DT | Dewhurst Torevell

Economic Commentary – April 2017

Overview

The surprise announcement of a UK general election in June impacted financial markets in April. The FTSE 100 is now at 7,265 having started April at 7,323 and started 2017 at 7,142. All of our core UK equity fund choices outperformed the broad market in the last month, with their emphasis on quality companies, and limited exposure to cyclical areas, such as mining, proving beneficial.

Sterling has strengthened against the US Dollar from $1.24 at the beginning of the month to $1.28 by the end. This had a short term negative impact on the FTSE 100 due to the dominance of multinational companies in the index, which have overseas revenues and in some cases report and pay their dividends in US Dollars. The FTSE 250 fared better, with a total return of 3.8% across the month, due to the presence of many more domestically focused companies in the index. This underscores the importance of choosing funds which invest across the scale in terms of company size, which has always been our practice when choosing UK equity funds.

Currency movements also affected US equity returns when expressed in Sterling. The S&P 500 was down 2.4% in Sterling terms in April, although it had a total return of 1% when considered in US Dollar terms. This had a short term impact on our global equity fund choices, due to their exposure to the US.

We have discussed currency risk in many of our recent fund manager meetings. Short term currency risk is very difficult to predict accurately and studies indicate that hedging currency risk only tends to reap modest improvements to returns over time and there is no predictability as to whether it will be advantageous, or simply add to costs. We therefore prefer funds which either do not hedge currency, or which only do so on a limited basis. In any case, funds which have exposure to multinationals have a degree of "natural hedging" through the diversified geographical revenues and sophisticated treasury operations of these companies.

Fixed Interest and Cash

Further political uncertainty in the last month provided support for gilts yet again and the FTSE Actuaries UK Conventional Gilts All Stocks index gained a modest 0.24%. We retain our negative views on bonds as a long term investment based on the high prices and correspondingly low yields which prevail and the likelihood of volatility when yields rise and negative returns over the long term, especially if inflation is taken into account. As previously discussed, we prefer to insulate portfolios through the use of tactical cash despite the low interest rates available.

United States

Recent political debate regarding healthcare reform and the possibility of a government shut-down if agreement cannot be reached on the debt ceiling for government borrowing have cooled US equity markets a little. We remain circumspect.

UK

Capita's quarterly Dividend Monitor report estimates UK dividends grew by 9.5% to £15.4 billion in Q1. Underlying dividends rose 16.2% to £15.3 billion; this figure excludes special dividends, which declined in the first quarter following a number of large payouts in 2016. Despite evidence of dividend growth for the first quarter of 2017, we remain vigilant. Dividend growth was unduly influenced by currency translation effects totalling over £1.5 billion. If these effects are stripped out, underlying dividends would have fallen slightly year-on-year, indicating that broad based, sustained dividend growth is not evident.

40% of UK dividend payouts in the remainder of 2017 will be made in foreign currencies and the Sterling exchange rate could be either helpful or a hindrance; depending on its level. We are cautious because there is a consensus among the managers we have spoken to that Sterling is currently undervalued.

On the positive side, dividends for FTSE 250 companies rose 11% on an underlying basis in Q1, and continue to show superior growth when compared to FTSE 100 companies. More than nine-tenths of mid-cap dividends are declared in Sterling, so the impact of exchange rates is fairly negligible. Recent meetings with the managers of our carefully selected UK Equity Income funds have highlighted their exposure to some quality, domestically focused mid cap companies and some subtle addition to this exposure over time.

Despite the muted outlook for dividend growth in 2017, we retain our positive view on actively managed equity income funds for long term investment based on the compounding effects which dividends have on total returns over time and the fact that quality, cash-generative companies tend to be defensive at times of market turbulence. It is also the case that the yield available on equities by far outstrips that available for other asset classes. The FTSE 100 currently yields 3.8%, compared to a 10-year benchmark gilt yield of 1.1% and a yield of 2.6% for UK property net of taxes and other charges (as estimated by Capita).

We have recently had positive and informative meetings with Richard Colwell of Threadneedle UK Equity Income, Carl Stick of Rathbone Income and Nigel Thomas of Axa Framlington UK Select Opportunities. Later this month, we will meet with Paul Spencer of Franklin UK Mid Cap.

Europe

Stronger economic data has been overshadowed by commentary focused upon the French election. Whilst we do anticipate that politics will be a short term influence on European equities this year and remain cautious, we believe our limited exposure to high quality European companies, including some non-Eurozone exposure, has solid long term potential. We will be meeting with Richard Pease of Crux Asset Management to obtain an update later this month.

Asia and Emerging Markets

Asian markets fell in Sterling terms in April, but made gains in local currency terms. We retain limited exposure and a selective approach. Growth in China is likely overstated and is likely to be unsustainable due to rising core inflation and a debt:GDP ratio of 279%. Japan is beset by structural problems and spiralling government debt associated with aggressive quantitative easing, so far this has lifted asset prices but has failed to spur the real economy and increase inflation.

On the other hand certain large and influential companies in the region have had excellent performance in the year to date. Samsung (a core holding in our fund choices in the region) is up 11% in local currency terms in the year to date, despite some company executives being embroiled in a corruption scandal. Solid cash flow and profits saw $3.5 billion paid out in dividends last year and it is anticipated this will increase in 2017 and be supplemented by share buybacks.

The outlook for emerging markets is dependent on US trade policy and the degree of monetary tightening or US dollar strength. We maintain our negative view on direct investment, other than placing trust in our preferred global equity managers to identify a few high quality, cash generative companies for their portfolios. We continue to prefer to tap into rising affluence in emerging markets through developed market multinational companies.

Alan Torevell and Georgina Ogilvie-Jones

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