Economic Commentary – August 2017

Overview

Despite various political and economic events, equity markets have made headway in the year to date. The FTSE 100 started the year at 7,142 and is now at 7,438 having finished July at 7,372, indicating very modest returns in the last month, which is primarily attributable to some stock specific issues discussed below.

In percentage terms the FTSE 100 has returned 7.3% including dividends so far this year, whilst the FTSE World index has returned 10.1% on the same basis. This highlights the importance of the global exposure within client portfolios, which has assisted overall performance. Gilt returns have been more modest and the FTSE Actuaries UK Conventional Gilts All Stocks index has returned only 2.5%.

Our preferred fund managers take a long-term view and focus on fundamentally strong businesses, which typically have both income and capital growth potential. Specifically, these companies are those with better business models and strong balance sheets which were purchased at reasonable valuations.

We continue to advocate tactical cash holdings in portfolios. Interest rates remain low, it is, however, important to protect the holdings in equity funds from a forced sale should markets prove turbulent.

Fixed Interest and Cash

Historically low bond yields (and high prices) in developed markets are creating demand for riskier assets. Issuance of emerging and frontier market debt continues apace, with new and infrequent issuers coming to market recently, including Iraq, Belarus and Tajikistan. The 10-year Belarus bond has a yield of 7.6%. The bond issue was fully subscribed, despite the risks involved, with the country having a predominantly state controlled economy and being dependent on Russia for many imports.

Tajikistan is Central Asia's poorest country with a GDP per capita of just $804, according to the World Bank. The country failed to secure a deal with the IMF to bail out a number of banks last year due to previous funds being diverted by the country's political elite. Rating agency Moody's have evaluated the US Dollar denominated issue as B3 ("junk") and have warned on the country's low rankings on corruption control and the rule of law. Nevertheless, the issue is expected to have a similar yield to the Belarus issue, which seems inadequate given the default risks involved. As a point of reference, UK benchmark Gilt yields were around 7% in 1997 and ranged between 4.5-5% in 2007. They are now 1%.

The demand for, and inherent risks of these frontier market debt issues, and the 100-year Argentinian bond issued earlier this year, inform our negative view with regard to fixed interest.

US

Headlines regarding the US are focused on political rhetoric and the need for an agreement to raise the US government debt ceiling by October.

The US economy remains strong, however. According to data released in August, corporate capital expenditure is increasing. The average US S&P 500 company grew profits by 9% in Q2. 79% of companies in the index grew sales and 73% grew earnings. All 11 sectors, except for utilities, enjoyed positive earnings growth with the biggest gainers being energy and information technology.

Consumer data is also healthy. Retail sales grew 4.2% year on year in July, consumer confidence remains high and the unemployment rate continues to fall. Lack of real wage growth acts as a restraint though.

The above factors should provide a fairly supportive backdrop for US equities, but we remain cautious regarding valuations. The S&P 500 is trading at 30x earnings, which is historically high, but remains below the 44x reached in December 1999 at the height of the technology bubble.

UK

UK stock markets have not been as strong as developed market peers in recent months, ongoing Brexit uncertainty and inflationary pressures could dampen economic activity. In the last 3 months inflation has ranged from 2.6%-2.9% year-on-year. Wage growth remains muted, although unemployment is at its lowest for 42 years. Retail sales growth data was flat in July (0.3%) and fell 1.1% in June. In particular, discretionary consumer spending is subdued and this has affected the performance of some clothing retailers, such as Next, which is held by some of our preferred funds.

Provident Financial, AA, AstraZeneca and tobacco stocks have also been impacted by some stock and sector specific issues in the last couple of months, which has influenced the short term performance of some of our core fund choices. We have obtained commentary from the relevant fund managers and the long term investment case is considered to be intact for each of these companies.

Provident Financial

Provident Financial specialises in non-standard lending to individuals with poor credit records or no credit history. This has been highly profitable since the financial crisis, with traditional banks scaling back or exiting this market, creating good cash flow and steady dividends. The company has not performed well recently though. The share price fell 67% on 22 August after it delivered its second profit warning in two months, announced the departure of its CEO, rescinded its dividend and revealed an FCA probe into its repayment option plan product. There has also been a significant decline in doorstep loan collections. This is due to problems with new software and difficulties in hiring and retaining staff, rather than an increase in defaults by customers.

The share price has since recovered 37% of the loss. We have obtained commentary from each of the managers who invest in Provident Financial. Two of them consider the long term investment case to remain sound, predominantly because the flagship Vanquis and MoneyBarn brands have profit margins of up to 40%. The other manager has been selling down his holding since the share price peaked in 2015 and will look to exit the holding should the price recover.

AA

The share price for AA has fallen 22% in August due to the sudden departure of their executive chairman. This was based on personal conduct and not due to company specific issues. AA has strong brand recognition, market leadership in roadside assistance, high recurring revenues and cash generation and the opportunity for digital transformation. On a long term view, Neil Woodford retains his conviction in the stock; it is not held by any of our other core UK Equity Income fund choices.

AstraZeneca

The company share price fell 15% on 27 July when a key lung cancer drug failed a clinical trial. The price has not made much headway since, recovering only 1.8%, but the company remains one of the UK's top dividend payers. AstraZeneca has many other products on the market and other promising drugs in later stages of development and testing. The managers of Artemis Income, Invesco Perpetual High Income/Income, Trojan Income and Woodford Equity Income are therefore maintaining their holdings based on the long term prospects for the company.

Tobacco

Tobacco stocks were adversely impacted at the end of July when the US Food & Drug Administration (FDA) announced plans to cut the amount of nicotine permitted in cigarettes. Tobacco companies are accustomed to overcoming regulatory challenges. For instance, the FDA has not been able to execute its attempt to ban menthol cigarettes following a report published in 2011. Moreover, although the US is a big market for tobacco, the companies receive substantial revenues from other countries. Additionally, industry consolidation, price increases and growing sales of e-cigarettes have helped to sustain profitability, cash flow and dividend payments. Our preferred UK and Global Equity Income funds therefore retain some exposure to tobacco companies to varying degrees.

Europe

The Euro has surged dramatically in recent months on the back of the region's economic recovery, rising almost 9% against Sterling and 14% against the US Dollar in the year to date. A strong Euro could also complicate the ECB's efforts to hit its inflation goal of just under 2% by making imports cheaper and exports less attractive outside the region.

The German Federal election will take place on 24 September and there may be some ripples in stock markets as this plays out, but this will likely only have a short term impact. Our fund choices in the region are well diversified and complementary to each other in geographical positioning and focused on long term potential rather than on reactive moves to political and economic developments.

Asia Pacific and Emerging Markets

Asian economic news is mixed. In Japan, the economy grew by 4% on an annualised basis in the second quarter, influenced by both business investment and consumer spending. On the other hand, data from China including retail sales, exports and industrial production, was weaker than expected.

We retain our negative view on Japan based on the overall structure of the economy, government debt and demographics. We also remain cautious on the outlook for China based on the ongoing rebalancing of the economy towards domestic consumption and the need for financial reforms. Rather than pressing reforms, President Xi has allowed unrealistic growth rates to be set and has committed to the maintenance of a large state-owned enterprise sector. The debt to GDP ratio passed 300% in June and these policies fuel the need for further government debt. We also remain concerned about the potential for a credit crisis in the country.

In spite of their current popularity, we continue to avoid direct exposure to emerging markets. In part, this is because we are concerned that the increases in value are driven by flows into tracker funds which simply follow the market.

Alan Torevell and Georgina Ogilvie-Jones