GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary - October 2015

FTSE 100	**6,061**	S&P 500	1,920
Resistance	6,300	Gold	$1,135
Support	5,900	GBP/EUR	1.3353
VIX	25%	GBP/USD	1.5214

Introduction:

The current pattern of each attempted rally in equity indices faltering before matching the previous peak is an ominous one. There have been plenty of '*buy the dips*' calls from the bulls, each one so far condemned to failure. Seasonals do not turn supportive for another month and therefore, short-term risks remain tilted to the downside.

However, as the old stock market adage goes '*only monkeys pick bottoms*' and if you can look through the next 20 trading days, we would argue that now is an opportune time for picking up quality companies at great prices. Numerous technical indicators suggest the market is putting in a bottom, if one has not already been formed. In this month's Market Commentary, we look at these in detail and provide some recommendations for this market.

Economics:

The UK is recovering from the economic crisis faster than was thought. Output is now 5.9% higher than before the global financial crash in 2008. And it grew by 0.7% from 1st April to 30th June, according to the Office for National Statistics. The revised figures show that Britain has been the fastest growing major economy for two years. A pickup in productivity in the second quarter also suggests Britain's economic health is improving after a weak performance for eight years. On a per-hour basis, output produced by British employees rose 0.9% during the three months to June from the previous quarter.

Fears over the stuttering health of the Eurozone recovery returned after another set of economic indicators suggested the single currency was failing to reap the rewards of collapsing oil prices and central bank stimulus. Markit's purchasing manager's index (PMI) expanded to 52, slipping to a five-month low. Any figure over 50 indicates growth. In a worrying sign for policymakers, no major economy showed signs of reaping the dividends from a weak currency. Figures from September show deflation has returned, with consumer prices falling by 0.1%, pushed down by lower commodity prices. Ratings agency Standard & Poor's now expects the ECB to more than double its QE package to €2.4 trillion in a bid to smash the threat of deflation.

US businesses created only 142,000 jobs in September, about 64,000 fewer than expected by analysts. Employers kept average pay rises at zero and thousands of workers quit the labour market, taking the participation rate back to levels last seen in the 1970s. Despite this, Yellen has said she expected that interest rates would be raised before the end of the year if the US economy continued to show signs of improvement. Indeed, other indicators are looking very solid – the housing market is picking up, consumer spending is strong and auto sales are driving ahead.

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Market Commentary (cont)

Technical Analysis:

The market continued to trade lower in the historically weak month of September. However, the market appears to have found support around the 5,900 level. The FTSE has bounced off this and is now trading just shy of its 20-day moving average, signalling any further gains may be more muted. The three major moving averages (20, 50 & 200 day) are all pointing downwards and we would await a further retracement to the 5,900 level before aggressively entering into a long position.

"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 2015 is likely to be a positive year if the past is anything to go by.

October

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 47% of the time, with an average return of -1%.

Despite its reputation for volatility (since 1987, seven of the ten largest one-day falls in the market have occurred in the month of October), for the most part the market posts a positive return - rising 0.8% on average 77% of the time.

Fourth Quarter

The FTSE 100 has risen 23 of the 31 years between 1984 and 2014, posting an average gain of 3.8%

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. Some investors, therefore, tend to reduce exposure to the stock market from May.

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.

Third-Year U.S. Presidential Cycle

The stock market tends to bottom out during the second year of each new presidential term and then

Market Commentary (cont)

Seasonality (cont):

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 Goat ☺
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 goat, the strongest year of the Chinese zodiac historically for equities, with positive returns averaging ~18%.

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 5th year has been positive in 14 of the 21 decades, rising on average 6.2%. This makes it the best performing year for stocks.

Quote of the Month:

"The stock market is the story of cycles and of the human behaviour that is responsible for overreactions in both directions" – Seth Klarman

Success in the market leads to excess, as bystanders are lured in by observing their friends and neighbours becoming rich. Eventually, the last incremental buyer gets in, the last speculative dollar is borrowed and invested, and someone decides or is forced to sell. Things quickly work in reverse, as leveraged investors receive margin calls and panicked investors dump their holdings regardless of price. Then, the wisdom of caution is once again evident, as not losing money becomes the watchword of the day.

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. The markets, in our view, remain in the process of forging a medium-term bottom off the late August lows, fortified by the solid economic backdrop, reasonable valuations and a level of fear, as measured by the richness of downside put options to bullish upside call options, above the levels observed during the depths of the Financial Crisis in 2008-09.

Market Commentary (cont)

Market Outlook (cont):

The current bull market is probably closer to the end than the beginning, but bull markets don't just die of old age. Bear markets are typically ushered in along with an economic recession, or the bursting of a bubble. In 2000, the Technology Dot-Com bubble burst. In 2008, it was housing. If the market is the body, then suffering through the Technology troubles in 2000 was like breaking a leg. The housing meltdown affected the entire financial system; that was more like a heart attack. The bubble this time around has been the Chinese stock market. Hopefully, this can be a case of the flu, or a bad migraine. After all, exports to the Chinese economy don't even account for 1% of the all-important US GDP. That alone shouldn't cause a recession, or a bear market.

Recent market moves were at times smacking of panic, as a number of equity markets entered bear territory in a very short space of time. Concerns are many, but we see a number of supportive arguments for equities as well:

1-Oversold signals. European and US RSIs have entered oversold territory. Typically, equities rise double digits from these levels over the following six months. A similar conclusion can be found with the VIX, which recently touched its highest level since 2008.
2-Investors appear to have derisked. This is a good contrarian sign. Flows into Eurozone, EM and high beta sectors have been subdued as of late. Bull-Bear, a good contrarian indicator of sentiment, has recently seen the lowest levels since April 2013. The backtest shows that from these depressed levels of sentiment, the forward performance of European and US equities is typically positive.
3-There is no conclusive evidence of growth contagion. In the Eurozone, the latest PMI, economic confidence, IFO and bank lending surveys were all constructive. In the US, housing data, durables orders and consumer confidence are all encouraging. This should keep GDP growth in the 2%-3% range for the next several quarters.
4-Market internals appear to have undershot the fundamentals. Cyclical sectors have lost all their outperformance vs Defensives year-to-date. This is at odds with IFO and PMIs, as well as with the moves in bond yields.
5-Equity valuations are not strained. Yes, stock prices were recently at all-time highs. But so were corporate earnings. On a P/E basis, stocks may have been modestly above their average levels in some markets but compared to bonds, they have been, and remain cheap.
6-Current insider-sentiment readings are extremely encouraging with insiders now more bullish than they have been in years. Insiders are generally long-term investors with a good sense of developments at their companies and in their industries. As such, they are unlikely to let panicked market selling overly impact their decision-making process when it comes to owning shares in the companies for which they work. Indeed, insiders have clearly used the current downturn as an opportunity to add to their positions.
7-The initial response to the FED's decision to not raise interest rates was one of continued confusion and uncertainty. We do not see it that way. We think the FED's message was loud and clear. The FED is very sensitive to global financial conditions and will respond to any weakness in equity markets. Put another way, the wellbeing of risky assets is still the FED's key focus, and it is prepared to be more dovish than economic data would seemingly suggest. Likewise, the ECB is opening the doors to QE2.
8-The FED, in holding off raising rates, is considering factors beyond its shores in doing so. China is seeking to devalue the Yuan and cut interest rates immediately. A first FED rate hike might trigger an uncontrollable drop in the Yuan, which could threaten a broader global economic slowdown. Thus, a rate hike is unlikely before December.

Market Commentary (cont)

Market Outlook (cont):

Europe is our favoured market after the global sell-off and we see plenty of positive drivers on the cards:

1-At 14x forward earnings, in line with its 25 year average, rising domestic demand should push EPS higher. Multiple expansion may be challenging if US rates are rising, but earnings dynamics for Europe continue to look good

2-Oil is still down 54% from last year's highs, effectively a huge tax cut for the consumer

3-The Euro is down 20% vs the Dollar from last year's highs, a major benefit to exporters

4-There is still plenty of slack in the economy (i.e. we don't agree with those who say we are in the last stages of this cycle)

5- Low interest rates and QE are set to remain in place well into 2017

7-Inflation is still subdued

Overall, fundamentals are robust, valuations spell CHEAP, sentiment points to further gains and the technicals are a tailwind. It is interesting to note that among European sectors, Banks, Technology, Utilities and Insurance have historically performed well after the first FED hike and it is these sectors we would look at positioning ourselves towards.

The Insurance sector, for example, has outperformed the market for a fifth straight year, yet P/Es remain at a stubborn discount to the market. One driver for a re-rating is the potential for technological change to drive efficiency improvements and enable well-run companies to take market share. Investment bank UBS believes the sector is capable of achieving mid-single digit earnings growth over the next five years, which should be compelling given strong balance sheets, P/Es of ~10x and dividend yields ranging from 4% to 6%. European multi-line insurers Allianz, Generali and Zurich Financial are their top picks.

In summary, we re-iterate our call that the selloff should be seen as an opportunity to add exposure. Sentiment surveys are at record bearishness, a good starting point for potential gains into year-end. Seasonal factors also typically turn positive from October onwards. In the past, stock market corrections within a solid economy have provided opportunities to acquire oversold high-quality stocks at attractive prices. Economic data suggests now is such an opportunity.

Market Commentary (cont)

Tweet of the Month:

"History suggests that if EPS projections are accurate, today's negative sentiment towards equities should unwind"

The key to the outlook for global equities is earnings. There are two key issues in the EPS outlook – global GDP and the effect of lower oil prices. With global GDP expected to remain above the key 2.6% threshold for EPS growth through 2016, global EPS should grow by 8.4%. Although EPS growth will be subdued as a result of lowered global growth forecasts, the outlook is still consistent with decent EPS growth and the possibility that the oil "*dividend*" (the transfer of ~$2trn from oil producers to oil consumers) will be priced into the market. Indeed, if oil prices remain at current levels, we would expect an improvement in the prospects for "*oil consuming*" sectors while a recovery in crude prices should lead to upgrades for "*oil producers*".

There is little doubt that monetary policy remains supportive for global equities. Real M1 money supply growth is close to 10%, largely the result of faster money growth in the Eurozone. The lags between money growth and stock prices are famously variable but history suggests the market will eventually respond. Looking ahead, the world's major central banks are also likely to remain supportive. The ECB is expected to announce an expansion of its current QE programme by the end of the year and the FED has just postponed its first interest rate rise.

Stocks are not overvalued at these levels either. Global equities currently trade on 14.5x forward earnings, slightly below the post-1987 average of 15.5x, and thus the recent strong expansion in real money growth does not appear to be fully factored into stock prices. A striking feature of the recent correction in global equities has been the accompanying deterioration in sentiment toward the asset class. Bulls are now in the minority – the last time this occurred was in 2011 and this usually signals a market bottom. We recommend overweight positions in Continental Europe, Japan and Emerging Markets.

Europe

The expansion in monetary growth suggests that the ongoing recovery in domestic demand in the Eurozone will continue and that recovery is a key element of the projections for EPS growth. Also, the market does not seem to be priced for a European recovery. European stocks are relatively cheap. Given this relatively low starting valuation, an upturn in European profitability should lead to a re-rating and outperformance.

Japan

Japanese equities are pricing in a sharply lower profit cycle. However, greater discipline over capex and pricing has allowed Japanese companies to expand their margins and improve their returns during this period of currency weakness. Payouts to shareholders have also risen. Several measures confirm the low valuation attached to Japanese stocks. Amongst them, the relative P/E is at multi-decade lows while the EV/EBITDA multiple is flirting with prior troughs. If we are right about the sustainability of Japan's earnings recovery into 2016, these multiples appear far too low.

Emerging Markets

Investors have been aggressively selling EM equities over the past 12 months and the degree of selling (relative to developed market equities) has reached two standard deviations below the average. This degree of negativity has occurred five times since 2003 and on each occasion EM equities have outperformed developed market equities over the subsequent six months. We expect this pattern to repeat itself. Turning to valuation, EM equities offer investors a higher risk premium than that on offer in developed markets. The gap – at 170bps, has, in the past been associated with outperformance by EM equities over the subsequent two years.

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	Food & Drug Retailers
2nd	Electricity	Construction & Materials
3rd	Life Insurance	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, Life Insurance 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 Britvic Plc in the fourth quarter (681p, 14.8x P/E, 3.3% yield, ~17% 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 trends to rise in the first two weeks, then to fall back, before a surge in prices in the last few days of the month. This is perhaps because October marks the end of the weak six-month period of the year, so many investors are looking to increase their exposure to equities towards the end of the month. *Going long the market via a CFD at the beginning of the month before switching to short on 19th October and then going long on 26th October would be best to capture this move.*

FTSE 100 Outperformance vs FTSE 250

Although the FTSE 250 index has greatly outperformed the FTSE 100 over the long term (since 1986, the FTSE 100 has increased 377% compared with an increase of 1013% for the FTSE 250), the FTSE 100 has outperformed the FTSE 250 in the months of September and October. This suggests a strategy of investing in the FTSE 250 for most of the year but switching into the FTSE 100 in September and October. From 2000 to 2014 a FTSE 100 portfolio would have grown -3%, a FTSE 250 portfolio 144% and a switching portfolio would have gained 225%.

Strongest Days

The 5th of October is the 8th strongest day of the year, rising 76% of the time, posting an average gain of 0.3%. *Going long the market via a CFD would be best to capture this move.*

Option of the Month

Sell Astrazeneca December 3800 puts at 55p

Strike price at 18 month low. Stock has a 4.5% yield and 15% potential upside to the average broker price target. *Click here to view our guide to the Traded Options Market.*

Market Commentary (cont)

Recommended Investment:

Equities

We believe that recent market weakness is unlikely to be a start of a prolonged fall, but a correction which should be used to add exposure. One cyclical sector that has fared worse than most is Mining, which J.P. Morgan Cazenove has just upgraded to Overweight, highlighting the following factors:

1-Risk-reward is improving as the sector is by far the worst performer year-to-date, down almost 30% in absolute terms.

2-The iron ore price has picked up since July - now up 30%+ from its lows. From current spot levels, JPM projections are for broadly range-bound commodity prices next year. EPS downgrades have already been severe, with Mining EPS 80% down from its highs. Unless commodity prices fall significantly further, downside is likely to be limited from here.

3-Bearishness on China is omnipresent these days, but there are some improving data points. Auto sales were up 12% month-on-month for August; steel PMI is up from 37 at the lows to 45 currently; infrastructure orders appear to be bottoming out to meet annual budget plans; and property transactions are stabilising.

4-The sector is clearly doing self-help. Major miners' capex spend has halved over the past three years. Companies are working to improve their balance sheet strength.

5-Mining valuations have improved, with Price/Book relative at its lowest since 2001.

Our two favourites of the sector are Rio Tinto and BHP Billiton. Rio Tinto has a 6.2% yield and 26% potential upside to the average broker price target. The company offers the most attractive valuation of the UK diversified miners, trading at 7% FCF yield, 11x P/E and 0.8x P/NPV. If spot prices hold, the dividend looks well covered by cash, and the balance sheet robust with net gearing to fall ~20%. Rio also has the highest near-term growth profile, a strong management team, and some further restructuring potential.

Also worth considering is BHP Billiton which has a 7.7% yield and 29% potential upside to the average broker price target. Like Rio, BHP also has low cost assets in all of its businesses (comparable to Rio in iron ore, and is one of the world's lowest cost producers of coking coal) and a strong balance sheet (gearing ratio of 25%). BHP also has low geopolitical risk (its operations are in OECD countries) and lower operating risk than almost all other miners.

While these companies may lag shares of more leveraged and volatile miners in a recovery scenario, downside risk should be assessed just as much as potential reward. These shares are suitable for those investors who want to sleep well at night, whilst being compensated with above-market dividends in the meantime.

Market Commentary (cont)

Investment Calendar:

2nd October	Nonfarm payroll report
5th October	8th Strongest Market Day
8th October	MPC interest rate announcement at 12 noon
	ECB Meeting
13th October	New moon (markets tend to reach tops around this time)
27th October	Full moon (markets tend to reach a low point around this time)
	FOMC meeting

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)
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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