Economic Commentary – May 2017

Overview

The global economy is extending its broad-based recovery, with stronger data coming through from Europe and emerging markets to set alongside established US recovery. Corporate earnings prospects are reasonable, but could see subtle negative effects from more populist policies in some countries. Inflation and debt levels remain the greatest economic threats in our view.

The FTSE 100 and S&P 500 both reached record highs during the month of May. Whilst this has had a short term positive effects on portfolios we do remain cautious with regard to equity market valuations. Markets are being driven more by "animal spirits" rather than by compelling fundamental data. Following the inconclusive UK election, the FTSE 100 has returned to just over 7,300 and the pound has fallen 2% against the Dollar and 1% against the Euro. The FTSE 100 started the year at 7,142 and finished May at 7,204.

Within the FTSE World Index tobacco and technology stocks have increased by 16% in the last month. Consumer stocks and healthcare, have gained 10%, and 8% respectively. Mining and banks are just positive, whilst oil and gas are down by 11%, in line with falling oil prices.

Many of our equity income fund choices are orientated towards healthcare and consumer stocks and have limited exposure to resources and banks. Despite all the noise regarding "rotation" and the need to move into more cyclical areas towards the end of 2016 we remained with managers who ignored this, and this has been beneficial.

Cash and Fixed Interest

UK gilt markets were volatile in May. 10-year yields rose to 1.2% in the middle of the month before falling back to 1%.

Inflation as measured by the Consumer Prices Index (CPI) was 2.7% year-on-year in March. This is of importance, because it means the real yield, which takes inflation into account is -1.7%. To give a flavour of 10-year benchmark yields available outside of the UK: US Treasuries offer 2.17% (inflation is 2.2%) and German Bunds offer 0.29% (inflation is 1.5%). We retain a negative view on fixed interest believing bonds to be overvalued and offering very poor yields.

Interest rates remain stuck at historic lows but we still consider it important for clients to maintain some cash which can be deployed when markets come to more reasonable valuations. We will soon be publishing our in-house research on the impact of investing at a market peak and the benefits which have historically accrued to long term investors even following a comparatively modest decline in market valuations.

UK

The FTSE 100 gained nearly 5% in the month of May and is up over 7% in the year to date on a total return basis. The international orientation of the FTSE 100 is often more important than domestic considerations and UK equities have made headway despite political uncertainty in the lead up to the election.

Dividend cover, the extent to which a company's dividends is covered by profits, currently sits at around 1x for the FTSE All Share as a whole. This is a decline of 10% from a year ago and half its level of two years ago. This suggests the overall level of dividends in the broad UK equity market could come under pressure. Once again this underscores the importance of active management and choosing funds where the manager looks for longevity in each company's cash flow.

US

US equities continue to look expensive in both absolute terms and in comparison to other regions.

Analysis reveals the S&P 500 index has been fuelled by tobacco (up 17% in the year to date in Sterling terms) and IT stocks (up 15% in the year to date). Our global and US fund choices will have participated in this upswing through exposure to companies such as Microsoft, E-Bay and the major tobacco companies. The funds do not, however, invest in the "FAANG stocks" - Facebook, Apple, Amazon, Netflix and Google (Alphabet). These stocks have been the single largest contributors to S&P 500 performance in the year to date. Given the significant growth expectations inherent in these companies' valuations, any slight shift in sentiment about their long-term prospects could spark large swings in their stock prices. Apple is very dependent on the iPhone which accounts for about 66% of revenues with the iPad, Mac and services parts only bringing in about 10% each. Alphabet is very much focused on digital disruption and both hits and misses are to be expected in this area. Amazon's has an appetite for aggressive investments and has rarely posted a profit in its 20-year history and has never returned money to shareholders. On balance we prefer companies with steadier business models in the technology sector.

Europe

The Eurozone is slowly, but steadily recovering and the unemployment rate is now 9.3%, still high, but down from 12.1% in 2012.

Politics remain influential on equity markets with an election now likely in Italy and with the certainty of German elections in September.

We retain our focus on funds which invest in resilient businesses and which have an allocation to non-Eurozone countries, providing some insulation from any systemic problems which may arise.

Asia Pacific and Emerging Markets

Ratings agency Moody has downgraded China's sovereign debt for the first time since 1989. The report cited concerns about the amount of debt in the Chinese economy, in particular the shadow banking system, and the lack of progress in financial reforms. On the positive side, China signed a trade deal with the US, revealing a pragmatic approach to trade relations from President Trump despite the rhetoric broadcast during the election campaign last year.

We retain a circumspect view on the Asia Pacific region centered upon funds which invest in financially robust companies which pay dividends and/or have good growth prospects.

Emerging markets have performed well in the year to date, but longer term 5-year cumulative data reveals the outperformance of developed markets and global indices. We remain cautious on this eclectic mix of countries and economies based on their potential for volatility. This is yet another area where politics could have repercussions for markets in the coming months. The decision by a four-country alliance led by Saudi Arabia to cut diplomatic ties with Qatar joins a growing list of “hot spots” including the Korean Peninsula and the latest political scandal in Brazil.

The Japanese economy remains turgid, despite the massive injection of money into the system through quantitative easing and individual companies can be vulnerable to the exchange rate against other major currencies. Nevertheless, there are some good quality, adaptable global businesses listed in Japan. Some of our global funds have very selective exposure and we much prefer this to having an explicit allocation through a Japanese equity fund.

Alan Torevell and Georgina Ogilvie-Jones

Issued by Dewhurst Torevell & Co Ltd, 5 Oxford Court, Manchester M2 3WQ. Tel 0161 281 6400. www.dewhurst-torevell.co.uk. Dewhurst Torevell & Co Ltd is a company registered in England 3279315 and is authorised and regulated by the Financial Conduct Authority (FCA number 183210).