Economic Commentary – January 2016

Overview

Equity markets have had a very difficult start to the year with an estimated 40% of stocks in the FTSE All-Share down more than 20% from their peak in the last year. The fall in value was broad based with only various consumer sectors and (counterintuitively) the oil and gas sector being up over the last month. The FTSE 100 started the year at 6,242 and is now at 5,632. The vast majority of our UK Equity Income funds once again proved more defensive than the market as indicated by both the FTSE 100 and FTSE All-Share. It is also important to remember that market sell-offs are indiscriminate and that experienced fund managers will be buying some stocks while they are available at attractive prices. On our side, we consider that it is too early to look for value ("bargains") following market retrenchment and we continue to focus on income generative investments which are predominantly in stable, defensive industry sectors and high quality companies. We are carefully monitoring events and also continue to gain insight from our regular private meetings with fund managers. We had 44 such meetings in 2015 and have already met with a number of experts in equity and fixed interest in January.

Fixed Interest and Cash

Corporate credit markets are facing dispersion between sectors with good demand in more defensive sectors such as consumer and much tighter conditions for sectors such as energy. Recent meetings with fixed interest managers indicate that liquidity for high yield debt has deteriorated and that liquidity for investment grade debt is patchy. Large scale outflows from corporate bond funds, defaults and any downgrades of investment grade debt could all act as catalysts to create a correction in fixed interest markets and we remain very cautious on this asset class.

Our views on the need for a cash "cushion" in such uncertain times remain unchanged despite the consensus that interest rates will not rise in the UK in the near term. Inflation is still in abeyance and so the purchasing power of this cash remains intact.

UK

The UK economy grew 0.5% in the last quarter of 2015, the slowest for 3 years. The consumer sector is quite healthy but manufacturers are struggling.

At the market level the outlook for dividends is quite subdued with the latest Dividend Monitor report from Capita forecasting a 0.9% fall in underlying dividend growth and a 1.3% fall in headline growth (which includes special dividends) in 2016. This has been influenced by deteriorating prospects for resources and food retailing stocks. We have discussed the outlook for dividends with a number of UK and Global Equity Income managers in the last few months and the managers we invest with are focused on individual company cash flow, secure dividends and the potential for dividend growth. Several have adjusted their portfolios to remove any holdings where dividends could be vulnerable.

US

The US economy is in mid cycle and wage increases and consumption are driving growth. US markets declined by around 6.5% in dollar terms in the last month but due to the strong dollar this translates into a loss of 2.5% in Sterling terms. We remain vigilant as US markets could correct substantially following a long period of overvaluation.

Europe

Although there are some signs of recovery within the Eurozone countries, exporters could be hurt by the slowdown in China and we have checked exposure to this issue within our European fund choices and found it to be minimal. We retain a cautious view on Europe.

Asia Pacific and Emerging Markets

The main issue for the Asia Pacific region is how the structural issues present in China will be addressed. There is a need to rebalance capital from the public to the private sector, but this will take a long time to play out, as evidenced by recent government interference in the Chinese A-share market. We remain cautious on this region and negative on emerging markets.

Japan has now resorted to negative interest rates meaning that commercial banks will have to pay the central bank for certain deposits. This is a new level of unconventional monetary policy and despite 80 trillion Yen being pumped in through quantitative easing operations, the economy remains well below the target of 2% inflation. We remain negative on the outlook for Japan based on structural and economic factors but recognise that there are individual high quality companies such as Canon, Nintendo and Astellas.

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