Economic Commentary – June 2017

Overview

We are now nearly a decade on from the financial crisis and the major world economies remain characterised by comparatively low growth and low inflation.

Equity markets have seen good absolute returns in the year to date. By the end of the second quarter (in Sterling terms) the FTSE 100 had gained 5%, the S&P 500 4%, the FTSE World Europe index 13%, the FTSE Japan index 5% and the FTSE World Asia Pacific ex Japan index 12%. Asset prices have responded positively to economic data that has in general been better than expected, especially in Europe. Inflation remains fairly benign and fiscal and monetary policies are still supportive of risk assets, although recent comments from the governors of the major world central banks have indicated this cannot continue indefinitely. There are political risks in the UK, US and Europe but they have so far not materially impaired markets.

Energy and commodity prices have moderated in the year to date, for instance the Sterling Brent crude price has dropped by 20%. Energy and mining companies have not performed well as a result and our portfolios have benefitted from their limited exposure to these sectors. They have also been advantaged by good performance from the following sectors: consumer goods (especially tobacco), healthcare/pharmaceuticals and their exposure to more mature technology stocks which are cash generative.

It is important not to be complacent and assume the 8-year bull run in equity markets can continue indefinitely. Equities are generally at historically high valuations. Conversely, volatility remains low, with the VIX index currently 11, compared to a long term average since 1993 of 19. This index only covers the US equity market and has other limitations. It is a reasonable guide to market sentiment in the largest global equity market though. The 46% spike in the index on 17 May is an indication of how quickly more turbulent market conditions could emerge with little warning.

Despite the need for vigilance, we still favour equities above other asset classes. We also expect active management and careful stock selection on the part of the fund managers who make up our panel to add substantially to returns. We retain our perennial preference for funds which invest in companies with resilient, global business models and which generate ample cash. Such companies should prove defensive relative to those with weaker balance sheets in the event of a market downturn.

We have met with most of the managers of core fund choices in the first half of the year and have discussed portfolio positioning in detail for each fund. It is clear that even companies operating in traditionally stable and defensive industries such as consumer goods and healthcare must continue to evolve their business models and adopt changing technology and adapt to (or acquire) new entrants.

Fixed Interest and Cash

We aim to avoid permanent capital losses for clients. We therefore continue to view the low interest rates available for tactical cash balances as favourable to investing in bonds, which we believe remain overvalued despite some price correction in the last year. The FTSE Actuaries UK Conventional Gilts All Stocks index has fallen by nearly 1% in the last 12 months as prices correct in fits and starts following an era of historically low interest rates and quantitative easing. One reason why this is such a slow and incremental process is that regulation-driven demand for gilts from pension funds remains strong, artificially supporting the market.

The best indication of how stretched fixed interest markets are in general is probably the $2.75 billion which the Argentinian government has borrowed via a 100-year sovereign bond. The issue was nearly four times oversubscribed. Bearing in mind that Argentina has defaulted five times in the last century and the "ultra-long" nature of the borrowing, this looks like a very risky investment despite its 8% yield. Higher yielding assets typically have higher volatility, greater default risk and a significantly positive correlation to equities. All of these factors have the potential to lead to partial or total capital losses which cannot be recovered.

UK

The UK election produced a hung parliament. We do not think this result will have long term significance for our UK Equity Income fund choices because they all feature a number of resilient, globally facing companies within their holdings. The weakened political mandate in the UK might create some turbulence over the coming months for equity markets, however. On the positive side, opportunities to buy good quality companies at reasonable prices may occur and the managers of the UK funds included in client portfolios will be scanning for opportunities. We will also be looking for any market falls which are significant enough to consider deploying our tactical cash balances.

The portfolios of our UK Equity Income choices have already evolved in the year to date. The managers are considering the prospect of a different economic environment, framed by rising interest rates and inflation. In essence, they are balancing their core, more defensive holdings with exposure to stocks which will benefit from an improving economic outlook. This means some funds now have exposure to more cyclical companies including housebuilders, oil majors and banks, provided they have robust balance sheets and are cash generative. Exposure to mid cap companies has also increased, in particular domestically focused UK companies which have become more fairly valued following the Referendum last year. The managers in question have made the changes with a view to creating long term capital growth and income in anticipation of the very different environment which may lie ahead as QE winds down. It is encouraging to see diversification in our fund choices and that managers are not complacent and are actively managing the funds whilst avoiding frequent transactions and the associated costs.

US

Partly due to disappointing US economic data, the "reflation" narrative which emerged in the latter part of 2016 premised on an acceleration of growth and inflation has not come to fruition.

We retain a cautious view of the US based on equity market valuations. It is important to keep in mind that many world class companies are headquartered in the US though and these companies feature prominently in our carefully selected global fund choices. Despite a comparatively low yield for the S&P 500 of 2.2%, the US is still an important source of income for investors. The country accounts for over 40% of global dividends according to the latest Henderson Global Dividend index report. Despite higher valuations compressing yields for some companies, several sectors offer attractive dividend income.

Mature businesses like Intel and Cisco offer 3% yields sourced from strong balance sheets. Meanwhile, telecoms and mature pharmaceuticals companies offer sustainable dividends and robust financials.

Europe

We have met with the mangers of our preferred European funds in the last couple of months. Both remain overweight in high quality companies and include some mid cap companies which have relatively stable businesses because they provide niche products and services. In both cases the managers are overweight in Northern Europe and have diversified currency exposure through holdings in Switzerland and Scandinavia.

Asia Pacific ex Japan and Emerging Markets

While Asian markets are proving more resilient against external global shocks than they have been in the past, potential headwinds persist. Our limited exposure to the region is held in actively managed funds which predominantly invest in high quality stocks in the more developed markets in the region.

We remain negative on direct investment in emerging markets due to volatility and the fact that disparate countries with varying prospects are included in this sector.

We also remain negative with regard to Japan because of long standing and possibly intractable structural issues such as an ageing population and high debt levels. We are also aware that largescale purchases of passive exchange-traded funds by the Bank of Japan in the course of its quantitative easing (QE) operations is creating market distortions and propping up prices. When QE eventually ends, prices could fall substantially.

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