DT Dewhurst Torevell

Economic Commentary – February 2014

Overview

After a relatively strong couple of years of performance, equity markets have started 2014 uncertainly and the Federal Reserve's announcement of a further $10 billion reduction in its quantitative easing programme prompted consolidation. The S&P 500 has dropped from around 1,831 points to around 1,751 points since the beginning of the year, whilst the FTSE 100 is down to a level of around 6,458 from around 6,717. In tandem the Volatility Index (VIX) has risen from around 14% to nearly 20%. Additionally, recent corporate earnings reports have revealed that earnings growth remains subdued and this could constrain markets as the easy money from quantitative easing begins to dry up in the wake of tapering.

This environment has offered some respite for bond markets with 10-year yields on US Treasuries declining from 2.99% at the beginning of the year to 2.67% and UK Gilts declining from 3.00% to 2.67%, thereby putting the prices up. For example, the price of the 4.5% UK Treasury Gilt 2034 has risen 2.36% since 1 January 2014, whilst the yield has dropped from 3.57% to 3.38%.

We continue to take a cautious stance on both equity and bond markets and anticipate volatility in these asset classes in the coming months. We have also been meeting with fund managers whose investments might offer some protection against volatility.

United Kingdom

The credibility of forward guidance is likely to be tested in the coming months as the unemployment rate is falling faster than anticipated and is now 7.1%, which is only marginally above the stated threshold for considering an interest rate rise. This raises the question of when interest rates might increase to more "normal" levels, but for the time being the return on cash remains at historic lows which is leading us to consider alternatives such as multi asset funds which attempt to mitigate volatility. However, we still consider a "cushion" of cash to be desirable in such an uncertain environment. Cash is uncorrelated to risk assets and can be deployed when these assets come down to more reasonable prices from their current elevated levels.

Capita have published their latest Dividend Monitor report which revealed that UK dividend payments declined 1% in 2013 when compared to 2012. This was due to the lack of large special dividends in the year. Underlying dividend growth, which excludes special dividends, was healthier at 6.8%. Whilst overall dividend growth in 2014 will be distorted by the extraordinarily large special dividend to be paid by Vodafone, Capita are forecasting underlying dividend growth for the coming year of 6.2%. We remain cautious on the outlook for dividends this year, but still consider that Equity Income funds provide a solid foundation for portfolios and this view encompasses both UK and global funds, which can hunt in multiple markets for quality and value.

United States

US economic data softened in January with weaker than expected employment and durable goods data being published, although the employment data may be partially explained by abnormal weather. This has created short term stock market volatility and this may be expected to continue because the various factions of US government need to renegotiate the debt ceiling yet again by the end of the month.

There are some positive long term trends underpinning the US economy such as the boom in domestic oil and gas production and the decline in energy imports, although there are externalities associated with this production, including its high demand for water.

Europe

Recovery in Europe remains subdued with high unemployment in many areas. The risk of deflation remains despite the loose monetary policy pursued by the European Central Bank (ECB).

European banks are facing an Asset Quality Review later in the year, which is likely to reveal that there is a shortfall in tier one capital at a number of banks. This could lead to volatility in European markets and create a renewed gulf in bond yields between peripheral European countries and those perceived as safe havens. A number of commentators have also expressed concerns about credit quality and indebtedness in France. Additionally, the review could restrict lending in Europe as lenders rush to shore up capital and this could cramp the tentative recovery unless the ECB undertakes further monetary policy intervention.

Asia and Emerging Markets

Japan's use of expansive monetary policy to devalue the Yen has been successful so far, but the policy risks drawing the ire of political and economic rivals China and Korea. The jury is still out on the tough structural reforms required to truly transform the economy.

Fears of recession in China resurfaced in January with the publication of weak manufacturing data. Additionally, China has uncomfortably high private debt levels and Morgan Stanley estimates that 45% of this debt must be refinanced in the next 12 months, so a difficult period may lie ahead.

The effect of reduced liquidity from quantitative easing is being felt most keenly in emerging markets. In a bid to support their weakening currencies South Africa, India and Turkey have all hiked interest rates. The moves appear to have had limited success in stalling currency depreciation so far and we continue to have a negative view on both emerging markets equities and debt.

Outlook

To recap we remain positive on equity income, especially global equity income where there may be more value to be found than in the saturated UK market. We maintain a watching brief on bond markets, whilst a conservative approach is prudent at the present time, it is possible that interest rate risks have been overstated. However, we are waiting for capital values to come down to more realistic levels having been

grossly inflated by quantitative easing. We are reviewing multi asset funds which might temper some of the volatility emerging in equity and bond markets, although we are wary of the allocation to precious metals within some of these funds as a provision for inflation, which has yet to emerge.

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