DT Dewhurst Torevell

# Economic Commentary – September 2014

## Overview

Although the global economic backdrop has improved overall and the US and UK economies are recovering well, Japan and Germany faltered in the second quarter and the Eurozone currency bloc is facing difficulties in general. A number of recent meetings with equity, fixed interest and multi-asset managers have refreshed and reinforced our current asset allocation views.

## UK

UK equity markets have dropped in the last month and the FTSE 100 is now at 6,500 from a 52-week high of 6,878. The UK Equity Income managers we have spoken to do not anticipate cuts in dividends in general and also anticipate dividend increases for some stocks. Additionally, the UK recovery is strengthening and this is borne out by economic data and by business sentiment. In aggregate, these factors make us a little more positive on UK equity markets as valuations have come to more reasonable levels and the outlook for dividends is steady if not stellar. We acknowledge the political risks that may open up in the run up to the general election in May 2015, but this does not alter our positive view on high quality, cash-generative equities.

## US

The US economy rebounded in the second quarter and seems on course for solid third quarter growth. US households have undertaken a significant amount of deleveraging but non-financial corporate debt and public debt are still increasing and this is a cause for concern.

Quantitative easing operations will cease in October, but the current consensus among commentators is that interest rates will not rise until June 2015 and will remain comparatively low. However, there are risks associated with the ending of an extraordinary era in monetary policy and both bond and equity markets could be prone to volatility.

US corporations have substantial amounts of cash on their balance sheets but this is being used for buybacks and mergers and acquisitions to a much greater degree than it is being used for capital expenditure or for dividend increases, which is a debatable use of resources.

## Europe

The Eurozone needs to pull clear of deflation although it is not yet clear whether the ECB will resort to outright quantitative easing operations. The Euro has weakened substantially since the ECB aggressively cut interest rates and this makes us a little more positive on the region at the margin.

**Asia Pacific and Emerging Markets**

Global trade has yet to fully recover from the financial crisis and many trade orientated emerging markets are vulnerable, especially where external funding is relied upon. We retain our discerning approach to investment in Asia Pacific focussing on defensive companies with high quality, comparatively stable earnings.

Although quantitative easing operations in Japan have increased the rate of inflation, the sales tax increase has negatively affected consumption and growth. We retain our slightly negative view on Japan because of the demographic and structural headwinds that the country faces.

**Fixed Interest and Cash**

We remain very circumspect regarding fixed interest because we will not buy in to fundamentally expensive investments which might suffer an irrecoverable loss of value. All of our existing holdings are in unconstrained strategic funds which are taking steps to position themselves for an era where interest rates will gradually rise, through management of the fund's duration and exposure to assets such as floating rate notes.

Interest rates remain extremely low, especially in real terms. Whilst we will be making small steps back into the market as buying opportunities open up, this will be incremental and we will retain quite a substantial amount in tactical cash for the time being.

**Update on UK Equity Income Positioning**

Since the announcement of Neil Woodford's departure from Invesco Perpetual we have had a number of meetings with Mark Barnett who now manages the Invesco Perpetual Income/High Income funds and a number of similar investment trusts. The results of these meetings have been positive and we have been encouraged by the performance of the funds since he took full responsibility for them in March 2014. As a result we are now considering his funds for the investment of new money. At the same time, we are reviewing existing holdings in the funds and will be diversifying exposure where we feel individual holdings are disproportionately large.

We have known Neil Woodford for many years and have had regular contact with him before and since the start of his new investment company in June this year. Since launch the fund has performed well and, having now completed our due diligence on the fund, we are starting to introduce the fund into our client portfolios. We are comfortable with the approach that Neil Woodford is taking and with the fund's positioning, including the fact that it offers some diversification compared with the other UK Equity Income funds on our panel. The fund has been very successful at gathering assets and is £2.68 billion in size.

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