Economic Commentary – October 2016

Overview

The FTSE 100 started the year at 6,242, by the end of September it was 6,899, and having reached a new intraday high of 7,129 on 11 October, ended the month at 6,954. At the aggregate level corporate earnings are under pressure and markets are mainly being driven by the liquidity provided by quantitative easing. We remain mindful of the possibility of a market correction but still prefer equities to other asset classes based on a long term view. In addition we continue to avoid funds with complex strategies that are opaque and will continue to do so.

Fixed Income and Cash

Imports have become more expensive due to Sterling weakness and this is feeding through into inflation figures; the Consumer Prices Index (CPI) rose 1% in the year to September. Clearly there is a risk of cash being eroded by inflation in the longer term; however, we still value cash for its short-term capital preservation qualities and the fact it can be deployed tactically if equity markets come to more reasonable valuations than their current levels.

Global government bond markets responded negatively to rising inflation expectations in the last week of October with yields on benchmark 10-year Treasuries, which rise as the bond price falls, climbing to their highest level since May. Bond markets are looking increasingly discordant and we retain our negative views on this asset class.

UK

Currency differentials have increased UK dividend payouts by £2.5 billion in the third quarter, according to Capita's latest Dividend Monitor report. Beneath the surface the picture is muted with pay-outs falling slightly in the last 3 months. Capita now expects headline dividends to total £84.7 billion in 2016, up 6.6% and underlying dividends (which exclude special dividends) to be £78.6 billion; an increase of 2.7% year-on-year.
Declining company profitability and increasing pension deficits create a tempered dividend outlook for 2017, however UK equity yields still outstrip those available on bonds and cash. The FTSE 100 yield is currently 3.6%, which compares favourably to other equity markets, for instance, the yield on the S&P 500 is only 2.1%.

US

It is easy to become fixated on short term data and political risks such as the upcoming Presidential election on 8 November, but it is important to step back and look at the whole picture. The 2016 Dalbar market study revealed that over the last 30 years, the S&P 500 has averaged a 10.35% return each year. As long term investors, we are retaining some exposure to the US having trimmed selected positions based on valuation concerns and remain alive to valuation risks. However this must be set against the fact that a large number of resilient, high quality businesses happen to be domiciled in the US.

Europe

The pace of growth within the Eurozone remains subdued. Political risks include the Italian referendum on constitutional reform in December, a possible third attempt to resolve political deadlock in Spain and scheduled elections next year in France, the Netherlands and Germany.
We retain our cautious stance, focused on funds with substantial investments outside of the Eurozone and with an overall emphasis on resilient, quality businesses.

Asia Pacific and Emerging Markets

Japanese consumer prices fell 0.5% year-on-year in September indicating that the Bank of Japan is failing to meet their inflation objectives. Large scale quantitative easing operations have created a situation where the Bank of Japan owns over 45% of the government bond market, 65% of the domestic ETF market and is a top 10 shareholder in 90% of listed Japanese companies. We remain skeptical about the effectiveness of these policies and the long term outlook for Japanese equities in such a distorted environment.

Chinese economic data continue to point to the challenges in transitioning the economy away from large scale state investment. There was a sharp slowdown in the growth rate of industrial profits in September to 7.7%, with the Chinese Yuan sliding to a six year low against the US Dollar in October. As previous devaluations have not substantially helped, we remain cautious.

A number of the fund managers we have spoken to in the last month have expressed concerns about the slower pace of growth in emerging markets and the impact on these markets themselves and on certain developed market multinational consumer goods companies. Our carefully chosen active managers are rotating their developed market multinational holdings accordingly and we remain wary of direct investment in emerging markets.

Alan Torevell and Georgina Ogilvie-Jones

Issued by Dewhurst Torevell & Co Ltd, 5 Oxford Court, Manchester M2 3WQ. Tel 0161 281 6400. www.dewhurst-torevell.co.uk. Dewhurst Torevell & Co Ltd is a company registered in England 3279315 and is authorised and regulated by the Financial Conduct Authority (FCA number 183210).