Economic Commentary – February 2016

Overview

Equity markets have remained unsettled in the last month. In particular, UK equities have faced headwinds in the last month due to “Brexit” concerns and some stock and sector specific issues. Whilst mining and energy stocks have generally seen better performance, bank stocks have fallen on fears of rising loan losses and lower interest rate margins. The FTSE 100 is now at 6,096 having started the month at 6,083. Whilst the index is little changed over the month, the last few weeks have seen high levels of volatility with the index falling below 5,500 on 11 February.

Sterling fell to its lowest level against the US Dollar for seven years on 22 February due to the uncertainty created by the upcoming EU referendum. In consequence, global stock market returns expressed in Sterling have been greatly influenced by currency effects in the last month. For instance, the S&P 500 had a total return of 0.59% for the month when expressed in US Dollars but currency effects would inflate this to 2.93% if expressed in Pounds Sterling. This effect has been a positive influence on some of our global and global equity income fund choices in the last month due to their exposure to the US.

The textbook view of low oil prices being positive for global growth and equity markets has not held true across the board on this occasion. According to recent analysis by Sarasin, equity market declines across the globe in January may have been exacerbated by “forced” selling from sovereign wealth funds. This is because most sovereign wealth funds contain assets from the world’s oil and gas producers, some of whom are under pressure to reduce risks and in some cases release funds.

Our portfolios have remained relatively resilient compared with the market in trying times and have been protected to an extent by their tilt towards income generative equities and comparatively high cash balances. We retain our focus on equity income funds which have a spread of exposure between stocks which have decent, sustainable yields today and stocks where it is anticipated that dividends will grow.

Fixed Interest and Cash

The effectiveness of quantitative easing has waned and a number of central banks are pursuing other extraordinary policies. Negative interest rates, are now being utilised for certain deposits in the Euro area, Japan, Switzerland, Denmark and Sweden.

British 10-year gilt yields hit a record low yield of 1.22% during the month. Despite this, in our view they remain overvalued and at risk of irrecoverable losses. Evidence is also emerging of lower demand for gilts, partially due to the uncertainty surrounding the EU referendum. Additionally, primary dealers have warned that tighter regulation is reducing their ability to take risk, limiting them from buying bonds at auctions without immediate orders to sell them. This has led Societe Generale and Credit Suisse to cease acting as market makers for gilt auctions.

The UK 10-year Gilt yield remains in positive territory but $5.5 trillion of global debt has a negative yield. According to Bloomberg, bond prices are so high in Japan that almost two-thirds of its government debt has a negative yield and one-third of Euro area debt is in negative territory.

In the corporate market, credit spreads have widened and bond liquidity remains a real issue with anecdotal evidence suggesting that many corporate bonds can only be traded in blocks of around £1 million at a time.

We retain a negative view on fixed interest as an asset class in general but recognise that there might be pockets of opportunity and we have frequent discussions with specialists in this area.

UK

GDP for 2015 was 2.2%, above average for the EU, but below the previous year. Bank of England Governor Mark Carney has stressed that he needs to see above-average economic growth and evidence of wage rises before increasing interest rates.

We remain focused on funds which invest in high quality, cash generative companies which should be more defensive during difficult times in the market.

US

Manufacturing weakness is evident in the US but the backdrop for the consumer looks supportive fostered by low oil prices, rising wages and employment growth.

We are still cautious on US markets because valuations remain high compared to historical levels.

Europe

European equities have lagged the UK and US in the last month. In particular bank stocks have been affected by fears that negative interest rates will affect profitability.

We are cautious regarding European equities. Some leading exporters are facing risks associated with the slowdown in China, but we have recently affirmed that there is limited exposure to this risk within our fund choices.

Asia Pacific and Emerging Markets

We retain a very selective approach to investment in the Asia Pacific region and a negative view on direct investment in emerging markets.

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