Economic Commentary – May 2014

Overview

Global equity markets were marginally positive in sterling terms in April 2014 despite weaker than expected economic growth figures for the US and UK and continuing concern about the Chinese economy. However, equity markets have made only modest headway in the year to date with the FTSE 100 now at 6,808 having started the year at 6,731 and with the S&P 500 now at 1,888 having started the year at 1,831. Unless earnings growth begins to come through, volatile times could lie ahead.

US

First quarter GDP growth was a mere 0.1%, which is blamed on the extreme weather conditions seen earlier this year. Data for the employment market and retail sales was more positive and the outlook for the US economy was sufficiently strong for the Federal Reserve to continue to taper its quantitative easing operations.

UK

At 0.8% first quarter GDP growth was slightly below consensus estimates, with poor weather conditions being the main culprit. On the positive side, UK unemployment has reached a 5-year low of 6.8% and there is now some evidence of wage growth. However, the strength of Sterling remains a headwind to UK companies with overseas operations.

The Halifax house price index rose by 8.7% in the first quarter of this year, representing the fastest pace of annual growth since the third quarter of 2007. Bank of England Governor Mark Carney has warned of deep structural problems within the housing market and noted that demand significantly outstrips supply. The comparatively hawkish tone of the most recent Monetary Policy Committee meeting minutes has raised expectations that an increase in interest rates could be on the cards.

Equity markets have been spurred by merger and acquisition activity, especially within the healthcare sector with the ultimately unsuccessful Pfizer bid for AstraZeneca helping to drive markets, alongside more fruitful deals such as the novel asset swap and joint venture arrangement between GlaxoSmithKline and Novartis.

High quality equity income funds continue to be the foundation of our portfolios and we are keeping a close eye on the outlook for UK dividends. The size of Q1 dividends was quite extraordinary, due to the huge special dividend paid out by Vodafone. Beneath the surface the story is quite different, with Capita forecasting underlying dividend growth of 6.3%, a respectable but by no means extraordinary level of growth.

Europe

Overall economic growth faltered in the first quarter and results by country were mixed with Germany and Spain recording modest growth, France remaining flat and Italy declining. Bank lending is still falling with data revealing that loans to the private sector fell 2.0% in the 12 months to March 2014 whilst loans to non-financial companies contracted by 3.1%. Tighter credit conditions and an environment of subdued inflation are creating growing pressure on the European Central Bank to use additional monetary policy tools to help support the fragile recovery. Worryingly, company earnings have continued to contract in Europe, according to analysis by JP Morgan, and this will not assist equity markets in the region.

Asia Pacific and Emerging Markets

Performance across emerging markets remains diverse and we remain cautious overall, but parts of the Asia Pacific region are looking more robust than they did last year. In particular, India and Indonesia have recovered strongly following assertive monetary policy measures to tackle inflation and current account deficits. Additionally, necessary political reform may finally be coming through in India following the elections. China faces frictional problems in the short term due to the need to reduce unfocussed fixed asset investment and tackle issues within the banking sector. However, the government has had some success in steering the economy from export-led manufacturing towards the service sector and retail, which now account for around 49% of GDP.

Japan's economy grew at the fastest pace in nearly three years in the first quarter due to increased spending ahead of a sales tax increase on 1 April. However, sentiment towards Japan is weak in the wake of the tax increase and the Bank of Japan is holding off on adding to its quantitative easing operations at present. Both of these factors are weighing on the local equity market. Structural reforms will take time to implement, but there is some evidence that certain companies are implementing cost control measures rather than simply trying to grow top-line earnings and this is a positive development.

Fixed Interest and Cash

An increase in interest rates would signal a return to “normal” monetary policy and create rational pricing for fixed interest assets, with a resulting downturn in sentiment for fixed interest markets. In 2013 the mere suggestion that rates might increase caused US 10-year benchmark yields to double in six months, which is a strong indication of adverse reaction to actual rate changes. Both the US and UK authorities are expected to raise interest rates by mid-year in 2015. In contrast, Europe is facing deflationary pressures and monetary policy is likely to remain loose. Divergent monetary policies around the world may well create volatility in fixed interest markets.

Furthermore, the Budget introduced a significant change in that investors in defined contribution pension schemes will no longer have to buy an annuity upon retirement. Traditionally, annuity purchases have been one of the key determinants of demand for longer dated bonds and under the new rules this demand is likely to diminish.

We believe the combination of brighter global economic prospects, higher interest rates and reduced demand from annuities will lead to an increase in bond yields, which will create a corresponding decline in capital values for bonds from their current elevated levels. We therefore retain a very cautious approach to fixed interest markets at the present time.

Cash rates remain low but we still consider a meaningful cash reserve to be essential given the likelihood of volatility in both equity and fixed interest markets.

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