Capital Financial Markets

MARKET SHARE

GHC Newsletter September 2014

Are UK and US interest rates about to rise?

For all the geopolitical uncertainty currently facing investors, financial markets remain remarkably sanguine. Only this week, the S&P500 closed above the 2,000 mark for the first time. However, as soon as the markets get a whiff of the possibility that central banks might start to tighten policy we get a sudden burst of volatility with investors heading for the comparative safety of government bonds. We've seen examples of this in both the UK and US in recent weeks. In the UK it was the news that two members of the Bank of England's Monetary Policy Committee had voted in August for an immediate quarter point hike in Bank Rate, whilst in the US several Federal Reserve officials have intimated that the target for the federal funds might increase earlier than financial markets currently expect.

Given this, it seems appropriate to provide our view on where official interest rates in the UK are likely to be heading over the next 12-18 months. The next move in Bank Rate will almost certainly be up, but just because two members of the MPC think it should be increased immediately doesn't mean it will happen any time soon. One of the dissenters, Martin Weale, has previous in this respect, voting for quarter-point increases each month between January and July 2011, arguing (wrongly) that persistent above-target inflation would drive up inflation expectations and hence inflation itself over the medium term. He did this despite the fact that economic activity remained extremely depressed at more than 5% beneath its pre-recession peak! He was, of course wrong, and changed his mind in August as the downside risks to activity intensified. Now he and Ian McCafferty are concerned that the recent tightening of labour market conditions is likely to drive up wage inflation in the months ahead. With changes in policy taking time to feed through to economic variables, their reasoning is that the Committee should act well in advance of any increase in actual inflation. They are right about the lags involved, but what both are missing is that the MPC's central projection shows inflation remaining beneath 2% throughout all of the next two years, reaching the target only "at the end of the three year forecast period". Consequently, there is no urgent need for an immediate hike in Bank Rate.

Fortunately, most members of the Committee appear to concur, arguing that tightening prematurely could endanger the recovery, increase the vulnerability of highly indebted households and push up sterling, which in turn would exacerbate the downward pressure on already beneath-target inflation. To base a call for an immediate tightening solely on the risk that wage inflation might accelerate is completely misguided. Given that annual average earnings growth is currently negative, it would be more of a surprise if wage inflation were not to rise from here. But how fast a rate of increase is inflationary? We do not believe wage inflation will be a material threat to the inflation outlook for a considerable period of time. With it only becoming significant when underlying inflation is already on the rise which, according to our calculations, won't be until the second half of 2016. Allowing for lags, we could see the first hike in Bank Rate in November, but February next year looks more likely.

John Clarke - CIO GHC Capital Markets Limited

Key events

***Tesco plc** announces cut in dividend and capital expenditure.*

***Royal Bank of Scotland** release profit before tax figures of £2,652 million.*

***Bank of England** MPC members vote against rise in interest rates.*

***Ukraine conflict** rumbles on for another month.*

***Jonathan Bishop** joins GHC Capital Markets.*

In This Issue

Asset Allocation

As far as our asset allocation constraints have allowed, we have maintained an overweight exposure to global equities ever since the US Federal Reserve and the Bank of England's Monetary Policy Committee first decided to implement their respective asset purchase programmes back in 2009. We have been handsomely rewarded as a result. But with the US Federal Reserve about to call a halt to its asset purchase programme in two or three months' time and the MPC not adding to its holdings of longer dated gilts since October 2012—and both likely to start increasing interest rates in early 2015—shouldn't we be looking to book some profits on our longer term overweight exposure to global equities?

Much rests with valuations. In this regard, both Wall Street and the London market look far from stretched. That said, the last 3-6 months have been characterised by a succession of record highs on both the S&P500 and the Dow Jones Industrial Average. Given this However, the big (and growing) problem in the US is that the profits share in GDP is close to a record high and falling. There is still some scope for a re-rating of US equities, but returns on Wall Street over the next 12-24 months are likely to be significantly lower than we have become accustomed to in recent years. By contrast, the profits share in the UK remains comparatively low. And as economic growth accelerates over the coming quarters, the profits share should rise. And with the dividend yield ratio still well beneath one, we expect UK equities to outperform most other major equity markets in the year ahead. Thus, whilst we are maintaining our overweight exposure to equities in general we are trimming our positions in US equities with the proceeds used to further increase our weighting in UK equities. We remain sceptical that the policy response from the ECB will fail to address the underlying problem in the Eurozone; namely a lack of monetary growth and as a result growth will remain anaemic. We are retaining our underweight position as a consequence. Japanese equities look attractive on valuation grounds and are likely to find further support from further unconventional measures from the Bank of Japan.

UK equities—The UK market has rather lagged behind its US counterpart over the past couple of years, but should outperform in the year ahead. Rising interest rates should not prevent decent gains being achieved in the year ahead, with the market supported by above trend growth, accelerating corporate earnings growth, increased M&A activity and multiple expansion.

Commodities—Commodity prices have been remarkably well behaved in recent months, with crude oil prices slipping back beneath the $100 a barrel mark. Much of this has been driven by growth concerns about China, which should now have been alleviated by the latest GDP and business survey data.

Government bonds—Yields have fallen back to historical lows in the past month or so. The decline has been particularly pronounced in the Eurozone, where growth concerns have driven yields in Italy and Spain (that were both well above 7% barely two-and-a-half years ago) to around 2½% currently, which is broadly in line with UK gilts. This simply cannot be right. And with yields in the UK likely to rise, albeit modestly, in the year ahead, we expect higher returns from most other major asset categories.

John Clarke - CIO GHC Capital Markets Limited

Jonathan Bishop Joins GHC

After qualifying from Law School in Chester in 1984 Jonathan spent a brief spell working for law firms before starting his career as a Private Client adviser for Charlton Seal Dimmock in Manchester in 1986. From there he moved to W H Ireland in 1990 to develop equity sales to high net worth individuals, but soon became Probate Director, Manchester, liaising with several hundred solicitors across the country. After 18 years at W H Ireland, Jonathan joined Redmayne Bentley in Liverpool, where he further developed his professional relationships from which he generated a substantial amount of business.

In 2014 Jonathan joined GHC as a Private Client Stockbroker to help expand our offering to professional intermediaries, with a specific focus on Court of Protection and Probate work. Jonathan says " I joined GHC because I wished to be part of a dynamic open-minded team where I can use my networking skills to further develop the private client business".

In the coming months, Jonathan will be arranging a series of events throughout the country for the professional community.

Jonathan Bishop

Share in focus

Pennon operates a water and a waste business.

As the Water side is regulated it is possible to estimate the profits giving investors a degree of certainty. Pennon has a dividend policy of inflation + 4%. Water generated £520m in revenues in 2014, up from £498m the year before. Net Income was a healthy £162m after spending £141m on capital investment. Pennon was given early insight to its regulatory review for the 2015/20 period in April and although water bills will fall for its customers by 7% over that period the company have said that they will be able to outperform their return on capital numbers.

Viridor the waste management business is a different story. The company has been undergoing a lot of change from a Landfill company to a recycling & renewable energy business. It generated revenues of £802m in 2014. This side of the business is not nearly as profitable and made a loss of £21m in 2014 and £154m in 2013. This year Viridor has invested in five new Energy Recovery Facilities as they call them. Viridor believe these sites are 'central to the UK's waste & renewable strategy as a low cost alternative to Landfill'. The first of these comes online in October in Rochester and Virdor says in its trading statement Aug 2014 that EBITDA will increase significantly this financial year on the back of these sites.

The certainly of the water side coupled with the recovery in earnings in waste yield of 3.5% and the outside chance of a bid from Qatar make this stock worth a look.

Paul Coffin
Capital Financial Management

Pennon Group plc-image reproduced from website

Top Stocks

This is where Jonathan Bishop of GHC Capital Markets takes a look at the background to a few of the stocks and shares that have been popular with people trading through GHC over the past two months

Royal Bank of Scotland: Shares were in demand after the company announced their interim results on 1 August 2014. The profit before tax was £2,652 million for the first half of 2014 against £1374 million in the first half of 2013, Ross McEwan the Chief executive said, "the results are pleasing but no one at this bank is complacent about the challenges ahead."

AstraZeneca: Shares in AstraZeneca have been brought on speculation that Pfizer may return to bid for the company. Pfizer cannot bid until 26th November, six months after its last public offer expired.

Chemring: Speculators have been buying the shares as a way to get exposure to the conflicts in Syria and Russia, as it is a supplier of Pyro Technics. Purchasers of the shares are banking on an increase in defence spending in the next few years by European governments.

Tesco: Tesco have seen a return of buyers in the last few weeks. During the last year the share price has fallen by 30% and the company has seen the resignation of both the CEO and Finance Director. There is a battle underway between the main supermarkets that Tesco, with its various incentive schemes (notably fuel) hopes to eventually win. On 29 August 2014 the company announced a dividend cut and capital expenditure would be cut by £400m. The new chief executive will now join on 1 September 2014.

Balfour Beatty: Shares in both Balfour Beatty and Carillion were heavily traded when Carillion tabled a third bid on 19 August 2014. The speculators have long been purchasing Balfour Beatty for its yield of 5.8%. The company has issued three profit warnings recently and there has been much uncertainty surrounding them.

City Recommendation

Our review of what market analyst are recommending:

Stock	Date	Price (P)	Broker	View	Target (P)
BHP BIliton	**20/08/2014**	**1968p**	**Citigroup**	**Neutral**	**2100p**

Citigroup downgrades BHP Billiton (BLT.LN) to neutral from buy, leaving its price target at 2100p. This comes after confirmation of the demerger of the Aluminium, Manganese, Coal South Africa, Illawarra and Cannington businesses.

Dixons Carphone	**20/08/2014**	**340p**	**Deutsche Bank**	**Buy**	**400p**

Deutsche Bank initiates coverage of Dixons Carphone (DC.LN) at buy with a 400p target price. Says the merger of Dixons and Carphone Warehouse creates a bigger and better positioned electrical retailer in Europe. The 400p target price implies the market is not fully pricing in either the synergy or the growth opportunity.

WPP	**20/08/2014**	**1235p**	**JP Morgan**	**Overweight**	**1552p**

Analysts at JP Morgan remain overweight (target price 1552p) WPP (WPP.LN) but see better entry points after the 1H results on August 26. JP Morgan sees a buying opportunity after the results when the full extent of negative FX movements in 1H have been reflected and the market re-focuses on the "positive underlying operating momentum and attractive shareholder return story."

Rio Tinto	**20/08/2014**	**3421p**	**Investec**	**Hold**	**3552p**

Rio Tinto's (RIO.LN) single commodity exposure is often portrayed as a weakness, say analysts at Investec. Investec thinks Rio capable of delivering a class-leading dividend yield, bolstered by buy-backs. Investec remain at hold but up their target price to 3552p from 3220p

Persimmon	**20/08/2014**	**1334p**	Citigroup	**Buy**	**1525p**

British house builder Persimmon (PSN.LN) delivers a strong set of 1H results with pre-tax profit up 57% to GBP212.9 million, ahead of market expectations. "Results show the group is managing to deliver strong growth and return on capital employed whilst strengthening its balance sheet to support its capital return schedule. The bank rates Persimmon a buy with a price target of 1525p against a closing price Monday of 1335p.

Vodafone	**21/08/2014**	**201.73p**	**Citigroup**	**Buy**	**410p**

Citigroup lowers its revenue forecasts for Vodafone Group (VOD.LN) saying growth in Emerging Markets is "not quite offsetting" weaker performance in Europe. Says investors are waiting for the company's network investment plan to start paying back from 2015, which would boost confidence in the group's dividend and competitive position.. Has a buy rating and 250p target price. Shares -0.4% at 200.4p.

Premier Oil	**21/08/2014**	**337p**	Citigroup	**Buy**	**341p**

Oil and gas explorer Premier Oil (PMO.LN) reports a strong set of 1H numbers, with production 11% ahead of guidance, while the company continues to make progress with its commitment to dispose of non-core assets, according to Citigroup rate the oil company a buy with a target price of 410p. Premier shares open the session 0.77% higher at 341p.

The information above does not represent any offer to buy or sell shares and are the views and target prices recently published by analysts in individual stocks. The details are subject to change without notice and may not necessarily represent the view of GHC Capital Markets Limited. All prices quoted are correct as at the date quoted E&OE.

Please note that shares may go down as well as up, and what you invest may not necessarily be what you get back.

Contact Us

For more information about our services and products please contact us:

Paul Coffin
Capital Financial Management Limited
Salisbury House
29 Finsbury Circus
London
EC2M 5QQ

T:0203 6970560 (Main)
M:0780 143 8517

E:paulcoffin@capitalfinancialmarkets.co.uk W:www.capitalfinancialmarkets.co.uk