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Economic Commentary – October 2015

Overview

Equity markets recovered in October, rebounding from the August sell-off but the FTSE 100 still has some ground to make up – it is now at 6,384 having started the year at 6,566. Monetary policy remains the primary driver of equity markets and announcements from the major central banks are closely watched in the media. Mixed economic data for the US has led to indecisiveness on the part of the Federal Reserve with regard to interest rate increases. Worries also remain regarding deflation in other major economies and regarding growth prospects in China and all of these factors are influencing markets.

Equity dividend yields continue to outstrip those available on fixed interest with the FTSE All-Share yielding around 3.6% compared to a yield of around 1.9% on 10-year benchmark gilts. Higher dividends from banks and some special dividend payments will hopefully offset the likelihood of dividend cuts by oil and commodity companies. Our portfolios continue to favour high quality income generative equities combined with a cash component.

Cash and Fixed Interest

Analysis by the IMF shows that asset classes are increasingly moving in the same direction, meaning that diversification may no longer provide the protection it once did. This links in with our negative view on fixed interest based on valuations, liquidity and likely volatility and underlines the fact that diversification for the sake of it is unlikely to be beneficial in current market conditions. An article in the Financial Times recently highlighted the distortions that are evident in the fixed interest market - 16% of all Euro area government bonds are trading on negative yields and the average yield on Eurozone 5 year debt is -0.05%, whilst the average 10 year debt yield is just 0.56%.

We are not the only investors with a negative view on this sector and Investment Association data reveals that fixed income funds have seen net outflows since May 2015 with retail investor outflows of over £500 million in September 2015 alone.

The UK economy slipped back into deflation in September, with consumer prices falling 0.1% year on year. This is good news for the cash component of our portfolios which will benefit from low, or no, inflation. On the other hand interest rates are likely to remain low for the foreseeable future constraining the returns available on cash.

UK

UK economic growth slowed in the third quarter of the year, weighed down by the performance of the construction and manufacturing sectors. Gross domestic product grew by 0.5% between July and September, down from 0.7% in the second quarter. On the positive side government borrowing fell in the first six months of the year and the UK unemployment rate fell to a seven-year low of 5.4% in the three months between June and August. On balance the overall impetus within the economy is consistent with recovery.

So far in 2015 UK small and mid cap equities have held up much better than large caps, assisted by heightened M&A activity and a comparatively strong domestic economy. The large cap sector has struggled due to its exposure to China and the large number of commodities and resources stocks within the major indices. This underlines the need for skillful stock selection and active management and it is reassuring that our UK Equity Income fund choices have proved defensive and had better total returns in the year to date than both the FTSE 100 and the FTSE All-Share.

US

US GDP increased at a 1.5% annual rate in the third quarter, a significant drop from the 3.9% annual growth of the second quarter. On the positive side, consumer demand remains strong and the US corporate sector remains healthy, with 68% of S&P 500 companies beating earnings estimates so far in third quarter results.

Despite the summer sell off, the S&P 500 has proven comparatively resilient in the year to date but we retain a cautious approach to US equities based on valuations.

Europe

Consumer prices fell in the Eurozone in September, coming in at minus 0.1 percent, well below the 2% increase targeted by the European Central Bank and suggesting that as in the UK, US and Japan, large scale quantitative easing lifts asset prices but has little or no influence on consumer price inflation and economic growth.

On the other hand Eurozone unemployment is now at a 4-year low of 10.8% and the year-on-year earnings-per-share (EPS) growth or Eurozone equities is a solid 4%, leading us to have a neutral view on the region at present.

Asia and Emerging Markets

The Chinese economy exceeded expectations and grew 6.9% in the third quarter. The figure suggests that China remains on track to meet its full-year growth target of around 7%, but we retain a healthy dose of skepticism with regard to the veracity of China's official statistics.
Overall we retain a highly selective approach to investment in Asia, focused on high quality companies with strong balance sheets. We continue to have a negative view on emerging markets.

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