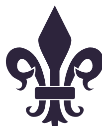


GIBRALTAR ASSET MANAGEMENT
STOCKBROKERS & INVESTMENT MANAGERS

Market Commentary

Market Outlook (cont):

negative into year-end, or to capitulate to a more bullish stance. You only have to consider the stock market's 4th quarter performance - the FTSE 100 has posted an average gain of 3.6% since 1984 - to understand that bearish money managers almost always capitulate to the bullish tendency. And as mildly bearish investors capitulate, they intensify the bullish tendency, eventually sweeping the last stubbornly bearish holdouts into the swelling year-end rally.

Thus, despite all the anxiety evident around us, we look for the stock market to follow its usual pattern of strengthening into the final three months of the year.

Recommended Investment:

JPMorgan Japan Smaller Companies
Japanese valuations are looking attractive. Due to a stronger economy, corporate earnings have grown substantially. But despite the market rising 50% over three years, the market's P/E ratio has actually gone down. Trading on a prospective market of 12 times (vs the long-term average of 15.5x), the Japanese stock market is trading at a discount to both the US (16x) and Europe (15x). It also looks cheap on dividend yield and price-to-book. Indeed, whatever metric you choose, Japan looks good.

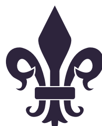
For this is a market where sentiment is unduly depressed - despite the economy being the world's third largest, overseas investors are still underweight. This though may be about to change. Japan's economy is in a sweet spot, helped by rising household consumption, private sector capital expenditure and exports - last year being the best for exports since the financial crisis. Indeed, economic growth rose 1.7% last year after trending at around 0.6% for many years. Unemployment is at a record low of 2.5% and competition for workers has resulted in rising wages, which in turn should create a stronger economy and outlook for companies.

Recent rumours that the Bank of Japan might reduce its pace of quantitative easing (QE) saw its governor promise to keep interest rates extremely low for an *"extended period"* and to maintain the main rate at -0.1%. Furthermore, he also signalled that the fight to raise inflation to 2% could go on for a lot longer, after cutting the Bank's inflation forecasts. Whatever the consequences of QE, such policies have been supportive of asset prices and this is a country that remains committed to the policy for the time being.

And the government is trying to address the country's major structural constraint - that of demographics. The population is ageing - some estimates suggest the workforce will drop from 67m to 59m by 2030. And while Japan is a world leader in automation, it still needs a larger workforce. Immigration rules are therefore being relaxed, with many immigrants now not even having to speak Japanese.

Meanwhile, government policies encouraging companies to be more shareholder friendly by way of better corporate governance and progressive dividend policies seem to be working, with further reforms expected to move Japan more into line with international norms. This will be attractive to foreign investors. In addition, huge domestic institutions, such as pension funds, are being encouraged to reverse their traditional underweighting of domestic equities.

And within this context, smaller companies look particularly attractive. And yet, for a long time many investment houses have not resourced their investment operations sufficiently given the market's lacklustre



Market Commentary

Recommended Investment (cont):

companies not covered at all - many gems are yet to be discovered.

The combination of a market looking good value, with smaller companies in particular looking attractive and yet remaining under-researched, a government pushing the case for equities, while engineering a faster pace of economic growth and addressing structural constraints, should make for a powerful combination for investors. The only downside for income seekers has been the lack of a fund with an attractive yield - that is until now.

Investment trust JPMorgan Japan Smaller Companies is introducing a new dividend policy which will pay a quarterly dividend equal to 1% of the company's NAV on the last business day of March, June, September and December.

The trust is listed on the London Stock Exchange (JPS.L), trades in sterling and invests in small and medium sized Japanese companies. The Total Expense Ratio is 1.09%. As the trust is trading at a 7.6% discount to NAV, the dividend policy equates to a 4.5% yield. We believe this policy will help to narrow the discount to NAV in the future as well as help portfolios achieve income from hitherto low-yielding assets.

The trust has beaten its benchmark over 1, 3 & 5 years, achieving a total return of 120% since 2013. Combined with the 4.5% dividend yield, we recommend the fund for capital growth and income seekers alike.

Tweet of the Month:

"To many investors, miners and emerging markets seem like different asset classes. Despite this, they are in fact hugely correlated"

The fall in emerging markets has claimed a UK victim - mining shares. Since late January, the FTSE mining sector has fallen almost 10% despite the benefit of a weaker pound against the US dollar because it has been dragged down by a 20% drop in emerging markets.

This is entirely normal - miners and emerging markets are highly correlated. Falls in one are usually accompanied by falls in the other.

One reason for this is simply that both are driven by sentiment and appetite for risk. Both have high and similar betas with respect to the All-Share index. Also, both are global cyclical investments; optimism about global economic growth drives both up, and pessimism drives both down.

Investors in both have a problem. Two separate indicators point to them both falling even further.

One is momentum. Because emerging markets and mining stocks are both especially sensitive to investors' sentiment, both are prone to momentum. This is because rather than rely only upon their own private valuations of the companies when deciding whether to buy or sell, investors take their cues from what others are doing. This is why both tend to fall and rise so much - to overreact on both the upside and downside. And momentum now tells us to sell both.