Economic Commentary – March 2016

Overview

The FTSE 100 is now at 6,146 having started March at at 6,097. There is still ground to recover and the index remains well below its all-time high of 7,122 in April 2015. Overall though the market was less volatile than in February and our portfolios have remained resilient.

Global growth is positive, if sub-par. Oil prices appear to have stabilised, at least for now, as more signs emerge that demand is robust and that supply can be slowed. Aggregate company profits in 2015 lagged expectations, but the vast majority of this can be traced either to commodity price falls (hurting profits for miners and energy companies) or currency shifts.

Domestic UK equities will be vulnerable in the run up to the EU referendum. The UK runs a current account deficit, and therefore needs to attract international capital flows into housing, infrastructure and more liquid assets like equities and gilts. Uncertainty over the future acts as a headwind for these capital flows and has the knock-on effect that Sterling has weakened. The global diversification in our portfolios protects us from this weakness and is actually beneficial for some of our carefully selected global and regional fund choices which have exposure to the comparatively strong US dollar.

Bonds and Cash

A review of US data for 1981 compared to today is a good illustration of the current distortions in bond markets. At the end of 1981 the US monetary base was $149 billion, compared to $3.8 trillion today. Interest rates were 12%, compared to 0.5% and the 10-year US Treasury yield was 14% compared to 1.8%. Low interest rates, low yields and correspondingly high valuations mean bonds look unappetising as an asset class and vulnerable to irrecoverable capital losses.

The European Central Bank (ECB) cut deposit rates from 0.3% to 0.4% and took its main refinancing rate to zero at its March meeting. It also expanded the size of monthly bond purchases to 80 billion Euros from 60 billion Euros, and will begin to purchase non-financial corporate bonds in addition to sovereign bonds and asset-backed securities. This decision has pushed average yields on Euro-denominated investment grade corporate bonds down to 0.9% according to Bloomberg indices. The drop in yields has also prompted a wave of corporate bond issuance of varying quality as firms look to take advantage of the low cost of borrowing. In our view this new round of quantitative easing only serves to create further distortions in bond markets and there is no guarantee that it will flow through corporations into greater investment and dividends as some of the money could be siphoned off into less productive share buybacks.

UK Inflation remains low for now, but this may not be sustained if oil prices begin to rise. As the rate begins to move back towards its 2% target, interest rates will begin to gradually rise, but this is not expected to happen until 2017 at the earliest and it is anticipated that rate rises will be very incremental.

We still consider a cash “cushion” to be an important component of portfolios and some of this could be deployed tactically in time to capture opportunities. Our recent research reviewing investment returns over the last 25 years suggests that investments made when stock markets are 5% or more below recent peaks receive better average returns with far lower probability of incurring a loss over a 5 year period.

UK

We retain our focus on high quality UK companies which are either domestic in focus or have genuinely diversified global revenues from Europe and elsewhere.

US

Robust data on the labour market, consumer spending and signs of a stabilisation in the manufacturing sector show that the US recovery is on track. Profit margins may have peaked for US companies though and this would limit returns. There is also significant political uncertainty in the US at this time. We therefore retain a cautious view regarding US equities, especially as valuations are still high compared to historical levels.

Europe

Reasonable valuations and supportive ECB policy are driving inflows to Europe, but weak growth and a challenged banking system mean that risks remain.

Asia-Pacific and Emerging Markets

Persistent weakness in emerging markets has weighed on global growth and excess capacity and debt continue to dampen both inflation and growth. China is committed to shifting its economy from resources to services and this will continue to weigh on global trade. We therefore remain very selective with regard to Asia Pacific.

High economic growth in emerging markets does not necessarily filter down to shareholders and these markets have historically been very volatile. We continue to prefer to access these markets indirectly through high quality multi-national companies which derive a proportion of their revenues from these markets.

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