Economic Commentary – June 2016

Overview

A new chapter in Britain's economic history opened on 24 June. After four decades, a majority of UK citizens voted to leave the European Union. The decision will have ramifications for both the UK and Europe.

The result was a surprise for financial markets, triggering sharp falls in UK and global equities (following volatility in the preceding week), a 30-year low in Sterling against the US dollar, and falls in global bond yields to fresh all-time lows in the US, Europe and Asia. Currency is likely to have a strong influence in the coming months and these effects are already being seen. For instance, the total return on the S&P 500 on Friday 24 June in the wake of the referendum was 4.76% in Sterling terms and -3.59% in US dollar terms, with the difference being purely attributable to currency.

In capital terms the FTSE 100 is now at 6,522 having started the year at 6,242 and ended May at 6,230. UK mid cap stocks have borne the brunt of the selling that took place immediately after the vote but despite this the FTSE 250 is up 2% in total return terms since the vote, compared to 7% for the FTSE 100. The majority of our UK exposure is to large cap stocks. Nevertheless we expect alternating periods of calm and turbulence within equity markets as the politics of Britain's withdrawal from the European Union play out.

We are long term investors and do not plan any changes to our strategy at the present time because we believe that significant exposure to carefully selected equity income funds together with a cash cushion is the most rational choice at this time. We have substantial holdings in global funds and the cash flow generated by many of the stocks held by our UK fund choices are global in nature. It is worth noting that Sterling weakness will have a positive effect on cash flows which originate in other currencies. The ability of UK multinationals to pay and grow dividends in Sterling may therefore improve. In some cases currency effects may also enhance competitiveness against global peers.

Fixed Interest

Core government bond markets have rallied as these assets are perceived as safe havens and the expectation is that monetary policy will remain loose in the major economies. Gilt yields fell below 1% for the first time ever on 27 June dropping down to 0.93%. US Treasuries and German Bunds have also seen yields decline to 1.46% and -0.12%. The 'losers' in government bond markets are assets which are regarded as riskier. As further EU breakup fears grow, Italian and other peripheral government bonds have seen a drop in price and a rise in yield. Bank sector bonds in the UK and Europe have also deteriorated.

Lack of liquidity has been an issue in corporate bond markets for some time and this may be exacerbated by the uncertainties created by the referendum. We retain our negative view on fixed interest markets based on overvaluation and concerns about untested liquidity.

UK

Given that 70% of the earnings for companies making up the FTSE 100 are from overseas, the implications of the "leave" vote may not affect the UK equity market as substantially as some commentators fear, although volatility is to be expected while negotiations take place. Within the UK equity market, we anticipate that sectors with substantial international revenues such as pharmaceuticals and consumer staples will outperform domestic sectors such as retailers, banks and homebuilders. Banks and homebuilders have been particularly hard hit with some stocks briefly suspended from trading in the last week. Our carefully selected UK Equity Income funds have very limited, if any, exposure to these sectors and are overweight in areas such as pharmaceuticals and tobacco, which should fare comparatively well due to their defensive nature and international revenues.

Europe

Various countries in Europe will face populist demands for similar referenda in the coming months and there are 5 general elections coming up in the next 18 months. Uncertainty regarding trade with the UK is weighing on European markets. We continue to favour fund choices which have a meaningful exposure to non-Eurozone countries. Our choices also have a bias to companies which have the potential to grow in a low-growth world due to participation in a niche business area and which focus on high quality companies with stable revenues.

US

The US economic outlook should not change much following the "Brexit" vote. The UK accounts for less than 4% of US exports and less than 3% of US imports. Domestic demand should remain moderately strong driven by an improvement in consumption and the fact that the housing market has recovered. Valuations remain high, the strength of the dollar is a headwind to earnings growth and the US is still in the midst of political uncertainty in the run up to the presidential election. We are therefore keeping a close eye on our US investments, despite the fact that they have benefitted from weakness in the pound when returns are translated into Sterling.

Asia Pacific and Emerging Markets

We retain a selective view with regard to Asia Pacific centred upon companies which invest in financially robust companies with good corporate governance. We continue to avoid direct exposure to emerging markets due to the volatility inherent in these economies.

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