Economic Commentary – January 2014

Last year brought gradual global economic improvement and few geopolitical shocks. Global economic expansion is on track to continue in 2014 with growth in the US and UK and recovery in Europe, although Japan has yet to prove it is on a sustainable growth path, despite the strides made in the last year. Emerging markets face mixed fortunes but a stronger US Dollar and weaker commodity prices are likely to be headwinds.

UK

Business and consumer confidence in the UK is strengthening and the Bank of England has revised economic growth forecasts for 2013 upwards from 1.4% to 1.6%. There has also been an unexpectedly fast and broad-based increase in house prices. According to Nationwide, the average price of a house in the UK increased 8.4% in 2013. The most recent Bank of England financial stability report highlighted this trend as a potential risk. Additionally, the terms of the funding for lending scheme have been modified, redirecting the scheme towards businesses rather than consumers. Inflation has dropped back to 2.2%, but upward pressure is anticipated from utility price increases. Increases in wages and salaries remain low compared to inflation and this may limit consumption growth.

Europe

The Eurozone is improving at a slow pace although the contributions of the various member states remain diverse with Germany contributing the most and countries such as Italy and France languishing. Monetary policy is likely to remain accommodative for some time yet.

Asia Pacific

Japan has met with some success in reflating its economy and there have been positive signals from capital expenditure and sales data. Despite this, doubts linger over the sustainability of the recovery and success now hinges on the successful implementation of structural reforms. After its Third Plenum, China announced ambitious reforms comprising 60 major initiatives in 16 areas. Ultimately public and private sectors will compete for resources on an even footing and the measures include many positive steps such as exchange rate liberalisation, the creation of a bank deposit insurance mechanism, improved social security, income distribution and relaxation of the one-child policy. Implementation will take time and will be long term and gradual, but in the very long term the measures should bear fruit. However, significant short-term risks remain, including overextended credit and housing markets, pressure on government-backed companies and rising bond yields.

Equities

Developed market equities performed well in 2013, with the FTSE 100 ending the year around 6,751 and the S&P 500 ending the year around 1,841. This was largely due to positive sentiment towards the asset class at a time when real returns on cash remained extremely low and when sentiment towards fixed interest soured because the tapering of US quantitative easing loomed on the horizon. Markets were well prepared when tapering was finally announced in December 2013 and the removal of uncertainty caused an initial upswing in equities. Despite this the coming year could bring volatility and friction as equity markets move from being driven by easy liquidity to being driven by the underlying strength of the economy. To this end we are reviewing funds which might offer some protection from market falls. There may be a market shift away from income generative stocks, which are perceived as comparatively safe, into growth stocks as recovery strengthens. However, the outlook for dividends is stable if not stellar and we continue to view income generative investments as a solid basis for portfolios.

Fixed Interest and Cash

Forward guidance on interest rates has assisted short term bond yields, but almost inevitably the tapering of US quantitative easing has caused a rise in longer term bond yields. The yield on the 10-year benchmark US Treasury has risen from around 1.85% at the beginning of 2013 to around 2.95% at the beginning of 2014. The equivalent UK benchmark gilt yield has risen from around 2.00% to around 2.95% in the same time period. This indicates a fall in prices and capital values. Eventually government bonds will become good value again, although there is some way to go before this is achieved. Additionally, quantitative easing has distorted fixed interest markets and it is not yet clear exactly how the large scale government purchases of US treasuries and UK gilts will be unwound. We maintain a very cautious outlook for fixed interest at the present time.

Although interest rates remain low, we consider a tactical cash balance as important at the present time to protect against market volatility and to provide flexibility and liquidity.

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