Economic Commentary – 08.10.2013

At any one time there are always a number of factors pulling investment markets in different directions. For some time we have had the negativity arising from slow world growth in general, with a particular emphasis on concerns with China and India, emerging markets and the Eurozone. We have also had the uncertainty arising from quantitative easing policies in the UK and US and now because of suggestions that this artificial increase in money supply would slow down and eventually cease.

All of this, together with specific guidance and comments from the world's central banks has kept interest rates very low, thereby artificially increasing the price of government bonds but in so doing increasing the relative attractiveness of good quality shares, with yields two or three times government bonds.

There has been concern that the number of such shares is limited, that they have already become overpriced and the dividends are hard to support taking the argument further. However, recently there has been more evidence that growth, albeit at a slow pace, is recovering and that should improve the climate for "risk" assets, particularly shares. Indeed, there is some evidence in the IMA statistics of switching between asset classes taking place as bond markets have steadily deteriorated in the last year.

For the time being, equities continue to be greatly influenced by monetary policy, especially that of the US Federal Reserve (Fed). Markets were surprised by the Fed's decision not to scale back its asset purchases in the last month, citing concerns about the US recovery. Additionally, higher US Treasury yields have led to a rise in borrowing costs and the Fed is monitoring the impact on credit sensitive parts of the economy such as housing. The unintended consequence of the decision not to taper has been to create further uncertainty for investors, who have also begun to focus on the developing battle in Congress over the US budget and the need to raise the debt ceiling, where negotiations are likely to be protracted, with a degree of brinksmanship leading up to the deadline on 17 October 2013. These factors may create short-term volatility in equity markets, but any pullback will create buying opportunities for investors, who will benefit when markets surge ahead once more. Additionally, although the US is facing fiscal headwinds and imminent monetary tightening, leading indicators such as manufacturing and purchasing are strong, suggesting the recovery has traction.

The Bank of England's forward guidance has backfired because the recent strength in macroeconomic indicators has led investors to conclude that interest rates will rise sooner rather than later. Gilt yield curves have steepened[i], compounding our unfavourable view of such investments. Moreover, the pound has begun to strengthen, which will not assist exports, whilst higher money market rates will ultimately feed through into lending, which is not helpful at this fragile stage of the recovery. Despite the rise in money market rates, cash deposit rates remain dire and we continue to review other asset classes, including Targeted Absolute Return funds and income generative investments such as property, for credible alternatives.

The Eurozone is out of recession, but banks are still deleveraging, curtailing sustained recovery and many peripheral countries continue to struggle with their fiscal requirements. Political developments have created some volatility in markets and this is likely to persist in the short term. However, valuations look comparatively attractive to the US.

Japan is facing substantial hurdles to eliminate deflation, repair its fiscal position and make necessary structural changes to the economy. Massive quantitative easing operations are underway, with some nascent signs of success and a positive side effect of a weaker currency for exporters (although this cuts both ways for a country that is heavily dependent on energy imports). Stock markets have been volatile and there have been many "false dawns" in Japan before, although the most intractable problems may prove to be the country's rapidly ageing population and its extremely high 245% debt to GDP ratio.

Emerging markets have stalled as a growth engine in the last year and equity markets and currencies in many of these countries have suffered as investors anticipate the removal of liquidity by the Fed. Most supply indicators now point towards a recovery in China, although risks remain, including the credit and property market bubble and the naturally slow speed of economic transition.

In this uncertain environment, we believe that a continued focus on funds investing in high quality income-generative companies remains a sensible "all weather" strategy, because although these investments might lag indices when markets are extremely bullish, these companies tend to fare better than more cyclical or speculative investments in a market downturn.

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[i] The yield curve plots the yield, at a set point in time, of bonds with equal credit quality, but differing maturity dates. The fact that the yield curve for gilts is currently steepening illustrates that the gap in yields between short term and long term bonds is increasing, making the curve appear steeper. This is borne out when we consider that the 1-year gilt yield was 0.39% in January 2013 and is now 0.40%, whereas the 10-year gilt yield was 1.90% in January 2013 and is now 2.68%.