GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary - November 2014

FTSE 100	**6,546**	S&P 500	2,018
Resistance	6,840	Gold	$1,169
Support	6,195	GBP/EUR	1.2792
VIX	14%	GBP/USD	1.5971

Introduction:

Last month, we moved to overweight on the stock market, noting that October was historically a good time for equities (occasionally punctuated by bond-jarring losses) but that any correction would be short lived. The August rally, following July's decline for example, showed that investors were anxious to buy into any dip, suggesting that corrections into year-end will only beget more bargain buying.

In the event, a correction did bring the market down to 6,195 (-6.9%), however thankfully the correction was indeed short lived with the market subsequently rebounding 5.7%. Our only recommendation was Eros 6.5% 15/10/21, which rose 1%.

Economics:

European inflation increased to 0.4% in October, well below the ECB's 2% target, thereby providing little relief for policymakers attempting to ward off inflation in the single currency bloc. The low core inflation reading reinforces concerns about deflationary risks and will keep pressure on the ECB to do more to steer inflation back to their target, most probably in the form of further monetary easing. Mr Draghi has previously said that he considered inflation below 1% to be in a "*danger zone*", which could lead to prices tipping into a deflationary spiral. The unemployment rate was unchanged at 11.5%. Unfortunately, stuttering economic activity and more fragile business confidence is slowing the already very limited improvement in labour markets.

Fortunately, the world's largest economy grew faster than expected in the 3rd quarter, boosted by a rise in exports and a jump in government defence spending. Annual growth in the US was 3.5%, stronger than the 3% forecast by economists. The better-than-expected growth figure echoed the upbeat assessment on the US economy from FED chair Janet Yellen, who last week called time on the central bank's $4.5tn bond-buying programme, suggesting recovery was on track with the economy expanding at a "*moderate*" pace. Monetary policy will remain loose she said, with interest rates likely to remain at a record low range of 0%-0.25% for a "*considerable*" time. US growth is good for the world and augurs well for continued improvement in US earnings as we head into the 4th quarter.

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Market Commentary (cont)

Economics (cont):

Things look pretty good in the UK as well with George Osborne hailing the latest GDP figure of 0.7%, stating "*these are strong figures; they show that Britain is leading the pack in what is an increasingly uncertain global economy. The recovery is broadly based, but we are not immune from the problems in the Eurozone…The great news is that manufacturing is buoyant as well*".

Technical Analysis:

Last month, we advised that the market was oversold and that it was a good opportunity to buy into the dip. Unfortunately, a multitude of factors brought the market down to its knees before staging a magnificent recovery. This proves that the bull market is still intact and with the RSI lying at 61%, the market is poised to continue its upward trend between now and year end, barring any geo-political shocks.

"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.

November

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%.

Since 1984 the FTSE 100 has risen 59% of the time in November, with an average return of 0.7%, making it the 6th best month of the year.

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.

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Market Commentary (cont)

Seasonality (cont):

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:

"In investing, what is comfortable is rarely profitable" – Robert Arnott

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 remains overweight. November is historically a good time for equities (rising on average 0.7%, 59% of the time). It is also the start of the strongest half of the year. Technically, the market quietly bullish with the RSI at 61% - a nice level for a continuing uptrend in the market.

Fundamentally, we acknowledge that there are a number of worrying signals: the sell-off in high yield bonds, falling commodity prices, a flattening yield curve, a narrowing participation in the market, geopolitics and the Ebola crisis in particular poses potentially significant tail risk. All of these could keep volatility elevated in the short term, but we think the underlying equity backdrop remains constructive and advise buying the dips. J.P. Morgan Cazenove lists the following bullish factors:

1) The Fed's bond purchases are ending, but the US economy does not need these anymore. The recovery is far from "*creditless*", "*jobless*" and "*houseless*". All three of these pillars are improving.
2) The strengthening USD should not be seen as a bearish signal. Although it can be seen as a "risk-off" indicator, now it is largely a result of robust US growth, and this has two key implications. First, it is positive for global exports. Second, it helps consumer purchasing power as commodity prices and inflation rates come down.

Market Commentary (cont)

Market Outlook (cont):

3) The recent credit sell-off was technical in nature, driven by retail outflows and recent large issuance. Buyers should now come back into the market as yields have been re-priced higher.
4) Eurozone growth has been undershooting expectations for a while now, so much so that bad data is now seen as good news, as it could usher in greater probability of a full blown QE, as well as continued currency weakness.
5) Q3 results are likely to be a positive event in the US, despite the stronger USD, given the very undemanding hurdle rate. 77% of US companies that have reported have beat EPS estimates, by 6% on average.
6) The start of US policy tightening should not be seen as a negative for stocks. Indeed, equities always made new highs within 6-12 months of the past starts of policy normalisation in the US.
7) Equities remain the asset class offering the best relative valuations.

We believe that 3%+ US GDP growth, share buybacks (roughly 25% of buybacks are executed in November and December), and the prospect of sustained low interest rates should limit any potential downside. In this market, we are now gravitating towards cyclical stocks, which trade at their lowest relative valuations since 2009. We like Total, Babcock, Philips and BMW at these levels.

Tweet of the Month:

"Investors buy too many expensive actively managed funds because they see skill where none exists"

Research by the University of Mannheim has found that investors make two errors when selecting funds:

1) They fail to see that, in a large sample of funds, a few will outperform consistently, or by a lot, simply by chance even if there's no skill. For example, a fund with no skill has a 50:50 chance of beating the market in any 12-month period. If returns are serially independent then it has a 3.1% chance of outperforming in each of five successive years. That might seem like a small chance. But as there are over 3,000 funds in the UK, we'd expect almost 100 to have such consistent outperformance – even if not one had any skill at all.

2) They are more likely to attribute skill to a fund with high but variable returns than to one with less spectacular but more stable returns – even if the latter really does have skill. This suggests that investors are prone to the intentionality bias – a tendency to attribute outcomes to people's intentions and abilities even when they are in fact due to luck.

This helps to explain why investors continue to hold actively managed funds even though most underperform their benchmarks over the long term. Research at Vanguard Asset Management shows that, over the last 15 years 85% of global equity funds have either underperformed, closed or merged (it's important to take account of fund closures in assessing the overall performance of fund managers, because otherwise survivorship bias – the tendency for only good funds to survive – will overstate the number of funds that do well. Unfortunately, investors also fail to appreciate how much funds' fees compound over time.

The moral of the story is that if you are going to buy an actively-managed fund, do so for a better reason than past performance. And ensure you are not being ripped off in fees.

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Market Commentary (cont)

Trader's Corner:

Quarterly Sector Strategy

The following sectors 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, compares 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 Diageo Plc in the fourth quarter (1841p, 19.3x P/E, 3.1% yield, -1.7% upside to average broker target). More sophisticated traders may look to use a CFD to gain leveraged upside to the sector as well as create their own hedge fund by shorting the weakest sector whilst going long the strongest sector via CFDs.

Seasonal Tendency

In an average month, the market tends to rise in the first three days before then falling back. It has a tendency to increase quite strongly over the final seven trading days of the month.

Going long the market via a CFD 20th November would be best to capture this move.

Gold Strength

Gold tends to enjoy good gains in November rising 60% of the time since 1986 with an average gain of ~1.3%

Seasonality of GBP/USD

On 15th August 1971, President Nixon announced that the US was ending the convertibility of the US dollar to gold and this led to the end of the Bretton Woods system and fixed-rate currencies, such as sterling, became free-floating.

Since then, November has statistically been a weak month for GBP/USD, falling on average almost 1.5%.

Going short GBP/USD via a CFD would be best to capture this move. Alternatively, buying a share that derives the majority of its earnings in USD and that historically performs strongly in November is an option e.g. Shire Plc.

Market Commentary (cont)

Trading Corner (cont):

<u>Strongest Weeks</u>
The week starting the 3rd of November is the tenths strongest week of the year, rising 66%% of the time, posting an average gain of 0.1%.

Going long the market via a CFD would be best to capture this move.

<u>Option of the Month</u>
Sell BHP Billiton January 1500 puts @ 22p
Stock at a 5-year low, supported by a 4.7% dividend yield. Premium equates to an annualised yield of 8.8%

Click here to view our guide to the Traded Options Market.

Recommended Investment:

BHP Billiton 1626p, 4.8% yield, 12.9x P/E ratio
This month's recommendation fits in perfectly with our overweight equity stance, in particular towards cyclicals, which are at their lowest valuation since 2009.

BHP is the world's largest mining company, formed by the merger of BHP Ltd and Billiton Plc in 2001. It is highly diversified with six major business units covering Petroleum, Aluminium, Base Metals, Carbon Steel, Coal and Stainless Steel.

Iron ore prices have come under pressure in the last 12 months (they have fallen ~40%), however, BHP is a low-cost producer (their break-even point is $49 a tonne) and will survive whilst high-cost producers will be squeezed out of the market. BHP is still bullish on medium term demand growth with Chinese steel production to peak at 1.1bt by mid-2020's as China's steel stock of ~5t/per capita is still only half that of US, Germany and Japan.

The company has delivered well on market expectations of a scale-back in capex and divesting the non-core assets and establishing a utility-style dividend yield. However, we believe all this is not priced in and still expect BHP to announce a sustainable buy-back over the next 12 months.

The company is due to be restructured early next year with the creation of a new company ("Newco") and a spinoff of its non-core assets by mid-2015 as a pro-rata distribution to all shareholders. The new company will have minimal debt and an investment grade rating. We believe that this restructuring will likely deliver an improved market valuation for BHP, as the market has been willing to place a higher multiple on companies that deliver higher returns.

The stock is now trading at a discount against a range of historic valuation multiples. Technically, the shares are at 5-year lows. Citi has a 2100p price target, suggesting 29% potential upside, plus a 4.8% dividend yield on top. **Buy.**

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Market Commentary (cont)

Investment Calendar:

3rd November	Start of the 10th strongest market week
6th November	Full moon (markets tend to reach a low point around this time)
	MPC interest rate announcement at 12 noon
	ECB Meeting
7th November	Nonfarm Payroll Report
21st November	Options Expiry Day
22nd November	New Moon (markets tend to reach tops around this time)

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)
thin 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)
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.

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FTSE 100
Index
7000
6900
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Apr
Jul
Oct
7/11/14
14 RSI (simple - Daily)
80
60
40
20
14 ADX (Daily)
40
20