Weekly Digest

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Investec Wealth & Investment

The weekly insight into world stock markets

The Week of Reckoning

It appears that at last I have no choice but to offer some thoughts on Brexit. I have been avoiding it for the past few weeks for two main reasons: first, there have been more important things to discuss from a global investment perspective; second, I haven't honestly felt it was possible to add much value given the lack of progress in negotiations and the seemingly entrenched views of the protagonists. What forces my hand today is that the clock is running down. With potentially three important votes in Parliament this week, we might actually get some idea of the endgame, although nothing is guaranteed, and Machiavellian machinations in the darker corridors of Westminster might yet produce a genuine surprise – possibly no votes at all!

Barring unexpected generosity from Brussels, everything is due to off tomorrow with a vote on Mrs May's Withdrawal Agreement which is broadly expected to produce a similar result to last time – a thumping defeat for the PM. Uncertainty is created by the view that Tory Brexiteers might be prepared to back the agreement on the condition that Mrs May resigns, allowing for the possibility of a Eurosceptic PM taking the reins in future trade negotiations with Europe. Number 10 is also warning the Brexiteers that they risk losing their prize altogether unless they are willing to accept what's on the table. Thus it is already clear that there is a fair amount of psychology and game theory involved in the first vote, with principles taking a back seat. In other words, your guess is as good as mine.

If the PM wins the vote (and somewhat dependent upon whether or not she has fallen on her sword to gather sufficient support) the pall of uncertainty that has hung over the UK will lift for a while, but in reality we are only going to be sentenced to another two years of horse trading over the actual terms of the UK's departure from Europe. It is still hard to envisage a huge inflow of investment into the UK, but there will certainly be relief that the worst case scenario of "No Deal" has been avoided. Should the vote go the same way as before, we move forward to a second vote on Wednesday to rule out a potential "No Deal" departure on 29th March. This one seems to be more clear cut, with an apparently strong majority in the Commons keen to avoid this scenario. That leads to Thursday's subsequent vote on extending the Article 50 period. That creates its own set of problems owing to the elections for the European Parliament that take place at the end of May, suggesting a relatively short extension and a lot of pressure to strike a deal quickly.

Markets have their own barometers which indicate the possible outcomes, with the pound remaining the key indicator of sentiment. In mid-December it was at $1.25 and €1.10. By the end of February it had risen to $1.33 and €1.17, reflecting increased confidence in avoiding a "no Deal" Brexit, and making it the best-performing major currency this year. Several high-profile sterling bears switched to the bull tack. In the last week or so it has slipped back to below $1.30 and €1.155. This reflects the fact that the risk/reward was again becoming more imbalanced. The average opinion around the City is that, against the dollar, the pound could rise to around $1.40 in the event of a "soft" Brexit, but fall as low as $1.10 in a "No Deal" scenario. At $1.25 in December sterling was offering equal upside and downside, encouraging some traders to close their negative bets and others to speculate on a more bullish outcome. That trade was much less attractive at $1.33. It seems probable that the pound is going to move quite a bit in one direction or the other this week, but betting on that would be not far removed from heading for the roulette table. We did recommend repatriating some overseas cash and bonds in December, but cannot see the case for further shifts right now.

Another Brexit barometer is the relative performance of large and mid-capitalisation companies in the UK. The FTSE 100 generates about three-quarters of its revenues outside the UK, and the Mid-250 around half. A "good" Brexit is relatively positive for the smaller companies because: 1) the translation of overseas profits back into sterling will be a less negative influence; 2) sterling's better purchasing power will help to reduce input costs; and 3) the lifting of uncertainty promises a boost to the domestic economy. So far in 2019 the FTSE Mid-250 Index has outperformed its bigger brother by 1.9%, and the gap has been as high as 6%. There is potentially a lot more in this trade. Historically the Mid-250 has tended to trade at a premium to the FTSE 100, reflecting the greater potential for growth, but now there is little valuation difference.

There is, though, one very important thing that needs to be understood. If the market gets the outcome it wants ("soft" or even no Brexit), it is probable that the value of sterling investment portfolios will go down (reversing what happened after the referendum). Not only will the currency translation effect weigh on profits and dividends declared in pounds, but holdings in non-UK assets would face a similar hit. Furthermore, government bonds are expected to sell off as the need for catastrophe insurance diminishes. This could be cushioned to some degree by the return of international investors to the UK. While this might appear unwelcome, it would be offset by sharply lower domestic inflation and much better buying power abroad, very much the opposite of the post-referendum experience. All very counterintuitive, but highly logical.

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FTSE 100 Weekly Winners

British American Tobacco	7.5%
Rightmove	5.4%
Reckitt Benckiser Group	5.0%
Unilever	4.5%
Imperial Brands	3.4%
Diageo	3.3%
Informa	3.1%

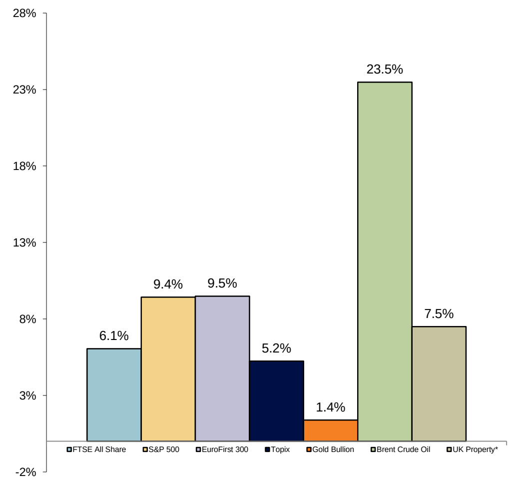
Source: FactSet

FTSE 100 Weekly Losers

GVC Holdings	-11.6%
International Consolidated Airlines Group	-10.6%
Royal Mail	-10.1%
Paddy Power Betfair	-9.8%
Schroders	-8.7%
Persimmon	-7.6%
Ashtead Group	-7.3%

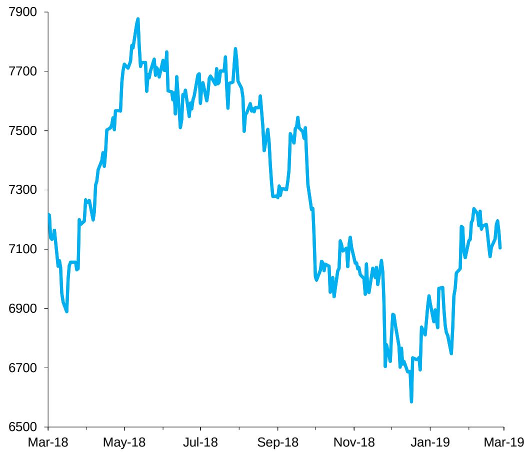
Source: FactSet

Year to Date Market Performance



Source: FactSet
*IPD Total Return to December 2018

FTSE 100 Index, Past 12 Months



Source: FactSet

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