DT | Dewhurst Torevell

Economic Commentary – December 2016

Overview

The FTSE 100 ended 2016 at a record high of 7,142 having started the year at 6,242. The index provided a total return of 19% in 2016. Sector performance was very polarised by the end of the year. Brent crude prices rose 56% in US Dollar terms and 88% in Sterling terms in 2016. This greatly assisted resources sectors such as oil and gas and mining which had total returns of 60% and 106% respectively across the year, having started at a very low base. On the other hand sectors such as pharmaceuticals and tobacco had more modest gains across the year of 8.5% and 19%. These sectors feature prominently in our carefully chosen UK Equity Income fund selections and this has influenced the performance of these funds relative to the FTSE 100 in the last year.

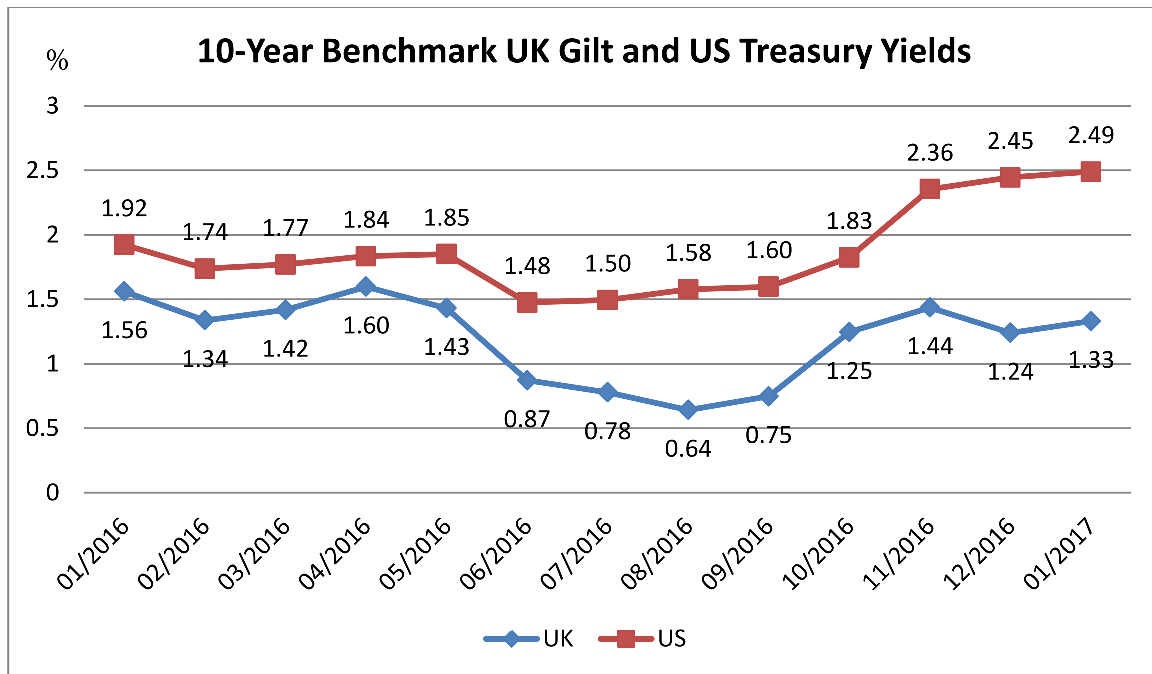
Taking a longer view shows a different picture though and highlights the folly of overly focusing on short term data. In 2015 the oil and gas sector lost 16.5% whilst the mining sector was down 46%. So these sectors had to recoup their losses in 2016 before any gains were actually made. Additionally, the pharmaceutical sector had a total return of 5.5% and tobacco returned 18.5% in 2015, showing more stable and consistent returns. On a 2-year cumulative view this means the tobacco sector gained 41% and the pharmaceutical sector gained 14.5%. In the same time period mining stocks gained 12% and oil and gas stocks gained 33.5% and with considerable volatility over the two years. This analysis leads us to the view that we should not consider any fundamental changes in sector positioning at this time. We retain our panel of carefully selected UK Equity Income funds, which have subtle but important differences in their portfolio positioning. For instance, the Woodford Equity Income fund has 50% of its portfolio in traditional blue chip companies and 70% in companies which pay a dividend. This is set alongside around 12% in earlier stage companies; which is a differentiator from our more defensive fund choices such as Trojan Income. We remain in regular contact with all of the fund managers on our panel.

The FTSE All-World had a total return of 29.6% in Sterling terms in 2016. Our carefully selected global fund choices had solid returns. In addition to stock picking, all of the funds were assisted by currency effects due to US Dollar strength and comparatively weak Sterling.

The fourth quarter of 2017 was dominated by market reaction to the election of Donald Trump and expectations that inflation will increase in the coming year rather than any substantive or fundamental data. Politics and policy are likely to influence markets again in 2017, with Brexit negotiations due to start and important elections in the Netherlands, Germany and France.

Cash and Bonds

There were three distinct phases in bond markets in 2016. Yields declined moderately in the first half, collapsed following the EU Referendum and then increased rapidly from October onwards with volatility evident in several upward spikes. The prospect of inflation and interest rate increases makes investors generally more reluctant to invest in bonds with yields that could be well below consumer price increases in years to come. In turn bond prices fell and yields increased substantially in tandem. The chart below shows 10-year benchmark bond yields for the UK and US monthly in 2016 to illustrate the speed of the falls and increases, especially in UK markets, and the volatility now inherent within bond markets.



Looking at the other side of the picture, major bond indices made losses in the last 3 months of 2016 and total returns across the year were subdued compared to equity markets. For instance, the FTSE Actuaries UK Conventional Gilts All Stocks index lost 3.4% in the last 3 months and had a total return of 10.1% for 2016. Additionally, the IBOXX UK Sterling Corporate All Maturities index lost 2.6% in the last 3 months and had a total return of 11.8% for 2016.

We continue to view the risks of capital loss in all bond markets and untested liquidity in corporate markets as unacceptable, especially when yields still remain so low in a long term context – at the beginning of 2007 the UK 10-year gilt yield was 4.98% and the respective US Treasury yield was 4.81%.

We also view a cash “cushion” as essential in such uncertain market conditions, despite the low interest rates available. In our view portions of cash can be redeployed into equity markets following periods of market stress when valuations are more attractive.

US

US equity markets soared following the election of Donald Trump as president, but it is important to keep in mind that the U.S. stock market is expensive. The Cyclically Adjusted Price Earnings (CAPE) ratio puts the S&P 500 at a ratio of 28.1. That is significantly higher than the historical mean of 16.7, although the ratio remains below its 2001 dot-com boom peak of 44.2. We remain cautious regarding the US based on the valuation level and the uncertainties surrounding a Trump presidency.

UK

Consensus forecasts for the UK are for 2% growth in 2016 but recovery is expected to slow sharply in 2017, to around 1%, as higher inflation squeezes consumers’ real incomes. Surveys of business investment intentions have been trending down since before the referendum. Fiscal policy is set to be looser but the extra spending on public infrastructure will not kick in until the years immediately before the next election. There is still a significant fiscal tightening built into the budget for 2017. The economic outlook for the coming year is therefore subdued.

Companies with overseas revenues will benefit should Sterling remain weak compared to other currencies. We could also see an increase in mergers and acquisitions activity as overseas companies look to purchase UK companies at favourable prices in their terms.

We consider that companies with robust cash flows which can maintain dividends and earnings growth are safest in this environment. We therefore retain our focus on a few carefully selected UK Equity Income and UK Growth funds of good pedigree and with a solid track record in a variety of market conditions. The funds we have chosen may face short term headwinds by not investing in certain more cyclical sectors, but we still consider their long term prospects to robust.

Europe

The European Central Bank has come up against some practical limitations in executing its quantitative easing operations due to the limited number of bonds available which meet its yield requirements. At the December meeting the decision was taken to reduce purchases from €80bn to €60bn per month and to extend QE operations by nine months.

We remain cautious with regard to Europe, especially with prevailing political risks. Overall we continue to focus on global leading businesses that happen to be based and listed in Europe or on growth companies which play in a niche area with barriers to entry. Our carefully selected fund choices have substantial non-Eurozone exposure and are orientated towards the stronger performing economies on the continent.

Asia Pacific and Emerging Markets

Asia Pacific funds with substantial exposure to India have seen some short term performance headwinds following an extraordinary ban on large denomination bank notes in a bid to tackle corruption. This is unlikely to have any long term effects.

Overall we retain our negative view on direct exposure to emerging markets and have limited exposure to the Asia Pacific region through defensively focussed funds which aim to invest in robust companies with stringent standards of corporate governance. We also continue to have a negative view regarding Japanese equities in general based on the structural issues within the economy which successive governments have failed to address. We do recognise, however, that there are a handful of outstanding Japanese multi-national companies which global fund managers may elect to invest in.

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