Economic Commentary – May 2015

Overview

UK equity markets have made headway this year with the FTSE 100 now at 6,950 having started the year at 6,566. Our main concern is that this rise has mainly been fuelled by extraordinary monetary policy on the part of global central banks and that valuations are high whilst earnings growth remains comparatively modest.

The Henderson Global Dividend report has revealed that the strength of the US dollar and fewer special dividends drove down global dividend payments in the first quarter of 2015, leading us to be cautious about the outlook for income in general this year. However, a number of recent meetings with the managers of the global and UK equity income funds on our panel has provided reassurance about the dividend outlook for these specific funds. Overall we continue to favour a long term view and a patient approach to investing centred upon high quality equities which pay dividends and that will reap the benefits of compounding over time.

Fixed Interest and Cash

Since 1986 government bond investors have only experienced negative returns in three calendar years, with the largest loss being a comparatively modest -3.1% in 1994. The reason that total returns have rarely been negative is that investors have historically received relatively high coupons and have therefore had an "income cushion" to protect against any capital downside. However, the collapse in government and investment grade corporate bond yields in the last few years has reduced the income contribution to total returns and there is now less of a cushion available to protect against the possibility of a fall in bond prices than has previously been the case. Recent analysis by M&G has indicated that a rise in yields of only 1% would lead to government bonds losing over 6%. Either interest rate hikes or higher inflation could cause this. Most commentators expect US interest rates to rise in the third quarter of this year and the consensus view is that UK interest rates will rise before the middle of 2016. We therefore maintain our very negative view on fixed interest at this time, especially as we are also concerned about liquidity in corporate bond markets.

We continue to recommend that a tactical cash balance is retained to be deployed when equity and bond market valuations come to more realistic levels.

UK

UK consumer price inflation fell to -0.1% in April, confirming that the country has slipped into deflation for the first time since 1960. This is primarily due to the decline in oil prices feeding through into other areas such as lower air fares and the effects may be short lived, especially as wage growth has picked up. However, productivity growth remains comparatively low and until this improves the recovery will not be on solid ground.

Fiscal policy may tighten with a Conservative majority now in power, although overall the general election was positive from the point of view of markets despite the uncertainty introduced by the fact that an EU referendum will now definitely take place.

US

There is evidence that the US labour market is continuing to strengthen. Cheap debt has spurred merger and acquisition activity which has helped to keep market valuations high. Additionally, earnings growth for S&P 500 companies in the first quarter is now expected to come in at 1.5%, stronger than expected. However, we still have concerns about US market valuations and are keeping a close eye on our exposure.

Europe

The FTSE Developed Europe ex-UK index has total returns of over 10% in the year to date in Sterling terms. The pace of this liquidity fuelled European equity rally leads us to be cautious where valuations are concerned and implies the need for continued strong earnings growth and a selective approach to investing in the region.

Political uncertainties centre upon the debt crisis in Greece and Spanish elections where anti-austerity party Podemos has already made gains in local elections and is eager to gain a wider platform at the general election in 6 months time. We are keeping a close watch on developments in the region.

Asia and Emerging Markets

We retain our selective view on Asia and a negative view on emerging markets

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