Economic Commentary – March 2014

Overview

After a faltering start to 2014 equity markets recovered in February, with both the S&P 500 and the FTSE 100 reaching new highs. A pick up in merger and acquisition and in IPO activity has boosted investor confidence, but there is little else of substance driving markets and most major developed markets look expensive and are above their long term Price/Earnings ratios. In the last few days there has been some reaction to events in Ukraine but the main issue is that unless stronger corporate earnings growth materialises, markets are likely to fizzle out and we remain cautious and prepared for volatility. We therefore continue to consider cash generative investments in high quality stocks through equity income funds to be the soundest basis for portfolios at the present time.

US

Despite transient weakness in US data due to adverse weather, broader indications are that the recovery is on course with an improvement in housing markets and a reduction in fiscal drag. Unemployment has now reached 6.6%, which is close to the 6.5% threshold set by the Federal Reserve for the cessation of asset purchases. There is an expectation that quantitative easing operations are likely to be phased out by the autumn, although present indications are that interest rates will remain low for the time being.

UK

Fourth quarter GDP data revealed a reasonably balanced recovery with contributions from both business investment and household consumption. Additionally, the Bank of England upgraded its 2014 growth forecast for the UK economy to 3.4% and this would be the strongest growth since 2007 if it were achieved.

Inflation is subdued and is now 1.9% on a CPI basis, which is below the Bank of England's target level. There is a consensus among commentators that interest rates are unlikely to rise before 2015, but ultimately they will have to rise to more "normal" levels after an extraordinary period of time. Concerns remain regarding the potential for a housing bubble and house prices rose by 5.5% year-on-year for the UK as a whole and by 12.7% in London. The possibility that the Bank of England may intervene in housing markets remains.

Europe

Europe's economy is slowly strengthening, final GDP figures for the last quarter of 2013 showed improvement for many economies and Italy exited recession. However, there may be some road bumps ahead, for instance, the region's strongest economy, Germany, has export exposure to emerging markets, which could mute data in the coming months. Additionally, bank lending in Europe is still falling which will impair economic recovery. These credit conditions, combined with very low inflation suggest that the European Central bank (ECB) may further ease monetary policy.

Asia and Emerging Markets

A string of poor economic data indicates that recovery in Japan may be losing momentum. Consumption taxes will rise in April, and this will prove a headwind, unless the Bank of Japan succeeds in offsetting the effect with its large scale quantitative easing operations. The greatest risk to the downside may, however, be China and the possibility of a crisis emerging from its shadow banking sector. Emerging markets have faced mixed fortunes with performance in Asian markets improving a little, whilst Latin American markets faltered.

Notwithstanding the events in Ukraine, we remain focused on the long-term performance of equity markets and do not focus on short term movements. We continue to prefer to gain exposure to markets outside of the UK through global funds and retain a selective view on Asian markets and a negative view on emerging markets.

Cash and Bonds

Figures produced by the Investment Management Association (IMA) suggest that there were net outflows of £17 million from retail bond funds in 2013 for the first time in many years. As market conditions have toughened, fund managers are searching for yield in areas such as peripheral European debt and are attempting to defend portfolios against interest rate rises by investing in shorter duration assets.

Government bonds are very expensive due to quantitative easing operations and with tapering now underway these assets face a lengthy adjustment process to lower prices and higher yields. The Financial Times has reported that many fair value models suggest that benchmark bond yields will eventually be closer to 4% than 3% and if this is correct, bond prices have a considerable way to fall given their inverse relationship to the yield. For this reason we continue to have a very cautious view on fixed interest.

Interest rates remain extremely low but we remain steadfast in our view that a cash cushion is essential in uncertain times with potential for volatility in both equity and bond markets.

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