Economic Commentary – November 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 of November at 6,784.

Following the US Election result, investor focus quickly shifted to the policies President Trump might pursue. The potential for tax cuts and infrastructure spending has driven equity market performance purely by sentiment as there is no certainty as yet as to what the new president will actually implement in office. Resources stocks have fared well in expectation of infrastructure spending and due to the OPEC production cut to support oil prices. This is presenting a short term headwind to some of our carefully chosen UK Equity Income funds, which either do not invest in resources stocks or have limited exposure. We retain our conviction in their long term potential based on their focus on robust companies with good cash flows and sustainable dividends.

Fixed Interest and Cash

Since the end of October bond yields have increased across the globe (and capital values have fallen) despite the quantitative easing operations being pursued by the UK, European and Japanese governments. Investors have been selling bonds based on expectations that inflation and interest rates will rise and that fiscal policy will replace monetary policy in the major economies.

Yield and price adjustments in sovereign debt have been substantial. For instance, gilt yields are now 1.45%, approaching the 1.56% level they were at in January 2016, despite falling to a historic low of 0.6% in the aftermath of the Referendum. There have been commensurate adjustments to prices and the FTSE Actuaries All Stocks Gilt index has lost 7.6% in the last 3 months. This is a very material move.

It is also very interesting to note that the effects are even being seen in Europe, where economic recovery is less advanced and large-scale quantitative easing operations are still in place. The German 10-year Bund yield reached 0.16% in November, its highest level since April 2016. Even more interestingly the percentage of Eurozone government bonds trading with a yield of below 0% has fallen from a high of 52% in September to below 33% in November.

Bond markets have become discordant and volatile and we retain our longstanding negative views. Irrecoverable capital losses are possible for some investors as prices fall from overvalued levels and yields rise, especially in sovereign debt such as US treasuries and UK gilts.

US

The Henderson Global Dividend Index analyses dividends paid every quarter by the 1,200 largest firms by market capitalisation. It is estimated that global dividends fell to $281.7bn in the third quarter, down 4.0% year-on-year, according to the most recent publication which analysed third quarter data. On an underlying basis, which strips out exchange rate movements and special dividends, the global total was 0.3% lower. It is interesting to note that the two largest influences on the decline were lower special dividend payouts in the US and a slowdown in US dividend growth. This sounds a note of caution regarding fundamentals and valuations at a time when all 4 major US market indices have recently reached all-time highs. We remain cautious and vigilant.

UK

The Office for National Statistics revealed at the end of last week that GDP climbed by 0.5% in the third quarter, driven by a strong growth of 0.9% in business investment. Trade made a larger contribution to the growth figure than it has in almost 3 years, because exports were assisted by Sterling weakness. It is still too early to say what the long term impact of Britain's exit from the EU will be, not least because the details still need to be negotiated.

The Autumn Statement included details of a new infrastructure plan which could boost GDP by 0.4% a year over the next five years. There was also a focus on boosting UK productivity growth, which has lagged many other developed economies since the financial crisis.

We remain selectively positive with regard to UK Equity Income funds because of the comparably good yields and long term capital growth prospects available. We remain neutral on domestically focused UK growth companies whilst the details of Brexit are determined.

Europe

Italy has rejected constitutional reforms and Prime Minister Renzi has resigned. The risk of political instability in Italy, Europe's fourth largest economy has created immediate falls in stock markets and the Euro. It is too early to say how quickly they might recover.

Further political risks lie ahead for Europe in the shape of French and German elections, whilst economic recovery remains subdued. We remain cautious and choose funds which invest in good quality companies, predominantly headquartered in Northern Europe and with significant non-Eurozone exposure.

Asia Pacific and Emerging Markets

Asian stocks markets sold off quite heavily in the wake of Donald Trump's election victory and the likelihood of more protectionist policies being pursued. There has since been some recovery. We have limited exposure to the region and still favour funds investing in resilient companies with sustainable business models.

Despite a number of policies aimed at lifting inflation and creating economic growth, consumer prices in Japan fell by 0.4% in the year to October, falling for the eighth month in succession. We remain negative.
Following gains of more than 42% in Sterling terms in the first 10 months of 2016, the FTSE Emerging Market index declined 6.6% in Sterling terms in the month of November, its biggest monthly fall since January this year. We retain our negative views on direct investment in this area based on volatility and the fact that indirect exposure can be obtained through more stable developed world companies.

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