Economic Commentary – November 2015

Overview

Equity markets have made little headway in 2015, the FTSE 100 is now at 6,356, having started the year at 6,566 and the April peak over 7,000 proved short-lived. US equity markets are showing more impressive gains in Sterling, but this is largely attributable to currency effects. The S&P 500 is now at 2,080 after starting the year at 2,058.

Global bond yields are at near-record lows and major developed world equity markets remain at high valuations on a historic basis, despite the summer correction. This leads us to be cautious.

The international economy has had to accommodate the strong US Dollar and global GDP growth is down 5% year-on-year in Dollar terms. With the exception of a 6-month period in 2009, global inflation is now at its lowest level since records began in 1969. It is therefore hard for many companies to achieve top line sales growth, particularly in US Dollar or Sterling terms due to the strong currency effects in play. This has implications for earnings growth and therefore for dividends. Dividends are being cut in the UK market at a rate last seen during the 2008-2009 financial crisis and the aftermath of the 1999-2000 technology boom. The dividend payout ratio for UK equities is currently 77%, compared to a world average of 51%, but it may decline due to a combination of lack of earnings growth and dividend cuts. FTSE 100 companies account for 90% of all dividends in the UK, with 45% being attributable to the top 5 payers – Vodafone, Shell, HSBC, BP and Glaxo. BP and Shell may have to cut their dividends due to declining profits as oil prices have fallen. Glaxo could also be at risk due to low dividend cover; over 80% of earnings for the company are paid out. Dividends in other developed markets may also be under threat. We are therefore keeping a close eye on the income generated by our carefully selected panel of UK and Global Equity Income funds. We still prefer an income strategy for long-term investment though; this is based on our own experience and the many empirical studies which support this approach.

Cash and Fixed Interest

We continue to see worrying signs in bond markets, especially within the Eurozone. 27% of Eurozone government bonds are trading at a negative yield and over 67% of Eurozone government bonds yield less than 1%. Even peripheral economies like Portugal have been able to sell short-term debt at a negative yield. Additionally, corporate credit spreads have widened over the past year suggesting increased concern about the potential for credit stress among borrowers with lower credit ratings.

We are increasingly concerned about the lack of liquidity in fixed interest markets. The Bank of England estimates there has been a 75% reduction in the bond inventories of dealers in the marketplace since 2008 and the latest data from the New York Fed shows US corporate debt inventories amongst primary dealers have turned negative for the first time on record. Until markets are tested we don’t know how they will cope with this reduction in liquidity.

Interest rates remain extremely low, although a rate rise in the United States seems imminent. We retain a negative view on fixed interest and in the absence of viable alternative asset classes based on yield, valuation and liquidity we continue to allocate a portion of our portfolios to cash.

UK

This year's Autumn Statement saw George Osborne reiterate his belief that the UK can return to a budget surplus during this parliament. The Office for Budget Responsibility (OBR) revised its forecast for UK GDP to 2.4% for 2016. Employment and wage growth have also strengthened and recovery is on a firm footing.

US

Strengthening economic fundamentals indicate that the US central bank should be raising interest rates, but there is concern about distressing financial markets with a hike. US companies have been using debt to fund dividends, share buybacks and M&A and this late cycle behaviour leads us to be cautious with regard to US equity markets.

Europe

The latest official growth data from Europe suggests a slowdown in activity in the last quarter, but fairly stable recovery. GDP slowed from 0.4% quarter-on-quarter to 0.3% in the third quarter, this was due to lower manufacturing production and lower exports to China.

Our fund choices in Europe focus on quality businesses with pricing power, incentivised management and attractive valuations and therefore tend to fare better than generic market indices for the region.

Asia Pacific and Emerging Markets

Asian growth stabilised in the third quarter, although there was some scepticism about Chinese growth data which is slowing but remains very close to the official target of 7%.

We retain a selective approach to Asia Pacific based on high quality companies with good corporate governance. We continue to prefer to access emerging markets indirectly via multinational companies listed in developed markets which derive a portion of their revenues from these countries

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