DT Dewhurst Torevell

Economic Commentary – June 2015

Overview

Equity markets have made little headway this year. The FTSE 100 index reached an all-time high of 7,122.7 on April 27 but had fallen back to 6,521 by the end of June, slightly below where it started the year. In Sterling terms, total returns for the FTSE 100 index over the first 6 months of 2015 have been 1.65% with dividend income offsetting a small capital loss. Returns from US and Asia Pacific markets (ex-Japan) were slightly negative, whilst European and Japanese markets produced positive returns of 4.7% and 12% respectively. We are now moving into potentially difficult territory with the possibility of interest rate rises and increased inflation ahead and with uncertainty surrounding Greek debt once again dominating news flow over five years after the issue first arose.

Global central bank policy continues to support many world economies with Axa Framlington estimating that 56% of world GDP is currently supported by zero interest rates. Sovereign bond yields in developed countries remain well below their historical levels, despite recent sharp moves, such as the increase in the German Bund yield from 0.1% to 0.8%. UK dividends continue to look attractive relative to UK Gilt yields with the FTSE All-Share yielding 3.25% compared to the 10-year benchmark gilt yield of 2.11%.

The quality UK Equity Income funds that we invest in feature holdings such as BAE Systems, Imperial Tobacco and Legal & General all of which have historical dividend yields of over 4% and forecast yields in excess of 4.5% at the present time. This is well above what would be paid by these companies' corporate bonds. To find an equivalent yield among 10 year sovereign bonds, you would have to invest in riskier countries such as Brazil, Turkey and Russia.

It is important to be selective when investing in UK Equity Income and to choose well diversified funds because the falling oil price and rising dollar has herded some investors into a narrow subsection of sectors including telecoms, healthcare and consumer staples leading to concentration in comparatively expensive stocks. Additionally, these sectors have historically had a negative correlation with UK 10 year bond yields and could be set for a decline should UK bond yields rise, leading them to be known as "bond proxies". We have therefore had a series of meetings with the managers of the Equity Income funds that we invest in to verify we are satisfied with the positioning of the funds in the current environment. So far the outcome of these meetings has been positive.

Fixed Interest and Cash

We retain our negative view on fixed interest and are selling down holdings in this asset class following the recent adverse price moves and volatility within sovereign bonds caused by revised expectations of inflation and based on our concerns regarding the impact of any interest rate rises later this year. We also remain wary regarding liquidity in the corporate bond sector following recent discussions with various multi-asset fund managers.

We still view a cash “cushion” as an important source of liquidity within portfolios despite the likelihood that interest rates will continue to be comparatively low compared to historical rates in the developed world due to high levels of government indebtedness and the fragility of recovery in some economies.

US

Revised data reveals that US gross domestic product shrank at a 0.2% annual rate in the January-March quarter, less than the 0.7% previously reported. Growth is expected to rebound in second quarter data and a steadily firming economy could encourage the Federal Reserve to raise interest rates later this year. US equity markets continue to look comparatively expensive to other regions and we retain a cautious view on further investment.

Europe

Greece has defaulted 5 times since independence in 1824 and faces a difficult summer which will see €3.5 billion and €3.2 billion worth of bonds held by the ECB mature in July and August. At the end of June Greece became the first developed economy to default on payments to the IMF and faces further uncertainty as we approach a referendum on 5 July and a deadline for the repayment of ECB loans on 20 July. It is possible that, once again, a temporary solution will be agreed but the situation is fluid and has deteriorated in recent weeks. The apparently inexorable slide into default has exposed the frailty of the Eurozone in its current form and these structural flaws will need to be corrected if the currency union is to move forwards.

We are monitoring our European investments closely at this time.

Asia Pacific and Emerging Markets

China faces slowing growth as the economy switches to a higher skill, consumer-led structure and we remain cautious. India may be better positioned with political reforms and financial inclusion progressing, although important issues such as land reform and infrastructure improvements remain unaddressed. We retain a selective approach to Asia Pacific focusing on funds that invest in high quality companies with good corporate governance. Our view on emerging markets remains negative.

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