Economic Commentary – April 2016

Overview

The FTSE 100 is now at 6,241 having started the year at 6,242. Despite a turbulent start to the year equity markets are ahead in total return terms for the year to date with the FTSE 100 showing a return of 1.5% and the S&P 500 showing a return of 2.8% in Sterling terms.

Oil prices have stabilised at over $40 per barrel and mining, energy and industrial companies' performance has improved since February. This has had short term effects on the relative performance of some of our carefully selected equity income funds simply because they do not tend to hold these companies. We retain our conviction in the long term positioning of our selected fund managers. Income generative equities also offer compelling yield and cash flow advantages relative to bonds and cash.

The outlook for the next few months is dominated by short term events such as the EU referendum, which is frustrating for long term investors. In our view, it pays to be brave and to remain invested. On the long view historical data shows equity markets to have been very resilient over time.

We are in an era of sub-par economic growth but analysis by Martin Wolf published in the Financial Times has revealed that the world economy has grown every year since 1946 when looked at in purchasing power parity terms. Innovations have been the catalyst for growth over time and there is no reason to believe that innovation is waning – we frequently hear about new technologies coming to the fore such as robotics, renewable energy and immuno-oncology at our regular private meetings with fund managers. There is therefore every reason to be optimistic for the long term.

Bonds and Cash

Monetary policy remains extraordinary and some investors are now taking the situation for granted. Five central banks now have official rates below zero, 62% of Eurozone bonds offer negative yields (as do all Japanese bonds of ten years or less), while according to Sarasin, in around 20 months' time the European Central Bank may have purchased every available German Bund that meets its current purchase criteria. Quantitative easing will continue to have a knock-on effect on the corporate bond market as investors hunt there both for bonds which are available for investment and for incrementally higher yields. We retain our negative view on bonds based on their unsustainably high valuations and untested liquidity.

In these uncertain times we believe it is prudent to maintain our comparatively high cash positions despite persistently low interest rates. Many equities have yet to reach fair value, but we would consider deploying some cash should a substantial market fall take place. This view has been reinforced by a recent research article we have produced covering 25 years of returns for the FTSE All Share Index. This provides empirical support that investing made when stock markets have fallen 5% or more below recent peaks ultimately generates better average returns with a far lower probability of incurring a loss over a 5 year period.

UK

The slowdown in UK economic growth momentum in the first quarter was broadly in line with expectations. GDP expanded by 0.4% quarter-on-quarter and 2.1% year-on-year. The UK has a strong labour market with record employment and this is boosting consumer confidence. If you exclude resources stocks, company earnings have held up quite well but we recognise that the outlook for dividends is subdued this year. Capita has recently published its latest Dividend Monitor report and this revealed that dividend growth in the first quarter was mainly driven by one-off special dividends. Additionally, some large companies in the resources and banking sectors have announced dividend cuts so Capita is forecasting the first decline in dividend growth since 2010 for the full year in 2016. Headline dividends (which include special payments) are expected to fall 1.5% to £78 billion, whilst the underlying level is set to fall 1.7% to £75 billion.

US

The US is experiencing a slow growth, low inflationary expansion with rising employment, modest wage growth and accommodative credit conditions. The strong dollar has created a mild earnings recession within the S&P 500, although Sterling investors have benefitted from currency differentials.

The valuation of the broad market is skewed upwards by stocks such as Amazon, Alphabet, Netflix and Facebook but the managers we have spoken to have indicated that value can be found on occasion in individual stocks. We are content to retain our allocations to Global funds with substantial exposure to the US and to some specific US funds based on a long term view, although we recognise that many stocks are not fairly valued at present and there is scope for further market correction.

Europe

The modest recovery in the Euro area is now entering its fourth year. Unemployment is still over 10% and this, combined with debt levels, is still holding growth back. We retain a cautious view on this market and favour high quality, cash generative companies.

Asia Pacific and Emerging Markets

The situation in China has improved somewhat and the currency has stabilised. We remain very sceptical about the official growth figures, however, and we consider that slowing growth and high levels of debt mean that risks remain.

The Japanese market has fallen this year in Yen terms. The strength of the currency has affected exporters and in the domestic economy the sales tax has reduced consumption. We are negative on this market overall but recognise that there are a handful of internationally competitive, profitable and shareholder focused companies which can be held in global funds.

There are large differences between the fortunes of the countries within the emerging markets group, depending whether they are oil exporters or consumers. We still prefer to avoid direct exposure to emerging markets and to tap into consumption growth in these countries through high quality developed market multinational companies.

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