Economic Commentary – November 2014

Overview

Equity markets have rebounded from their mid-October low and the FTSE 100 is now at 6,723, which is a welcome improvement, although the index remains below its 52-week high of 6,878.

Global monetary policy is diverging with the US and UK beginning to tighten whilst Europe and Japan are still loosening monetary policy. Other major factors influencing markets at present are the strength of the US Dollar and weakness in commodity prices, in particular oil. The fall in the oil price is a positive development which, if sustained, should feed into the world economy in the coming months, boosting purchasing power, corporate margins and growth, particularly in energy importing countries.

Henderson have recently published their latest Global Dividend Index report, which reviews dividends for the largest 1,200 companies globally as defined by market capitalisation. The overall message of the report is very positive. Global dividends reached a record level of $288.1bn in the third quarter and Henderson also anticipate strong growth of 9.6% in global dividend payouts for 2014, even when an adjustment for the record $26 billion dividend paid by Vodafone is made. On this basis, 2014 will be the best year of dividend growth since 2011. The main headwind is the effect of the strong US Dollar, which it is estimated will deduct about 1% from global dividend payments overall. Nevertheless, we are very happy with the report's findings and we believe it lends credence to our policy of using UK and Global Equity Income funds as the core of our portfolios.

Fixed Interest and Cash

Benchmark US and UK government bond yields remain surprisingly low at 2.29% and 2.02% respectively. Both were around 3% at the beginning of the year. We continue to believe that this is evidence of mispricing in bond markets caused by the distortions created by quantitative easing. The fact that German Bund yields remain below 1% is also evidence of an extraordinary environment.

We are also very concerned about liquidity in bond markets. A recent FT Alphaville article has highlighted recent research from the Committee on the Global Financial System (CGFS) which reveals that trading is highly concentrated in just a few liquid issues in most corporate bond markets. One example is US corporate bond markets, where the share of securities with a 12-month turnover ratio of at least 50% (i.e. the sum of traded volumes accounting for at least half of the securities' outstanding amount) has declined from 20% to less than 5%.

We retain a negative view on fixed interest.

The consensus view is that interest rates will remain "lower for longer" in the UK and US although small increases are anticipated in 2015. Therefore, returns from cash investments are likely to remain very modest but we still consider it wise to keep some tactical cash that can be deployed into other assets when appropriate valuation levels arise.

US

US recovery remains strong with third quarter economic growth revised to 3.9% and unemployment below the long-term average of 6.1%. Inflation remains low. Year-on-year corporate earnings growth for the S&P 500 was just over 10% for the third quarter. The greatest risk is declining oil prices, which although supportive to consumers, could put the brakes on shale oil production as the marginal costs of accessing unconventional oil sources are higher than for other methods.

UK

UK economic recovery remains on track, with third quarter GDP growth of 0.7%, despite continuing weakness in the Eurozone. We have seen a continued increase in private sector jobs and some private sector wage growth and the OECD expects that the UK will be the fastest growing economy in the G7 this year.

There are some political risks in the run up to the general election and also a risk of asset price correction, especially within fixed interest markets. However, we retain a positive view on high quality UK Equity Income funds and selected UK growth funds for long term investment.

Europe

Recovery within the Eurozone has stagnated and the European Central Bank (ECB) has forecast that inflation will remain below its 2% target until 2017. The ECB has stopped short of introducing US-style quantitative easing in the face of fierce opposition from Germany and the practical difficulties of purchasing sovereign bonds of the 18 member countries. However, it has introduced an asset purchase program for covered bonds and asset backed securities and together with earlier targeted lending programs this will increase the size of the ECB's balance sheet by roughly €1 trillion.

It is important to remember that as equity investors in Europe we are investing in high quality companies, not economies.

Asia Pacific and Emerging Markets

Japanese markets have been fuelled by the further commitment to asset purchases by the Bank of Japan and by the announcement that the Government Pension Investment fund will allocate a greater proportion of its investments to equities. However, the long-term debt situation in the country remains unresolved and we remain cautious.

China unexpectedly cut interest rates this month in a bid to boost its slowing economy. This has boosted a number of markets which are inter-connected, but we retain a cautious view as there is no guarantee that longer term structural changes in the economy can be achieved without friction. Our negative view on direct emerging market investment remains unchanged.

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