Economic Commentary – July 2015

Overview

Equity markets have made modest headway this year and have survived the latest crisis surrounding Greece without a substantial correction, but yet again this is down to the activities of policymakers rather than the strength of fundamental data. The FTSE 100 index is now at 6,696 having started the year at 6,566.

UK

UK economic growth rebounded to 0.7% in the second quarter. Recovery is well established with growth of 0.7% or more in five of the last six quarters, but will not be complete until interest rates rise towards more normal levels and public finances improve.

We continue to view dividends as essential in an environment where bond yields and interest rates are extraordinarily low. There has been good news on UK dividend levels recently with the quarterly Capita Dividend Monitor indicating that headline and underlying dividend payouts achieved a second quarter record level of £29.2bn and £28.3bn respectively this year. The difference between the figures reflects the fact that the underlying dividend figures do not include special dividend payments. The improvement was prompted by the currency effects of a strong US Dollar when translated into Sterling and greater payouts from the financial sector. The strong quarter should support the income component of returns for our UK Equity Income fund choices. Whilst Capita has raised its forecast for total dividend payments in 2015 we are mindful of headwinds in the supermarket and utilities sectors where cuts will take effect in the coming quarters.

US

Annualised US GDP growth came in at 2.3% for the second quarter, the equivalent of 0.6% growth quarter-on-quarter, as measured in most other countries. These numbers indicate that US expansion continues to be steady, if slow. Unemployment data reveals the US labour market is continuing to tighten and the consensus view is that US interest rates will rise in the autumn.

The overall trend for second quarter corporate results has been better than expected. Of the 185 S&P 500 companies to have reported so far, around 77% have beaten profit estimates, according to Bloomberg. Despite this positive data, we are cautious about the US market based on valuations.

Europe

European markets have calmed since Greece secured a last minute deal with creditors. Yet again the issue has been pushed away to a later date rather than resolved and ultimately structural reform will be necessary within the Eurozone.

The European funds we invest in have limited exposure to southern Europe, no exposure to Greece and also have substantial investments in non-Eurozone countries in Scandinavia and Switzerland. We continue to monitor the situation in Europe closely but it is fair to say that looser monetary policy and a weaker euro are promoting recovery in Europe at present.

Asia and Emerging Markets

Having lost touch with fundamentals over 18 months ago Chinese markets have corrected substantially since June, despite questionable (and futile) government intervention. Eventually market forces prevailed due to investor doubts regarding overcapacity and misallocation of resources. We retain a very cautious view on the mainland Chinese markets and the Asian funds we invest in have limited exposure, with the managers preferring the more developed market in Hong Kong.

Japanese corporate governance has once again come into question with a $1 billion accounting fraud being uncovered at Toshiba. This follows other scandals such as the $1.7 billion fraud uncovered at Olympus several years ago. There is a critical need for restructuring of the corporate sector in Japan and we still have a negative view on this market.

Overall we retain a selective approach to investment in Asia focussing on high quality companies with defensive characteristics. We continue to have a negative view on direct investment in emerging markets.

Bonds and Cash

Earlier this year fixed income markets overreacted to the prospect of quantitative easing by the European Central Bank and many sovereign bond yields fell to new lows. Dramatic bond market selloffs then occurred in May and June. This volatility was a healthy reminder to investors that core sovereign bonds are not a safe haven and is likely just the beginning of market corrections to bring pricing back to more realistic levels and to raise yields from their current lows in tandem with this process. We still have a very negative view on fixed interest as an asset class.

Interest rates remain low at the present time and we continue to have comparatively high tactical cash levels in the absence of compelling opportunities in other asset classes.

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