# Market Commentary - March 2014

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|---|---|---|---|
| **FTSE 100** | **6,809** | S&P 500 | 1,859 |
| Resistance | 6,960 | Gold | $1,329 |
| Support | 6,425 | GBP/EUR | 1.2123 |
| VIX | 14% | GBP/USD | 1.6578 |

## Introduction:

Last month we advised investors *"Following such a large fall in the market, we feel that technically the equity markets are due a bounce, having reached extreme oversold readings"*.

The market subsequently put in a tremendous 4.6% rally in just one month. Investors were even buying gold again, which is now up 11% so far this year and wagers on rising prices are at a four-month high in the futures market.

All our stock recommendation turned in a positive performance – Aberdeen Asset Management (1.5%), BG Group (4.5%), BHP Biliton (7.7%), BATS (11.2%), Diageo (3.1%), GlaxoSmithKline (5.7%), HSBC (0.9%), Imperial Tobacco (8.9%), Tesco (2.9%) and Unilever (4.2%) with an average gain of 5.1%, thereby outperforming the wider market.

## Economics:

Growth in the US was downgraded on Friday more than expected – the world's biggest economy grew at an annual rate of just 2.4% in the final quarter of last year, revised down from 3.4%. This was blamed on the cold weather which led to reduced consumer spending, lower exports and the resultant cut in growth figures.

A string of disappointing US data has raised concerns that the recovery is stalling, and with it the Federal Reserve's reduction of asset purchases. But, while the US has started off 2014 on shaky ground, anyone who thinks the poor data will mean a pause in tapering is mistaken. The fundamental story of the US recovery is unchanged and the Fed doesn't determine policy on short-term effects. Despite all the noise from the bad weather, the underlying signal of a US recovery is still strong, which means the FED is likely to continue its taper.

In the Eurozone, unemployment has stabilised at 12% (although it isn't getting any better), but youth unemployment remains stubbornly high at 24% having barely budged in the last six months. Inflation for

# Market Commentary (cont)

February was 0.8%, higher than expected and offering some relief to those fearing a Japanese-style lost decade of deflation. The Euro rallied in response, making it less likely that the ECB will have to loosen monetary policy next week.

UK house prices were 9.4% higher in February than they were a year ago, according to the latest house price index from Nationwide, against a background of record low interest rates, low supply, improved credit availability and rising consumer confidence. Whilst the Bank of England currently does not see excessive house price rises outside London, Governor Mark Carney has expressed concern about the UK's past record of house booms and busts. This could lead the bank to take further action later in the year to try and dampen the housing market, perhaps by recommending that the Government dilutes its Help to Buy mortgage guarantee scheme.

## Technical Analysis:

Last month's analysis ("*We feel the market is oversold and that a bounce is likely, which has happened on the previous occasions the RSI reached this level over the last two years*") again proved spot on. Looking ahead, the market has reverted to overbought levels. Lying at 6,809, the FTSE 100 is within just 55 points off its recent high, is at the upper end of the upper Bollinger band and is now 228 points above the 200 day moving average. With the RSI reading at 79, we feel the market is overbought and that a correction is likely.

*"The illusion of randomness gradually disappears as the skill in chart reading improves" – John Murphy*

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

The January Barometer ☹

Historically, the returns in January have signalled the returns for the rest of the year. If they are positive, the returns for the whole year tend to be positive and vice versa. First mentioned by Yale Hirsch in the Stock Trader's Almanac in 1972, a variant has it that returns for the whole year can be predicted by the direction of the market in just the first 5 days of the year.

Whichever variant you use, statistically 2014 is likely to be a down year if the past has anything to go by.

March ☺

The variation in performance that exists between the 12 months of the year is statistically significant. For example, December is the FTSE 100's best performing month since 1984, rising 2.5% on average, 86% of the time. September is the worst month of the year, rising just 48% of the time, with an average return of -1%.

March is the 7th best performing month, rising 57% of all the years in March, with an average return of 0.7%.

First Quarter ☺

The FTSE All-Share has risen no fewer than 19 of the 25 years between 1990 and 2005, posting an average gain of 4.2%.

# Market Commentary (cont)

## Seasonality (cont):

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.

Second-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.

Chinese New Year – Year of the Horse

The Chinese calendar revolves around a 12 year cycle where each year is associated with an animal (rat, ox, tiger, rabbit, dragon, snake, horse, goat, monkey, chicken, dog and pig). Each New Year starts between 21st January and 21st February, the exact date being dependent upon a variety of complex factors. The best performing animals since 1950 have been the goat and the dog. The worst performing animals have been the chicken and snake.

This year is the year of the horse, a decent year historically for equities, with positive returns averaging ~7%.

Market's Decennial Cycle

Since 1801, the strongest years for the FTSE All-Share have been the 2nd, 3rd and 5th years in the decades. The market has risen 14 out of the 21 decades in these years, with an average return of over 4%. The weakest has been the 10th being the only year to have a negative average change (-1.2%).

The 4th year has been positive in 13 of the 21 decades, rising on average 6.2%.

## Quote of the Month:

*"Money was never a big motivation for me, except as a way to keep score. The real excitement is playing the game"* – Donald Trump

# 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 turns to underweight.** Following such a large rise in the market, we feel that technically the equity markets are due a correction.

The equity markets will also take into account the current geo-political factors. Russia's military intervention in Crimea will almost certainly raise the fear levels and create what markets hate most – uncertainty.

Fundamentally, European equities continue to rate amongst the most attractive. A quick look at history makes clear that if earnings do indeed start to improve the upgrades could be significant – coming out of the early 1990s recession European earnings produced a 3-year CAGR of 24% and coming out of the 2001-02 recession a 4-year CAGR of 39%. So while the overall balance of risks is now less skewed to the upside, 2014 will still likely to be another good year for European equities. Macquarie is forecasting 15% total return for European equities in 2014, the great bulk of which they expect to come from upside surprise to earnings.

We would use any sell-off in the markets as an opportunity to reload on some of our favourite European names – GDF Suez, ENI, Ageas, Veolia Environment, Munich Re, Iberdrola, Bpost, Allianz, Suez Environment, Axa, Total and Delta Lloyd.

## Tweet of the Month:

*"Small, Medium or Large – Does a company's size determine its returns?"*

The old saying that the best things come in small packages certainly seems to apply to the stock market. The FTSE SmallCap index delivered a total return of 33% in 2013, followed by the FTSE 250 index (32.3%) and finally the FTSE 100 (18.7%). This has played out over the long term as well – a £1,000 investment that tracked the path of the Numis Smaller Companies index in 1955 would have grown to £4.7m by the end of 2013, whereas an investment in the blue chips would have grown to just £0.62m. Strangely, since 1985, it is actually the FTSE 250 that has outperformed both the large caps and the small caps, while incurring less volatility than the SmallCap index.

One reason for this outperformance is their higher risk. The FTSE SmallCap and FTSE250 have been more volatile than the FTSE 100 and suffered greater 'hits' during bear markets. However, that does not mean that large caps should be ignored. They outperform when the OECD leading indicator of economic activity for the UK has fallen.

So, what is the chance of small and mid caps repeating their 2013 performance? Unfortunately, their valuations are no longer compelling. Analyst's bottom-up forecasts put the average earnings growth rate at 12.3% a year, which is only 2% ahead of what the blue chips are forecast to achieve. However, the FTSE 250 is trading on 22.4x earning compared with the FTSE 100's 13.8x.

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# Market Commentary (cont)

## Trader's Corner:

Quarterly Sector Strategy

The following sectors can be have been found to be the strongest/weakest in the FTSE 350 over the year's four quarters:

| Quarter | Strongest Sector | Weakest Sector |
|---|---|---|
| 1st | Industrial Engineering | Pharmaceuticals |
| 2nd | Electricity | Construction & Materials |
| 3rd | Software & Computer Services | Oil & Gas Producers |
| 4th | Beverages | Banks |

This suggests a strategy which cycles a portfolio through the four strong sectors throughout the year – Industrial Engineering from 1st January to 31st March, Electricity from 1st April to 30th June, Software & Computer Services from 1st July to 30th September and Beverages from 1st October to 31st December. Over the last 10 years, this strategy would have grown a £1,000 portfolio into £13,300, compared with a buy-and-hold in the FTSE All-Share of £1,669. *Investors looking to trade this strategy, could look to buy shares in Weir Plc (2148p, 14.8x P/E, 2% yield, 11% upside to average broker target) in the first quarter. More sophisticated traders may look to use a CFD to gain leveraged upside to the sector or even create their own hedge fund by shorting Pharmaceuticals whilst going long Industrial Engineering via CFDs.*

Seasonal Tendency

The market tends to rise for the first three weeks of March and then fall back in the final week, historically one of the weakest weeks in the whole year. *Going long the market via a CFD would be best to capture this move.*

Gold Weakness

On 17th March 1968, the system that fixed the price of gold at $35 collapsed and the price of gold was allowed to fluctuate. Since then, the gold price has been historically weak in March, falling almost 0.5% on average. *Going short gold via a CFD would be best to capture this move.*

Outperformance of FTSE 250 vs. the FTSE 100

The FTSE 250 tends to outperform the FTSE 100 in the first 3 months of the year as well as in August. In the more troublesome months of September (the year's worst performing historical year) and October (the year's most volatile month), the reverse applies. *The obvious way to play this trend is the go long the FTSE 250 and short the FTSE 100 via CFDs from 1st January to the 31st of March.*

# Market Commentary (cont)

## Trader's Corner (cont):

Strongest Week

The 31st of March is the year's 8th strongest week rising 66% of the time, posting an average increase of 0.7%. *Traders looking to profit may look to go long the FTSE 100 with a CFD or take out a binary bet for the FTSE to finish up.*

Weakest Weeks

The 17th of March is the year's 9th weakest market week, rising 45% of the time posting an average gain of 0.2%. The 24th of March is the year's 10th weakest market week, rising 45% of the time posting an average gain of 0%. *Traders looking to profit may look to go short the FTSE 100 with a CFD or take out a binary bet for the FTSE to finish down.*

## Recommended Investments:

**Fixed Interest**

1) Paragon 6% 05/12/20
The Paragon Group of Companies is a leading independent specialist lender focussing on providing buy-to-let mortgages to professional landlords. The average landlord is 54 years of age, owns 9 properties and has 13 years experience of letting. Arrears on their loan book are very low standing at 35bps, against an average of 1.16% for the BTL sector.

Paragon is a FTSE 250 company with a market capitalisation of £1.25bn. Its stable and experienced management guided the company through the financial crisis, always remaining profitable. The company is expected to launch a banking subsidiary imminently, which will further diversify its funding options.

Trading at 102.25, the bond is offering a very attractive gross redemption yield of **5.6%**. The debt is senior, unsecured, with the following key covenants designed to protect bondholders:

- Gearing covenant - Net Senior Debt of Issuer to Issuer Equity shall not exceed 1:1
- Negative Pledge on provision of security and subsidiary guarantees

It is a full negative pledge which catches bank debt, bond debt and all financial guarantees granted by the holding company.

In summary, Paragon is a straightforward business and easy to understand. A senior bond with covenants offering 5.6% seems to us a good deal in this economic environment where interest rates are not expected to rise for many years to come.

# Market Commentary (cont)

## Investment Calendar:

This is a busy month for company announcements with approximately a third of all FTSE 350 companies announcing their prelims in March.

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|---|---|
| 1st March | New Moon (markets tend to reach tops around this time) |
| 6th March | MPC interest rate announcement at 12 o'clock |
| | ECB Meeting |
| 7th March | US Nonfarm payroll report |
| 12th March | FTSE 100 Quarterly Review (shares joining the main index tend to subsequently fall) |
| 17th March | 9th Weakest Market Week |
| 18th March | FOMC Meeting |
| 19th March | Chancellor's Budget |
| 21st March | Options Expiry Day |
| 24th March | 10th Weakest Market Week |
| 30th March | New Moon (markets tend to reach tops around this time) |
| 31st March | 8th Strongest Market Week |

## Chart Legend:

| | |
|---|---|
| 20 day moving average | (signifies the short-term direction of the security. prices tend to gyrate around their 20 day m/a) |
| 50 day moving average | (signifies the medium-term direction of the security) |
| 200 day moving average | (signifies the long-term direction of the security - whether it is in a bull or bear market) |
| 400 day moving average | (signifies the long-term direction of the security - whether it is in a bull or bear market) |
| 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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Printout from Alpha Terminal - 02/03/2014 16:25