Economic Commentary – June 2014

Overview

Global stock markets have drifted in the first few months of 2014 and have recently faced headwinds from geopolitical factors and increased oil prices. In the UK we are back where we started with the FTSE 100 now at 6,733 having started the year at 6,731. In the United States the S&P 500 is now at 1,962 having started the year at 1,831.

The main surprise of the year is with government bonds where remarkably, yields have gone down and prices have gone up even as the prospect of interest rate rises has increased.

In terms of world growth, the World Bank has cut its growth forecast for the global economy in 2014 and is now assuming growth of 2.8% down from 3.2%. The United States and UK recoveries appear to be getting onto a firmer footing, although first quarter US GDP figures have been revised downwards. Europe still has some way to go and there is no guarantee that China can reposition its economy without some frictional slowdown.

Bonds and Cash

As indicated, the biggest surprise so far in 2014 has been the fall in core government bond yields, even though there has been a gradual reduction of quantitative easing in the United States and signs of recovery in the global economy. So whilst the 4% coupon on an issue such as the Treasury Gilt 2022 might sound attractive, the running yield is currently only 2.38% due to the high price of the stock (currently around £112).

There may be a number of reasons why yields have not increased, including the idea that whilst investors do expect interest rates to rise, they expect them to remain low compared to historical rates, with the consensus for an eventual "normal" interest rate of between 3.0-3.5% in the UK. The other explanations put forward for why yields have reduced are "after the event" and none of them justify the increase in price and reduction in yield that has occurred and we would therefore not recommend government bonds at this time.

Even though cash interest rates are low, we still feel it prudent, for the time being to hold a cash cushion within portfolios because of the irrationality of bond markets and because equity markets are near their all-time highs.

US

It is hoped that GDP figures will be stronger in the second quarter after the first quarter has just been revised to a negative figure, explained to some extent by the very bad weather. On the positive side consumer confidence reflected in new home sales seems to be rising. Equity prices have remained high largely because of the amount of cash held on United States companies' balance sheets and that is driving an interest in mergers and acquisitions and outright purchases, in addition to share buybacks and demand for extra dividends. Underlying all of this there needs to be earnings growth in companies and this has yet to come through.

UK

The Bank of England minutes, and an off the cuff remark by the Governor, revealed that interest rates may increase sooner than expected, although the Governor subsequently tried to reassure markets. Unemployment has fallen to a 5-year low and inflation remains below 2%. Despite some day to day fluctuations, Sterling has continued to be very strong against the US Dollar and Euro.

As in the United States there has been a lot of interest in new offerings of stock (initial public offerings) and merger and acquisitions activity, both of which are another potential sign that the market is peaking. It is also interesting that a lot of initial public offerings that have come to market have not fared very well since listing.

Overall we remain cautious about the outlook for equity markets and are still waiting for earnings growth to catch up with valuations. We therefore retain our tilt towards equity income funds which invest in high quality cash generative businesses. We also believe that as the economy recovers and we move into a more “normal” economic environment rather than one fuelled by quantitative easing that successful stock picking will come to the fore. We will therefore continue to predominantly use carefully screened, actively managed funds managed by individuals with a strong track record in identifying attractive stocks.

Europe

Concerns in Europe centre upon the very low rate of inflation at 0.5%, leading perhaps to deflation. The European Central bank has therefore taken action to reduce interest rates yet further, including a negative deposit rate to encourage lending. It has also announced a targeted long term refinancing operation, possibly worth up to €400 billion. We don’t yet know what the impact of these policies will be but the fact remains that there are some high quality multinational companies located in Europe which are as attractive as similar companies located in the UK or US.

Asia and Emerging Markets

These areas were expected to be the economic power house for growth but there are doubts as to whether this will be the case in the next year or so.

Japan has announced a number of long term measures to try to improve their economy including changes to corporate tax and immigration policy. It is by no means certain that Japan will hit the rather modest 2% growth level the government considers necessary to begin to reduce its mammoth public debt.

China is struggling to find the right balance between government stimulus and keeping inflation under control. On an optimistic note, the reported industrial production figures remain at a steady level and both retail sales and exports improved in May.

The World Bank has made the somewhat obvious comment that there is likely to be more volatility in emerging markets if both the United States and the UK start to raise interest rates. We have not been too enthusiastic about investing in emerging markets over the last year or two and that continues to be our position.

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