Economic Commentary – October 2014

Overview

After a long period of comparative calm, markets have fallen by over 5% in the last quarter with the FTSE 100 now at 6,363 having started the year at 6,749. We have also observed the largest spike in the VIX volatility index since June 2012.

A catalyst for the most recent bout of volatility was a slight reduction in IMF global growth forecasts for 2014 and 2015 to 3.3% and 3.8% respectively combined with the observation that economic recovery is uneven and fragile. Worries about China, Japan and certain European countries have resurfaced, although the outlook for the US and UK remains solid. Markets are reassessing the outlook for the global economy and coming to a more realistic view based on single-digit growth rates for China and a long recovery process for Europe. The fact that equity markets have come to more reasonable valuations has presented selected buying opportunities and we are looking to deploy some tactical cash to take advantage of this, although we retain comparatively high cash balances overall because we believe a steady and disciplined approach will prevail.

Fixed Interest

We have seen an extraordinary environment in fixed interest markets in the last month with great volatility and large price/yield moves on individual days. Despite signs of economic growth, UK and US 10-year government bond yields have fallen from 3% at the start of the year to around 2.2% now. At one point, on 15 October, yields fell sharply to below 2%. Meanwhile, 10-year German Bunds retain a yield of below 1%. This was a very peculiar situation in the month when US quantitative easing operations will wind down and while there is still such uncertainty about the path of future interest rate increases and inflation because the textbooks would suggest that in such an environment prices should fall and yields should rise.

The world's largest bond fund, PIMCOs $200 billion Total Return Fund, has had outflows of over $23 billion since the departure of founder Bill Gross in September, but we are encouraged that the situation is contained so far and has not sparked rotation out of fixed interest assets held with other providers.
We retain a negative view of fixed interest markets based on the lack of liquidity within many market segments and the apparent mispricing of government bonds which leaves the potential for significant capital losses once bond yields inevitably begin to rise as prices fall.

US

The US economy is on track for 3% economic growth in the third quarter and some wage pressure is beginning to emerge. Overall we retain a cautious view on the US and note that US equities remain comparatively expensive compared to other regions despite the recent market pullback.

UK

The latest Capita Dividend Monitor report presented a subdued forecast for UK dividend growth when special dividends are excluded for 2014 as a whole. The main factor constraining dividend growth has been the strength of Sterling, although weak corporate earnings and a sluggish global economy have also been implicated. Nevertheless, Capita do not anticipate a cut in dividends in 2014 and 2015 is looking a brighter with a forecast of 5.5% growth, excluding special dividends. We retain our conviction that UK Equity Income funds should form a core part of portfolios and remain satisfied with our choices following several meetings in the last quarter.

Europe

Stress tests on European banks produced better results than expected, although around one fifth of European banks failed. Most of the failures are comparatively small institutions and consolidation could lie ahead. The European Central Bank has yet to announce any quantitative easing measures and this has caused some market jitters. Whilst the monetary transmission mechanism in Europe still needs to be fixed and there are structural issues in individual countries, including France, markets do look good value compared to other regions and there are a number of attractive, high quality, cash generative companies located within the region.

We continue to get most of our exposure to Europe through global funds but we do have some holdings in Henderson European Special Situations and Henderson European Growth and are keeping a close eye on developments following the announcement that Richard Pease would be leaving Henderson in May 2015 to establish his own company, Crux Asset Management. Subject to shareholder approval, he will transfer the European Special Situations fund from Henderson to Crux in a manner which is designed not to disadvantage current unitholders. The European Growth fund will remain at Henderson and is now being managed by co-manager Simon Rowe. In line with our standard practice when a fund manager change takes place both funds are now under review.

Asia Pacific and Emerging Markets

Our views on these areas remain unchanged. We have selective investments in the Asia Pacific region focussed on defensive companies with high quality, comparatively stable earnings. We retain a negative view on direct emerging market investment, preferring to get exposure indirectly through the multinational companies that our Global, UK, US and European funds invest in.

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