Economic Commentary – August 2014

Overview

The past few years have been favourable to equity and bond markets with abundant liquidity and low inflation prevailing. The key challenge for markets in the months ahead will be whether policymakers can correctly judge the cessation of quantitative easing and the level and timing of any interest rate increases. History suggests that it is hard to get this right and policy errors have previously precipitated a bond market crash in 1994 and an equity market selloff in 1987.

There are also political uncertainties, including the Scottish Referendum and on-going strife in the Middle East, although the impact of the latter on markets has been contained so far. At the risk of being boring, we have been reacting to the uncertainties by holding relatively high levels of cash and also holding good quality dividend producing equities. Investment into bonds has been on hold for over a year now because of the unsustainably high capital values that have developed within bonds across the credit spectrum and the risk of liquidity issues and we retain this view.

US

Although US markets are relatively expensive, favourable economic fundamentals continue to support a steady uptrend in corporate earnings. High corporate cash balances have led to an increase in share buybacks as opposed to investment, which is a disappointing development. We maintain a cautious stance on the US because indices have been breaking through all-time highs and valuations are above average. Therefore, any softening of economic data could carry the risk of a market correction and this could be compounded by steadily tightening monetary policy.

UK

The UK economy grew by 3.2% in the second quarter and this noticeable improvement in domestic activity is feeding through into modest earnings growth, although the strength of Sterling has been acting as a headwind for multinational companies. The currency has weakened somewhat in the run-up to the Scottish referendum, but there is no guarantee that this effect will be sustained.

In the short term, some defensive areas of the market have appeared comparatively unattractive to cyclical stocks as a result of higher valuations and earnings pressure. However, we retain conviction in our investment process and in the use of Equity Income funds as the cornerstone of our portfolios. Some of our choices in the sector remain under review and we are monitoring developments in the portfolio positioning of the recently launched Woodford Equity Income fund closely.

Europe

One of the main sticking points in Europe has been corporate earnings, which have failed to show meaningful improvement. This has been due in part to a muted inflation rate, which at 0.5% is well under the European Central Bank (ECB) target of just below 2%. Limited quantitative easing by the ECB is now a distinct possibility and this has been a positive influence on European markets. We remain selective in this region, only choosing funds that invest in high quality, cash generative business and with an emphasis on both multinationals and companies with an element of family ownership, which aligns management interests with those of shareholders.

Asia and Emerging Markets

In essence, our cautious view on these markets remains unchanged from previous months. Economic data from China remains mixed and real estate is weak, denting industrial production and creating uncertainty in credit markets. However, exports and consumption have been fairly resilient and the government has scope to intervene to boost the economy if necessary.

Structural reforms have yet to be implemented in Japan but growing management focus on return on equity and the plans to cut corporation tax are supportive. However, the massive quantitative easing operations undertaken by the central bank will need to be ramped up if they are to remain effective.

Performance in emerging markets remains mixed. While some countries benefit from strong domestic fundamentals, others are under pressure due to current account deficits and tight monetary policy to support exchange rates. We continue to prefer an indirect approach through investments in developed country stocks which have exposure to consumption growth in emerging markets.

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