Weekly Report

Macroeconomic Analysis

The US Federal Reserve ends quantitative easing

As mentioned in a previous edition of the Weekly report on the 19th October, the October Federal Reserve meeting was a significant turning point. The Fed voted 9-1 in ending the third round of quantitative easing of $85bn every month which started in September 2012. Although due to tapering, the volume of this long-term asset purchases programme went down to $15bn ahead of the meeting. Quantitative easing has been an unconventional monetary policy pursued by the Fed six years ago, and over the course of three rounds of quantitative easing, pumped nearly $4.5tn into the US Economy.

Along with lower interest rates, quantitative easing has encouraged growth in US equities with the S&P now 80% higher from late 2009. The US unemployment rate has also dramatically fallen from a peak of 10% in 2009 to 5.9% this September. Economic growth throughout the period has been mediocre; however, the 3.5% growth in the last quarter shows the strength of the US economy despite the Eurozone and Emerging Markets slowdown.

Although quantitative easing has now finished, it isn't the end of "easy money". With the Fed's zero interest rate policy and the Fed's Funds Rate (overnight lending rate) at a negative real rate, commentators suggest that investors shouldn't be worried about the rise in interest rates. Economists are predicting a rate hike towards the end of next year, given the current low inflation rate in the US economy.

Despite the US Economy having a positive outlook, the attention has turned back to emerging markets because as a result of quantitative easing, huge volumes of liquidity have flown into emerging market projects such as infrastructure and corporate investment. Emerging markets have been hit before due to the effect of tapering last year, however since then equity markets in emerging markets such as Thailand and Indonesia haven't performed that badly, and are just 5% off the pre-tapering highs. The dollar has appreciated significantly against emerging market currencies and prices of many commodities have fallen due to most commodities being US dollar denominated. This has led to lower forecasts for emerging market growth, but ultimately this depends on how soon the Fed decides to raise interest rates.

Brazil: New opportunities or the same old problems?

Last Sunday, the results of the Brazilian run-off election were announced, and although President Dilma Rousseff secured re-election for a second term, few could have predicted just how narrow the winning margin would be. After months of closing the gap in the polls, and at one point taking the lead, centre-right candidate Aecio Neves obtained 48.4% of the vote, falling short of Rousseff's 51.6%. Looking further into the voting breakdown further highlighted the high levels of inequality in the South American country, with Rousseff gaining clear majorities in the poorer north and north-east regions, with the pro-business opposition candidate Neves dominating the southern, central-west and south eastern regions, populated mostly by the middle-classes. As well as the class divide, these patterns give significant backing to the theory that the Brazilian economy voted to elect Aecio Neves. The three regions dominated by his PSDB party make up 82% of formal jobs, 90% of tax revenues, 85% of exports and a staggering 81% of Brazil's GDP. Facing these facts, in addition to widespread claims of corruption (and even acceptance of such by her supporters), does Dilma Rousseff now face an impossible task in her second term?

If her first term was disappointing, then her second could be a disaster – and Ms Rousseff only has herself to blame. After experiencing recession at the beginning of 2014, Brazil's economy needs some serious attention, and words must

If her first term was disappointing, then her second could be a disaster – and Ms Rousseff only has herself to blame. After experiencing recession at the beginning of 2014, Brazil's economy needs some serious attention, and words must be backed up by action. Inflation is currently at 6.75%, above the ceiling of the Brazilian Central Bank (BCB) target of 2.5%-6.5%, and the current account deficit is the widest since 2002, at 3.7% of GDP. Very early signs in addressing the economy are positive, with interest rates rising 25 basis points on Wednesday to 11.25%, coming as a huge shock to economic forecasters, who very much expected the rate to remain unchanged. Other issues also need addressing, not least with the appointment of a capable finance minister, and a renewed effort to stimulate private investment into infrastructure. Early market signs show little confidence in the returning President, with the biggest sell-off in months occurring on Monday, the day after the results were announced. The situation may have been vastly different had Mr Neves been victorious. When it was announced in early October that he led the polls, markets jumped 5% in one day of trading.

Rousseff has promised reform, and has stated "dialogue" as a key priority, however only time will tell if the much needed lift to the Brazilian economy is forthcoming from a strong left party who, according to some, only remain in power due to the laws of obligatory voting.

Microeconomic Analysis

Game Digital: Is the game getting harder?

Game Digital Plc, previously known as Game Plc, is the remnants of the Game Group. Previously the Game Group included the company Game and it's once rival turned ally, GameStation. However, after years of declining high street retail sales and an over-compensated high street expansion, things become too unbearable for the group and they went into administration in 2012. OpCapita purchased the remains of the group and spent the next two years turning the company around. Most noticeable of these changes was the closure of more than half of its stores over this period, these were either loss making or heavily indebted (which in turn caused them to be making losses too). The company's Scandinavian operations were sold to a company called Nordic Games who still use the Game brand. Game and GameStation have also been merged into one company, resulting in the new Game Digital.

Game Digital have been in recent years and in conjunction to the above changes, concentrating on putting more emphasis on pre-owned games. This was due to the problem of customers using Game for brand new games but using GameStation for pre-owned games. When suppliers refused to allow Game to purchase new games on trade credit, this hit Game's profits. Whilst this only happened a couple of times and has now been resolved, it's better for the two companies to be one and to rely more evenly on both pre-owned as well as new games. And of course, it eliminates any competition previously caused between the companies. The company have also brought in pre-owned technological hardware to the business. Now, customers can bring in items such as; iPads (and other tablets), smartphones and similar hardware to trade in for cash or credit. Whilst this is a chance for them to diversify away from games, this is still a relatively new practice and this makes up a small part of the company.

At the start of June 2014, Game Digital made a return to the stock exchange with an IPO of 200p. Since then, however, the stock has risen by just over 58%, which begs the question; is the Game getting harder? It certainly is for investors interesting in investing in Game Digital as this increase may soon come to an end. At the same time, it could continue. Similar to selecting your team for that late Friday night Fifa game with your mates, or deciding whether you should buy the new Call of Duty game or not, this is a hard decision to make. Whatever happens, I shall be playing a mixture of Assassins Creed and Gears of War.

Events

Results of the Asset Quality Review

This week the European Banking Authority (EBA) and European Central Bank (ECB) released the results of the Comprehensive Assessment, a combined bank 'stress test' and the Asset Quality Review (AQR). Of one hundred and twenty three banks covered by the tests, twenty-five banks failed the stress test with thirteen still needing to raise additional capital as of 27th Oct. These figures were broadly in line with market expectation. An additional thirty-one banks had a core capital ratio below the 10% safe threshold suggested by the ECB.

The Comprehensive Assessment consisted of two elements. The EBA's 'stress test' aims to model how banks will perform in adverse economic circumstances. The scenario used in this test was a fall in European GDP of 7% and a 13% increase in unemployment. On average, this scenario saw the median European bank lose 4% of their tier 1 capital or in total, write-offs worth €123 billion. This saw the average Common Equity Tier 1 (CET1) fall from 12% to 8%. A shortfall of €25 billion was recorded across 25 banks. With figures based on data from December 2013, 12 banks have since raised additional tier 1 capital meaning that only 13 banks will need to submit capital-raising action plans by the November 10th deadline. Whilst the number of failures was towards the higher-end of

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based on data from December 2013, 12 banks have since raised additional tier 1 capital meaning that only 13 banks will need to submit capital-raising action plans by the November 10th deadline. Whilst, the number of failures was towards the higher-end of predictions, the vast majority of failures were very small and the result of adjustments made in the Asset Quality Review (AQR). 13 banks will need to raise an additional €9.47 billion between them.

The Asset Quality Review was designed to unify auditing before regulatory responsibility was handed over to the centralised European Banking Authority. The reclassifications of the review accounted for €21billion of the shortfall seen across the 25 banks who failed the stress tests. The AQR lead to €48 billion worth of gross adjustments to banks' balance sheets including the identification of an additional €136 billion of troubled loans. The largest reclassification was in Italian banks with an additional €12 billion of non-performing loans identified under harmonized accounting definitions.

Bond and equity markets remained low on the day with any moves tempered by the disappointing results of the German business climate index (Ifo fell to 103.2, a two year low). Moving forward, the comprehensive nature of the stress tests this year and the adjustments made under the AQR are widely believed to add credibility to the ECB and EBA's ability to regulate effectively. With some banks like Lloyds, emerging with lower than expected CET1 ratios, some people are now looking toward Additional Tier 1 (AT1) issuances in the upcoming months.

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