DT Dewhurst Torevell

Economic Commentary – September 2016

Overview

The FTSE 100 is now at 7,070 having started the month of September 6,746 and started the year at 6,242. This is the first time the FTSE 100 has been above 7,000 since May 2015, having first attained that level in March 2015. Overall the UK equity market is being driven by factors such as Sterling weakness and the liquidity provided by renewed asset purchases by the Bank of England rather than by earnings growth. The market is vulnerable to set-backs and volatility has increased so we remain cautious.

Global unemployment continues to fall. Lead indicators are mixed, however, and cycles are shallow and short-lived. There has been a modest rise in inflation due to increased commodity prices but there has not been a lot of momentum. Schroders estimates that the world economy has experienced growth of 2.5% per annum since 2012 compared with 5% per annum before the crisis. Combine this with an uneven distribution of those gains and there is a clear rationale for the rise in populist politics and anti-globalisation sentiment in many developed economies.

We retain our focus on robust companies which have strong cash flows and balance sheets with dividends which are sustainable. These companies tend to be more resilient in an unsettled market environment.

Bonds

Bond markets remain extremely distorted and bonds are behaving more like equities because in present market conditions investors can only really make returns by selling at a higher price.

Worldwide, yields on more than US$11 trillion of bonds are below zero. We are seeing increasingly extreme yields and pricing, for instance, Henkel and Sanofi both issued corporate bonds with a negative yield in the Euro market this month and two BB-rated non-investment grade Euro bonds from Heidelberg Cement and Peugeot are offering just 18 bps and 20 bps of yield respectively, which indicates that credit risk is being mispriced.

According to Bloomberg, based on a measure called duration, an increase of 0.5% in average yields would result in a loss of $1.6 trillion globally across global bonds in issue, so there is serious potential for capital loss inherent within fixed interest markets at present together with little or no yield and we retain our negative views.

Lower bond yields are creating pension deficits within final salary schemes. These schemes are held hostage by actuarial assumptions and are obliged to liability match using bonds whether they are fair value or not. Well-known companies such as BAE Systems, Tesco, BT and John Lewis have all been in the news due to rising deficits. If companies have to divert funds to shore up pension schemes this takes cash flow away from other activities. At the margin this could even hinder dividend payments and dividend growth and we are keeping a close eye on the situation. We are encouraged by the fact that two of the managers of our carefully selected equity income funds have indicated that they have sold certain companies due to the risks created by increasing pension deficits.

Our aim is to preserve capital and to grow in a sustainable way. We also focus on liquidity and flexibility and this leads us to continue to favour income generative equities and cash in the extraordinary market conditions which prevail. Returns on cash today are minimal or even negative but unlike bonds, cash is not prey to capital or liquidity risks. Additionally, whilst equities are comparatively expensive at the moment, a decent income is still available and unlike bonds equities do not mature and are typically more liquid so irrecoverable capital losses are less likely for patient long term investors.

UK

UK GDP growth in Q2 has been revised up to 0.7% quarter-on-quarter, with support from consumption and investment offset by weakness in net trade. It is impossible to say what effect "Brexit" will ultimately have on economic growth. There is substantial political will to support the economy and markets. It is unclear what form any fiscal stimulus will take but we note that such policies are often watered down by the time they are implemented.

In the short term the healthcare, telecoms and tobacco sectors within the FTSE 100 have faced some headwinds in the year to date as fickle investors have moved into more cyclical sectors, chasing trends such as the improvement in commodity prices this year. This trend has had a short term impact on some of our carefully chosen UK equity income funds but we retain our conviction regarding their longer term prospects based on long term data relating to reinvested dividends and our regular meetings with fund managers. In the last month we have met with Neil Woodford and Adrian Frost to obtain their latest views.

US

Over the last 18 months, profit momentum has slowed amid a stronger US Dollar and energy price weakness, whilst US wage inflation has begun to rise. US equity markets may zig zag ahead of the presidential election, but overall they continue to look comparatively expensive and we are still cautious.

Europe

"Brexit" raises political risks in Europe ahead of Italy's constitutional referendum later in the year and national elections in France and Germany in 2017 and this is likely to dampen markets within the region. We are circumspect with fund selections that are focussed upon stocks with ample earnings visibility which do not require sustained economic recovery to perform.

Asia Pacific and Emerging Markets

Aggressive quantitative easing and the introduction of negative interest rates have failed to revive the Japanese economy. The Bank of Japan's latest move is to anchor yields on 10-year bonds at around zero; it is always difficult to intervene with market forces and we do not expect this policy to be successful. Despite the lowest unemployment rate in more than two decades, consumer prices in Japan have fallen for six straight months as household spending remains subdued. We maintain a negative view on this market but we are keeping a close eye on the improving levels of income available. The dividend yield of the Topix index is now 2.2% and is actually higher than the 2.1% currently offered by the S&P 500. We therefore anticipate that selected opportunities in Japan may emerge and our panel of Global Equity Income fund managers will be carefully evaluating these.

Emerging markets have lagged developed markets since 2010. Only India out of the highly publicised "BRICs" has appeared to fulfil its promise, while the collapse in commodity prices and the slowdown in China's economic growth has tempered the previously rapidly accelerating consumption in the region. We retain our very selective approach to Asia Pacific with complementary funds focusing on quality companies that include an allocation to developed, income generative markets like Australia alongside substantial holdings in India. We do not invest in any emerging markets funds at present because we obtain plenty of indirect exposure through the multi-national companies which make up a substantial proportion of our UK and global equity fund exposures and we wish to avoid the intrinsic volatility associated with direct exposure.

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