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Economic Commentary – August 2013

UK and World stock markets have risen sharply since the beginning of the year. The UK FTSE 100 Index has produced a total return (capital growth plus dividend income) of almost 15% since 1 January and is up by over 20% over the last 12 months. American, European and Japanese indices are up by slightly more than this whilst emerging markets and many commodities are down in value since the start of the year.

There has been a general improvement in economic indicators for America and the UK and whilst it appears that the Eurozone has moved out of recession in the second quarter, many of its constituent countries remain depressed. Looking East, official growth figures for China remain remarkably close to the revised Government targets, although unofficial measures suggest that a great deal of this growth has been driven by unregulated credit and there are disturbing signs of property bubbles and wage inflation. At a political level, the failure to address fundamental imbalances within the Eurozone, along with China's economic transition and on-going instability in the Middle East remain major threats to investment markets over the coming months.

The last few months have also seen significant swings in currencies, with a sharp rise in the value of the Dollar against most major currencies. We have also seen a concerted attempt to de-value the Japanese Yen which has had a marked impact on economies in South East Asia and beyond. To put this into context, the S&P 500 is up by 19% in US Dollar terms in the first 7 months of the year, which equates to a return of almost 28% when translated into GBP. Conversely, the Nikkei 225 Index is up by 31% in local currency terms, but "only" 24% when expressed in GBP.

Against this background we remain concerned that markets are likely to remain volatile in the future. We have argued for some time that much of the rise in world stock markets (and fixed interest markets) over the last year can be attributed to the unprecedented injection of liquidity by the world's major central banks. We have recently seen the extent of investors' reliance on this financial stimulus, when many stock markets fell by 10% when Ben Bernanke suggested that the US Federal Reserve would consider reducing the scale of its asset purchase programme on 19 June. In the following weeks, US and other central bankers rushed to reassure investors that support would not be removed until they were comfortable that economic growth had taken root. The new governor at the Bank of England, Mark Carney, has recently confirmed that UK rates will stay at 0.5% for the foreseeable future, or at least until unemployment is above 7% of the workforce. In practice, it is more likely that any rate increases will be driven by decisions taken in America.

One of the positive aspects of the increase in the major Western stock markets over the last year has been the outperformance of quality companies with sustainable income streams and strong balance sheets. Our client portfolios have been based upon funds investing in this type of strong, dividend paying companies and it is encouraging to see their strong performance relative to the market over the last 12-24 months. If share prices of these companies continue to rise there will come a time when they cease to offer good value, but the fund managers we have met over recent months appear confident in their ability to identify good investment opportunities.

In response to current levels of uncertainty we have expanded our programme of fund manager meetings. In addition to regular updates on our core equity income holdings we have met with senior global fund managers from Fundsmith, Artemis, Sarasin and First State and a number of specialist US fund managers as we look to increase our exposure to the growing US economy.

We have also had meetings with managers of multi-assets funds from Troy, Darwin and others to get their views on current market conditions and the attractions and risks associated with the major asset classes. These have reinforced our concerns about fixed interest markets. Government stocks and corporate bond markets have been dramatically affected by the political manipulation of liquidity and interest rates and many investments are priced almost for perfection. With interest rates around the World at artificially low levels, it is difficult to see how fixed interest markets can provide real capital growth over the next few years. Instead there is a real risk that these funds could produce significant capital losses if we see increasing expectations of inflation or a return to more normal interest rates. This has led to a series of meetings with major fixed interest managers including M&G and Newton to try to identify those funds which have the greatest capacity to produce positive returns despite our negative outlook for the sector.

Overall, our core UK and International holdings have performed well since the beginning of the year. Our key Invesco Perpetual High Income and Artemis Income holdings have outperformed the UK market over the last few years with significantly less volatility than the market as a whole. The inclusion of global equity income funds (primarily with M&G and Newton) has captured much of the growth in US Dollar assets and continues to provide an attractive level of income for those clients that find this useful. Our major exposure to fixed interest markets remains the M&G Optimal Income fund. This has continued to produce positive returns despite our longer term concerns, but for the reasons noted above, we are looking to reduce our holdings in this area over the next few months.

You can find more information relating to this article in the following charts detailing the performance of the UK and World stock markets:-

Performance Report - using GBP*

Performance Report - using local currency*

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* performance data provided by Financial Express