further detail and analyse what effects its withdrawal will have for investors.

Equity markets have been on a roll for some time, driven in no small way by the FED's large scale-asset purchasing programme (QE), which currently stands at $85bn a month.

However, all good things eventually come to an end and tapering, the term for slowing the QE programme, is the first step of a multi-year process of monetary policy normalisation that leads to an eventual end to QE and, 1-2 years later, a gradual rise in interest rates.

Earlier this year, the FOMC seemed to have made tapering and future rate hikes exclusively a function of the unemployment rate, which has fallen faster than expected. As a result, the median consensus forecast seems to expect tapering in March, though investment bank J.P.Morgan considers January to be more likely.

What effect will this have on the equity markets? Well, we think concerns about broad market disruptions from FED tapering are probably overdone. This is especially true as long as the FED's effort to separate tapering from interest rate tightening remains successful.

Market Commentary (cont)

Already, the link between equities and fixed income is reverting to pre-QE patterns: as the US economy improves, equities are rising, but so are bond yields. Investment bank Barclays expects the FED's policy withdrawal to usher in an environment of lower long-only returns, higher volatility and the need for more active investment management.

With this in mind, we see a tactical case for overweighting equities. With interest rates set to remain at historically low levels for the next 1-2 years, we do not see an early start to FED tapering being especially disruptive for broader risk assets. Thus, FED tapering is offset by stable short-end yields and gradually improving US and global growth. Indeed, with global growth improving, we see a case to add to cyclically-sensitive domestic stocks as well as emerging market equities.

Once expectations of the first FED tightening appear, we anticipate a more disruptive period for the markets at which point an underweight stance to equities may make sense along with an obvious aversion to long-dated bonds. But that won't be for some time yet to come.

Recommended Investments:

Equities

1) Centrica - 341p, 11.9x P/E, 5.3% yield

The owner of British Gas is involved in the supply of gas, electricity and services for UK residential and business customers. Deutsche Bank has a 430p price target, indicating potential 26% upside.

2) HSBC - 683p, 11.7x PE, 4.6% yield

A banking and financial services giant, operating out of 7,200 offices in 85 countries, trading at the lower end of its trading range and much favoured by the investment analyst community. Nomura has a 850p price target, suggesting 24% potential upside.

3) British American Tobacco - 3255p, 14.9x P/E, 4.4% yield

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 4209p price target, indicating 29% potential upside. Technically, the shares are extremely oversold with a RSI reading of 15.

4) United Utilities - 658p, 15.4x P/E, 5.5% yield

We believe this stock offers good income for investors with a 5.3% yield that is set to rise at 2% above inflation. Despite the failure of the recent takeover attempt of Severn Trent, there is still an outside chance of capital gains through corporate activity. Deutsche Bank has a 800p price target, indicating 22% potential upside.

5) Provident Financial - 1592p, 14.7x P/E, 5.3% yield

Provident Financial is a rare financial company that offers double-digit earnings growth (EPS CAGR of 15%), resulting in 24% potential upside to Berenberg's price target of 1970p, coupled with a high and growing dividend yield of 5.4%. See trading note of 11th November 2013 for further details.

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Market Commentary (cont)

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)
red line	200 day moving average	(signifies the long-term direction of the security - whether it is in a bull or bear market)
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).

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