Economic Commentary – December 2013

Equity markets had a strong start to 2013, but have made relatively little progress since the spring. A cautious approach has prevailed in bond markets because they have become inextricably linked with news regarding monetary policy. Whilst the Federal Reserve will imminently phase out its bond-buying programme, central banks in Japan and Europe may pursue further easing measures.

The United States economy has shrugged off the recent US government shutdown and economic growth figures have been encouraging. Stronger economic data increases the likelihood that the Federal Reserve will begin to wind down asset purchases. BlackRock have estimated a US market return of 3%, based on a dividend yield of 2%, and another 1% for buybacks. However, taking into account the fact that corporate profit margins are already high, they estimate that US earnings growth is likely to be slow going forward, suggesting that the scope for outsized equity gains has diminished. Nevertheless, BlackRock still anticipate that equity returns will outstrip those of bonds and we concur with this view.

Europe is showing signs of recovery from its protracted recession but the Eurozone remains imbalanced with France and Italy lagging behind Germany. There has been some improvement in the peripheral economies, which have put the worst of the austerity behind them. The European Central Bank (ECB) has mentioned a negative deposit rate as one option to stimulate demand and there is also the possibility of quantitative easing. Either of these options would be positive for bonds in the region in the short term but would create longer term distortions. In any event, when the ECB cut its refinancing rate to 0.25% last month and left the deposit rate unchanged at zero, they broke the convention of leaving a difference of around 50 basis points between these two key rates. This, combined with talk of the potential for negative interest rates, is clearly an attempt to fix the monetary transmission mechanism and to encourage banks to lend some of the monies which are currently hoarded on deposit due to risk aversity.

The Autumn Statement has revealed that the UK economy is getting onto firmer footing and business and consumer sentiment surveys suggest more robust growth lies ahead. Inflation has been sticky but is at a manageable level. The FTSE 100 has been volatile recently due to fears of earlier than expected interest rate rises and amendments to the funding for lending scheme aimed at preventing resurgence in housing market inefficiencies. However, it is bond markets which are taking the brunt of the fears of interest rate rises, with the UK 10-year benchmark gilt yield back up to around 2.90%, having started the year at 1.97%. Rising yields mean falling prices creating the potential for capital losses.

The initial phase of quantitative easing in Japan has fuelled stock market performance and weakened the Yen. However, fiscal consolidation will be difficult given the ageing population and there are also significant risks surrounding the necessary structural reforms. China's economic data has improved but the credit market and shadow banking remain significant threats. The pace of productivity growth has slowed in some emerging markets and countries with current account deficits face difficult policy trade-offs in the months ahead.

In an environment of sustained low interest rates and threats to bond markets, we continue to view equity income as the soundest foundation for portfolios at the present time and we maintain our cautious stance towards investment in fixed interest. We recognise that cash rates remain extremely low, but we continue to view a cash cushion as a necessity in uncertain times and in the absence of compelling options in other asset classes, such as real estate.

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