DT Dewhurst Torevell

Economic Commentary – July 2014

Overview

Since the beginning of the year, US markets have advanced whilst UK markets have not made any headway. The S&P 500 is now at 1,930 having started the year at 1,831, whilst the FTSE 100 is now at 6,730 having started the year at 6,731.

Overall the pace of global growth and recovery remains uneven, but geopolitical risks have remained contained so far. Volatility remains low for the time being, but an increase could be precipitated by a number of factors including an interest rate increase, if corporate profitability fails to take off or by an as yet unknown factor. By some standards equities are overpriced and this often precedes a period of volatility.

US

US companies have enjoyed a strong earnings season with many companies reporting better-than-expected sales and profits. This is evidence that the improving economic backdrop in the US is helping to boost consumer demand and business spending and if this can be sustained it would be good news for equity markets in general and for earnings growth. Nevertheless, US equity market valuations are looking stretched and a correction could be in the offing.

UK

The latest GDP figures have revealed that the UK economy has finally returned to pre-crisis levels. Output grew 0.8% in the second quarter of the year, meaning that the UK economy is now 0.2% bigger than it was at its previous peak in early 2008. Overall, the continued improvement in the UK economy suggests the chance of an interest rate rise this year is increasing.

The latest Capita Dividend Monitor report has revealed disappointing dividend growth for the second quarter, with the weakness being attributed to slow corporate earnings growth and the impact of the strength of Sterling on companies which report in other currencies. Looking ahead, Capita anticipate that the situation will improve in 2015 if the pound maintains its current level and if global growth begins to be more even between the regions. We are keeping a close eye on the expected income from our UK Equity Income funds and on news regarding their major holdings. However, we still view a sizeable allocation to UK and Global Equity Income funds as the bedrock of our portfolios because of their defensive qualities and because they invest in carefully screened, high quality, cash-generative companies.

Europe

Financial markets have been calm for the last two years since Mario Draghi, the ECB's president, said he would do "whatever it takes" to preserve the Euro. Recent monetary policy action will take time to feed through into the economy and the Eurozone is barely growing at this time. Despite this there are some

stable multinational companies domiciled within the region from which seasoned global and regional fund managers can pick credible holdings.

Asia and Emerging Markets

Japan's core inflation rate fell for the second month in a row, casting doubt over whether the Bank of Japan can achieve its 2% inflation target. Fixing structural problems within the economy will require radical changes and there is no guarantee that the country can address its enormous public debt without adverse consequences for economic growth.

China reported an economic growth rate of 7.5% in the second quarter. Setting aside concerns about the reliability of China's statistics, it is still the case that the economy is grappling with a weakening credit market and a slowdown in corporate reinvestment of earnings, whilst the likelihood of a housing market correction is increasing.

Emerging markets continue to be a mixed bag in terms of performance and it is interesting to note that several funds in this sector have been steadily increasing their allocation to multi-national companies listed in the UK and US which derive a proportion of their earnings from emerging markets as a safer bet than exclusively investing in the diverse countries that are classified as "emerging". We remain very wary of this sector and do not make any recommendations within it at the present time.

Bonds and Cash

The period of low long-term interest rates and bond yields following the financial crisis has gone on for so long, it can be hard to keep perspective on how extraordinarily low they are. Core government bond yields remain surprisingly subdued given the increasing likelihood of an interest rate rise and the UK 10-year benchmark gilt yield moved fractionally lower to 2.56% in the last month. Low yields are also reflected in elevated prices, such as the 4% Treasury Stock 2022 which is priced at £112 but has a running yield of just 2.35%.

Corporate bond yields are also surprisingly low although liquidity in this market has declined sharply in the five years since the financial crisis according to proprietary research by RBS. The Financial Times states that investors have moved more than $1trillion into global bond funds in the last few years and a lack of liquidity in the overall corporate debt market would exacerbate the issues surrounding any large scale exits from these products once bond yields begin to rise and the inflated capital values within these funds are eroded. Additionally, high yield bond funds have seen outflows in the last month and yields for high yield debt have risen whilst prices have dropped. This sector of the debt market can be an early indicator of increased risk aversion from investors and could potentially be a warning for both equity and bond markets of coming volatility. We are monitoring the situation closely.

We continue to be very cautious regarding bond markets across the risk spectrum and we continue to think it prudent to hold some cash in reserve despite the prevailing low interest rates.

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