MARKET BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

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'Buds of May'

Uncertainty over President Vladimir Putin's intentions in Ukraine has unsettled global investors in recent weeks, but positive developments for the advanced economies continue to encourage markets. Central bankers on both sides of the Atlantic last week signalled that they would take action to support economic recovery and asset prices. With better-than-expected trade data from China soothing concerns over a slowdown, financial markets are heading towards summer with confidence. And, with corporate earnings growth due in the second quarter on the back of the global recovery, for fund manager Schroders' chief economist Keith Wade global equities remain well supported and their preferred asset class despite high valuations in some markets.

Last week the European Central Bank (ECB) president Mario Draghi held the benchmark interest rate at 0.25%, despite concerns that it should act to counter persistently low inflation. But Draghi hinted that the ECB could ease monetary policy. Acknowledging the market dissatisfaction with the low level of inflation, Draghi said the central bank was "comfortable" about action next month. The hint triggered a slide in the euro against the dollar, ending the week down 0.8% to $1.38. Peripheral eurozone government debt yields were pushed to fresh lows as prices rose. Analysts believe that a move by the ECB to cut the cost of money in the region further next month would make eurozone assets look even more attractive.

On the other side of the Atlantic, Janet Yellen, chair of the Federal Reserve, told Congress that the US economy is on the mend, but the Fed would act if it falters. Yellen reiterated that she was in no hurry to raise interest rates soon, allaying concerns that improved economic data could trigger an earlier rate rise. However, although the US economy in the second quarter has rebounded, she believes that employment levels have not fully recovered. "A high degree of monetary accommodation remains warranted," she said. And she warned that turmoil in emerging markets and the crisis in Ukraine could curb growth. Meanwhile, the yield on 10-year Treasuries rose last week by 3 basis points to 2.62%, but remains low in light of the strengthening economy.

Steady Yellen

Global equity markets responded positively to Yellen's pledge that monetary policy would remain accommodative, which followed the further reduction of its monthly bond-buying programme by $10 billion to $45 billion from the peak of $85 billion. The S&P 500 index rose 0.2% on Friday, but lost 0.1% over the week to close at 1,878 points. Technology stocks recovered ground after some steep losses in recent weeks and helped drive the index on Thursday to within a few points of its record high of 1,897 points achieved early in April. Wall Street's focus was also on Chinese e-commerce giant Alibaba's filing for an initial public offering in New York, which some analysts believe could raise as much as $15 billion.

Yellen's reassurances and improved Chinese trade data helped lift Japanese equities after a strengthening yen dented export-orientated stocks when the Tokyo market reopened after the May holiday. The Nikkei 225 Stock Average lost 1.8% over the three-day week to close at 14,200 points. Meanwhile, Draghi's policy hints last week boosted European equities, as did signs that Russia was looking to defuse the crisis in eastern Ukraine. The FTSEurofirst 300 index rose by 1.1% last Thursday to its highest level since June 2008 and ended the week up 0.3% at 1,355 points. Markets also gauged the decision by France's government last week to dismiss US conglomerate General Electric's €12.4 billion offer for the energy division of Alstom as "not good enough", and Chancellor Angela Merkel's expression of support of a tie-up with German giant Siemens.

In London, the FTSE 100 index on Friday lost 0.4% and ended the week slightly down, by 0.1%, to 6,815 points; following a ten-week intraday high on Thursday as Barclays' shares surged 8% following the issue of its restructuring plans. Investors this week will await confirmation of Carphone Warehouse and Dixons' £3.6 billion 'merger of equals'. Meanwhile, Pfizer's £63 billion takeover approach for AstraZeneca continues to divide investors and politicians on both sides of Atlantic. However, fund manager Neil Woodford believes the offer undervalues the UK group. "My view remains that AstraZeneca has a better future as an independent entity," says the founder of the newly launched Woodford Investment Management.

A problem of strength

Cash-rich UK corporates made record dividend payments in the first quarter this year. Capita Asset Services reports that payments were up from the same period in 2013 by 118.5% to £30.7 billion. However, much of the growth was from one-off payments led by the UK's largest-ever special dividend of £15.9 billion paid by Vodafone; easyJet and Next were also among the higher payers. But, beneath the headline one-off handouts, the underlying dividends rose just 3.3% to £14.3 billion, which is the slowest level of growth in two years.

The slowdown of growth in regular dividend payments, however, was beyond the control of UK boardrooms. Sterling's strength last year created a headache for income investors and could reduce 2014 dividends by £3.5 billion, according to Capita. Nine out of the top 20 UK payers denominate in dollars; while 22 of the FTSE 100 companies report in dollars. The energy and mining sectors, which are sensitive to the dollar exchange rate, sustained the biggest fall in dividends, and hit the first-quarter total by £400 million.

But first-quarter dividend growth sectors included food producers (10%), travel and leisure (43%) and tobacco and industrials (both up 7%). Only Vodafone and GlaxoSmithKline out of the top-five payers – which also includes Royal Dutch Shell, AstraZeneca and BP – are expected to raise dividends this year; but the two will account for 35% of all income. Capita cut its dividend forecast by £1.7 billion to £99.4 billion for 2014, or growth of 5.4%; the currency crunch could knock down special dividends by £700 million to £18.2 billion. However, recovering earnings and easing currency pressures are expected to correct some of these difficulties.

Mind the gap

The gap between UK equity yields and other asset classes have continued to widen in the first quarter. "Equities have therefore increased their attractiveness as providers of income, compared to other asset classes," notes Capita. Moreover, as the UK economic recovery broadened, the FTSE 250 grew faster than the more international FTSE 100 and its domestically more sensitive mid-caps rewarded investors. As dividends take time to respond to shifts in the economy, Capita suggests there could be rewards further down the line.

Interest on cash deposits shrunk in the first quarter to 1.3%, however, compared to 1.5% at the beginning of January, according to Capita. And savers were given no respite last week with the Bank of England holding the interest rate at 0.5%; although its Inflation Report this week will give an idea of its intentions as unemployment falls below its 7% review threshold and concerns grow over the housing boom. The pace of the UK's recovery has already brought forward market expectations of a rate rise to before the general election.

Meanwhile, UK savers and investors have entered a new world following the March Budget's changes to pension rules, which could fuel interest in long-term dividend income. The good news is that boardrooms are generally loath to cut back on dividend payments, viewing the commitment as a strong signal of corporate confidence. Dividend income remains an essential component of a well-diversified investment strategy and long-term wealth creation. And the signs are that the conditions are good for dividend payments.

Schroders and Woodford Investment Management are fund managers for St. James's Place Wealth Management.