Economic Commentary – July 2017

Overview

The FTSE 100 is now at 7,423 having started the year at 7,142 and finished June at 7,312. The index returned 5.6% to the end of June, to be set alongside 7.3% for the FTSE World index. Gilt returns have been flat in the same time period and the FTSE Actuaries UK Conventional Gilts All Stocks index has returned only 0.4%

Based both on our research, and on the opinions of fund managers we have recently met, we consider both bonds and equities to be overvalued. Bonds are overvalued to a greater degree, and have more inherent risk of a permanent fall in value. They are currently therefore, not generally, part of our portfolios.

Equities are historically overpriced, but they are generating higher levels of income. Even if there are price falls, we consider that carefully selected high quality equities have more chance of recovery; and of a good total return in the medium to long term. We maintain our focus on UK and global funds which invest in good quality companies with robust financials and which are cash generative.

We also maintain our tactical cash holdings. Cash is paying very little interest, it is, however, important to protect the equity holdings from a forced sale in poor circumstances.

Fixed Interest

Following on from the extraordinary investor demand for the 100-year Argentinian bond discussed in our last commentary, the Greek government brought a €3billion 5 year bond with a yield of circa 4.6% to market on 25 July. Once again, demand outstripped supply, with over £6.5 billion in orders being placed. Greece still faces contentious discussions with the EU, ECB and IMF to release further tranches of the bailout packages and debt relief measures agreed 2010 – 2013. This could cause Greek sovereign debt yields and prices to be volatile. We consider the demand for this 5-year bond to be yet another indication of the dislocation in debt markets which we wish to avoid.

Closer to home, the Bank of England has recently published a study on bond market liquidity. It examined how large-scale redemptions in European domiciled bond funds could cause turbulent conditions in markets. The study found that the market's capacity to absorb mass sales of individual bond holdings from funds to meet redemptions could become stretched and that bond prices could fall materially. This in turn could prompt further redemptions.

The study is pertinent following the freeze on UK Commercial Property funds last year, due to panic selling by retail investors following the EU Referendum. In the worst case scenario, there is therefore a risk that bond funds with more illiquid holdings could be forced to suspend daily trading for an indefinite amount of time in turbulent markets, until they could find sufficient liquidity to meet redemptions.

US

The US economy is still on a good footing. Unemployment is now lower than it has been 96% of the time since 1970.

Based on economic strength, the Federal Reserve (Fed) raised base interest rates by 0.25% once again in June, taking them to 1.5%. It also announced that it is likely to start reducing the size of its balance sheet in the near term.

US equities have historically been resilient in periods of rising interest rates. Sectors such as financials could stand to benefit further from a rising rate and yield environment. On the other hand, the more expensive “bond proxy” (utilities, property) and defensive (consumer goods, healthcare) sectors of the US equity market may come under some pressure. We are pleased to see the managers our carefully selected global equity income fund choices have made some adjustments to sector emphasis in their portfolios, in many cases adding some financial sector exposure, to prepare for this eventuality.

UK

In the UK, the economic and political outlook remains highly uncertain. Falling real wage growth and rising consumer credit do not bode well for consumption. In reality though, the largest companies in the UK are all internationally facing and their fortunes are not tied to the domestic economy. The current economic and political environment has also led the prices of domestically focused mid caps to be subdued at times. The managers of our carefully selected panel of UK Equity Income and UK growth funds have therefore taken opportunities to buy good quality domestically focused stocks which they consider have solid long term prospects at favourable prices. In particular, some managers have bought housebuilding stocks, based on demand for UK housing outstripping supply.

Europe

European equities have performed well in the year to date. Corporate earnings in Europe are improving, hand in hand, with improving economic growth and this has driven markets.

Italy and Spain were forced to recapitalise ailing banks in June and we retain our concerns about the banking systems in peripheral EU countries and weak credit growth across the entire region.
Pro-EU parties were victorious in French and Dutch elections earlier this year, all eyes are now on the German elections in September.

We remain circumspect. We continue to prefer funds which are well diversified, have substantial non-Eurozone exposure and are orientated towards the stronger performing economies on the continent.

Asia Pacific

China has published GDP growth figures of 6.9% year-on-year. On the face of it the economy is performing well, but we retain a healthy skepticism about the official figures, especially as the government is tightening monetary policy. The 19th Party Congress will take place in the autumn. This 5-year event is where long term policy and strategy goals are set. There could be far-reaching implication for both China and the region.

Taking the situation in China and uncertainty regarding US trade policies into consideration, we remain cautious on the outlook for the Asia Pacific region.

Despite the unprecedented scale of their quantitative easing, the Bank of Japan have reduced annual inflation forecasts and the expected timing of reaching their 2% inflation target to 2019. Inflation is currently 0.4% and the target for 2017 is 1.1%. This seems overly optimistic. We remain negative on the outlook for Japan and do not place direct investments in this market.

Emerging Markets

Largely because of corporate governance issues, we are reluctant to invest directly in emerging market companies, choosing to invest indirectly through companies in better regulated domains, who do business in these countries instead.

Statistics indicate that exchange-traded funds (ETFs) investing into emerging markets and following passive strategies have seen increasing inflows in the last few years at the expense of actively managed funds.

According to the Financial Times, the largest emerging market ETF, run by BlackRock, turns over some $2.6bn each day, more than any individual stock (excepting Apple). Unlike funds, which are traded once daily, ETFs are listed on an exchange and trade intra-day. Because the underlying emerging market equities which an ETF in this sector holds might prove less liquid than the ETF itself, there is a risk of mismatches and forced sales.

Additionally, emerging markets tend to be dominated by a few large, partially state-controlled companies, which automatically receive a large chunk of ETF money because of their weight in the index which the ETF tracks. This is at the expense of other companies which might have more attractive prospects, especially smaller companies. These ETFs could therefore hamper market efficiency in allocating capital. In conclusion, the rising influence of ETFs makes this sector even less attractive to us.

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