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Economic Commentary – April 2014

Overview

It has been a bumpy start to 2014 for investment markets partly due to geopolitical factors and partly due to corporate factors such as downward earnings revisions. The FTSE 100 has produced a total return of just 0.12% to 24 April 2014 with all of this gain being attributable to dividend income rather than capital growth. The S&P 500 has gained 0.53% in the same time period, with 0.42% of this gain being attributable to dividends. This lends credence to our focus on high quality, income generative stocks. In general we believe that equity market valuations are looking stretched and unless earnings growth begins to feed through, volatility is likely in the coming months.

US

Adverse weather has had some impact on short term economic data, but overall trends are looking positive with economic growth expected to be close to 3% in 2014. This should provide some support to stock markets, although US equities are expensively valued according to traditional market metrics and after hitting a number of all-time highs in recent months they could be vulnerable to a correction.

The dividend pay-out ratio of the S&P 500 is currently 30%, which is well below the long-term average of 50%. However, more than $1.4 trillion in cash is sitting on corporate balance sheets, leaving ample scope for mergers and acquisitions or to return cash to shareholders.

UK

The Chancellor gave an upbeat assessment of the economy in his budget speech and the Bank of England is forecasting growth of 3.4% for 2014, which would be the country's fastest growth since 2007. The labour market is improving much faster than anticipated and housing markets are forging ahead. Inflation is quiescent, dropping to 1.6% in March from February's 1.7%, the lowest level since October 2009.

The FTSE 250 has risen by nearly 19% in the past year, while the FTSE 100 is around 8% higher. As a consequence, valuation multiples are significantly higher for smaller companies than large cap stocks and with volatility likely in the coming months, large, defensive, cash generative companies look preferable to cyclical small and mid-caps.

Europe

The six largest European countries, including Spain and Italy, are now growing. However, despite the recent broad based pick-up, the Eurozone remains unbalanced with core economies like Germany bigger than their pre-crisis peak at the end of 2007, whilst peripheral economies have yet to return to their former size. Peripheral bond yields have dropped substantially with 10-year government debt yields in Italy at 3.29%, Spain at 3.15%, Portugal at 4.05% and Greece at 6.51% (down from over 8% at the beginning of the year) which gives some breathing room to government finances in these countries.

Headline inflation remains very low at 0.5%; this poses a real risk of deflation, leaving the window open for monetary policy intervention by the European Central Bank.

Asia and Emerging Markets

The effects of quantitative easing in Japan appear to be having a diminishing impact and there is little sign that structural problems are being addressed. Consumption tax increases have now been implemented, leading to speculation that growth will soften in coming months, unless wage increases begin to come through, positively influencing consumption.

Economic data from China continues to be comparatively weak and the government has confirmed an annual growth target of 7.5% for 2014. The first defaults have occurred in China's bond markets and whilst they are small in relation to the overall size of the financial system this is an important break with tradition where previously debt that could not be repaid or refinanced was rolled over or extended. This is a welcome step towards more efficient capital markets but it also indicates a tightening of policy, which could have ramifications for other credit markets and the economy as a whole in the coming months. Furthermore there are signs of deflationary pressures in China which might exacerbate similar problems in the Eurozone and elsewhere, especially if China tackles deflation by devaluing the Renminbi.

We retain our preference for developed, over emerging markets, which remain under considerable pressure. Many of the factors which have driven capital flows into emerging markets in the last decade are now waning – US quantitative easing is being tapered off, the commodity super-cycle has peaked and exports from emerging markets are not growing as rapidly.

Cash and Bonds

News stories regarding the "bond bubble" have been rife for some time now and concerns around rising interest rates have focussed the discussion. With economic indicators improving and the US Federal Reserve continuing to taper its quantitative easing programme, a rise in US interest rates is anticipated in 2015. Bond markets have reacted better than expected to tapering and capital values remain high. However, quantitative easing has pushed spreads lower, increasing the correlation of corporate bonds with government bonds and leaving both sectors more sensitive to interest rate changes so we retain a very cautious view on all fixed interest investments at the present time.

We are actively researching the infrastructure sector as a possible alternative to bonds and fixed interest markets. Infrastructure has historically delivered a reliable yield, which is steadily growing and frequently index-linked. In the last decade global listed infrastructure has performed well in rising markets and has had lower downside in falling markets than equities in general. Long term drivers for infrastructure markets include the need to replace and repair aged infrastructure in developed markets and new demand for energy and transport infrastructure in both developed and emerging markets.

Cash rates remain extremely low, but in the absence of compelling alternative options we continue to view a meaningful cash balance as a source of liquidity and flexibility.

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