DT Dewhurst Torevell

Economic Commentary – January 2017

Overview

The major US benchmarks reached new highs in January 2017, whilst an extraordinary situation arose in the UK whereby a new high was reached on each one of the first 12 trading days of the New Year, although the momentum faded at the mid-point of the month and the FTSE 100 ended January at the level of 7,099 compared to 7,142 at the beginning of the year. At the sector level mining and tobacco companies both performed well. We continue to have little exposure to cyclical resources companies but our Equity Income fund choices have substantial exposure to tobacco. Sterling strengthened a little over the month compared to the US Dollar and the positive influence of currency for our global fund choices weakened somewhat.

We have met with a number of equity managers this month including Mark Barnett of Invesco Perpetual Income/High Income, Nick Clay of Newton Global Income, Jacob de Tusch-Lec of Artemis Global Income and Derek Stuart of Artemis UK Special Situations. This has been very useful in refreshing and refining our views with regard to market valuations and rotation between sectors in addition to updating us on fund positioning.

Despite the FTSE 100 having a total return of -0.57% in January we retain our concern with regard to equity market valuations. Broad based stock market valuations such as Price/Earnings and Price/Cash Flow ratios are high in the context of historic levels, although they do remain below the extremes of past market bubbles. Recent fund manager meetings have emphasised the fact the market is not being driven by substantial factors like earnings growth but rather by sheer momentum. We remain concerned that there is little substance backing high equity market valuations and the risk of volatility remains present. On the other hand a market pullback might present an opportunity to deploy tactical cash balances.

There is so much confusion, that in an effort to understand, and explain, commentators fall back on labels, and try to fit market movements into them. We hear a great deal therefore about cyclical resource companies, such as oil and mining stocks, about value stocks, which may have been mispriced by markets and about momentum buying which means stocks are being bought because others are, and there is no fundamental reason for it. Quality stocks which generate good, and secure levels of income, are being labelled as “bond proxies”, often inaccurately.

You will be aware that the funds we recommend tend to ignore labels, and instead search out companies, in almost any area, which have a good market position, which have strong positive cash flows which they use wisely and which generally pay dividends.

Such funds have typically outperformed their relevant index over reasonable periods of time, but, as now, can underperform when markets are momentum driven. This can mean that even when markets are high, or have been high, but are falling a little, such funds when chosen with care, can provide a good home for future solid growth.

At the aggregate level both UK and US corporates have significantly increased their debt levels since the financial crisis due to the cheap cost of funding. Highly leveraged companies are vulnerable to a rising cost of capital as interest rates increase and this is another reason to retain a focus on quality companies with low debt levels and strong balance sheets.

Cash and Bonds

We retain our negative view regarding bonds based on the view that the market is in the process of correcting artificially high capital values and supressed yields following years of extraordinary monetary policy. We expect this to be an elongated, incremental process with reversals along the way.

Government bond yields increased again in January influenced by expectations that inflation will continue to rise. The 10-year UK benchmark gilt yield is now 1.29%, whilst comparable US Treasuries offer 2.4%. The US is now above its 1.9% level in January 2016, but UK yields remain below the 1.6% level at that time. In line with yield increases, capital values have fallen and the FTSE Actuaries Conventional Gilts All Stocks index declined 2% in January. The price of a US 10 year treasury stock is lower than it was a year ago. The price of the UK 10 year treasury stock is slightly higher than it was a year ago, but substantially lower than it was in the summer.

There is no guarantee that as bond yields increase the money will instantly “rotate” into equity markets. Sharp rises in government bond yields and a surge in inflation expectations in the UK have caused some previous stock market crashes in the mid-1970s and 1987. We retain comparatively high cash positions both to help insulate portfolios and ensure that client needs for income can be met and to leave cash to be deployed into the market once valuations become more appealing.

UK

UK fourth-quarter GDP growth came in ahead of expectations at 0.6% for the quarter and an annual rate of 2.2%. The path the UK will take to exit the EU remains unclear although multiple trade deals are a possibility as the UK will not seek continued single market membership.

US

We remain cautious with regard to the US due to political risks, comparatively high equity market valuations and rising interest rates.

Politics will be a big influence on US equity markets in the coming year but idle speculation is pointless. It is clear Donald Trump will be a different type of president to a “Washington insider” but how his policies will play out and to what degree he will be stymied by other branches of government and the judiciary is unknown.

Europe

Europe faces headwinds in 2017. Inflation is set to rise which will reduce the purchasing power of households, while political uncertainty could weigh on confidence. On the positive side Eurozone economic growth was stronger than expected for the last quarter of 2016 at 0.5% and employment figures are also improving.

We remain focused on funds which invest in resilient companies with robust financials and pricing power to combat inflation.

Asia Pacific and Emerging Markets

The latest IMF analysis on the global economy indicates the Chinese economy grew at an estimated 6.3% in 2016 and forecasts further deceleration in the next two years as the rebalancing process between trade and domestic consumption continues. India is also estimated to have grown at a slower pace of 6.6% in 2016, down from 7.6% in 2015. We remain cautious with regard to Asia Pacific, in part because of the possibility of protectionist trade policies from the US. We retain our negative view on direct investment in emerging markets.

Additionally, we are undertaking a review of our fund choices in the Asia Pacific region to ensure that stock picking is the primary driver of performance rather than factors like currency differentials.

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