Weekly Digest
25 March 2019

Investec Wealth & Investment

The weekly insight into world stock markets

Brexiternity

I feel it is incumbent upon me to say something about the interminable Brexit situation, but I have to say that it's increasingly difficult to add much value. One of the larger investment banks produces a table of potential outcomes, which are "No Deal", the current Withdrawal Agreement, a general election, a second referendum and a non-specific Article 50 extension. It currently sees very little to choose between them. A general election with Article 50 extension (30%) is the current favourite, and when combined with the chances of another referendum, also with A50 extension, (15%) and an unspecified extension to Article 50 (20%), it means that the odds suggest there so no end in sight. Brexiternity? And economists wonder why there's no productivity growth!

On a practical level, this uncertainty continues to take the gloss off UK equities, still a much unloved asset class. Several investment banks have recently published analysis highlighting the good value on offer in UK companies, particularly those smaller ones more exposed to the domestic economy. A number of UK-focused fund managers have also visited us recently with a very similar message about their funds. Admittedly they have something of a vested interest when they make this claim, but they definitely make a strong case. So far we have resisted the temptation to recommend shifting more exposure towards the UK, partially because it's not entirely clear what the source of funds would be on a risk-neutral basis. After all, one could make similar claims of value for Europe (ex-UK), Japan and Emerging Markets. The US remains superficially the most expensive market, but it is better value than it was and still home to the best-in-class companies generating the highest returns in many industries. And so we wait for more certainty on the political front. This might entail having to invest at a higher valuation, but, in this case, we are willing "to pay more to know more".

Last week I mentioned that this US economic cycle was on course to be the longest of the modern era (dating back to the 1850s, when more reliable information started to be produced). That moment comes in July, and it is worth repeating that investment performance for the next couple of years could be defined by making just one big call: when will the US economy fall into recession? Last week markets seemed to be saying "sooner" rather than "later". Citigroup's Economic Surprise Index, having rebounded nicely in January, fell sharply again in February, and, while stabilising, has failed to rally much. But the initial trigger for last week's market wobble seemed to be the latest statement from the US central bank, in which it downgraded growth and inflation forecasts for this year and next. It also removed its expectation of any interest rate rise this year, while also bringing forward the date at which it will stop shrinking its balance sheet. At other times this might all have counted as good news, and, in fact, the knee-jerk reaction of markets was positive, warming to the idea of lower interest rates and a reduced discount rate. However, more sober reflection led to the view that the Fed's members could see something much scarier around the corner. Further fuel was thrown on the fire in the form of weak purchasing manager survey data in Europe, and a nagging fear that the US and China might not find it easy to reach a trade agreement.

As is the way these days, a 2% fall across equity markets on Friday had the pundits asking (again) if this was the beginning of the next bear market, even though the falls only took us back to where we had been a week earlier. I suspect living on the San Andreas fault might stir such existential angst every time there is a tremor. In this case, though, we are not at the mercy of unpredictable geophysical forces. It is very unusual, to say the least, for a recession to evolve spontaneously. The usual suspect for killing the economy is the Federal Reserve, and, yes, it has spent the last three years or so gradually raising interest rates, but they are hardly usuriously high at 2.25 -2.5% against inflation just below 2%. No doubt higher indebtedness makes the economy more sensitive to higher interest rates, but consumers are in aggregate a lot less indebted than before the crisis, while the government still has easy access to bond finance. If there is one area of concern, it is corporate indebtedness, but even here the signs of excess are limited. The bear market and recession of the early noughties was not called the "Tech Bust" for nothing. There had been a massive build-out of capital projects which were never going to generate a return sufficiently large to service the debt, and so there followed an equally impressive capex recession. The financial crisis centred on sub-prime mortgage debt, another area that remains benign, thanks to the scars of that era as well as more stringent regulation. Even the last US-inspired recession alert in 2016 was largely built on the travails of just one sector, Energy, which had been sinking capital into oil rigs and wells at a Hurculean rate just before a huge collapse in the oil price. It still seems improbable that what are, admittedly, pockets of weakness in the US economy will coalesce into something more far-reaching, especially now that interest rates are on hold. Even so, the perceived proximity of the end of the cycle means that markets are likely to remain more volatile as fears ebb and flow with every scrap of economic data.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Ocado Group	9.8%
J Sainsbury	5.8%
Fresnillo	3.9%
DCC	3.6%
GlaxoSmithKline	3.6%
Next	3.2%
Pearson	2.5%

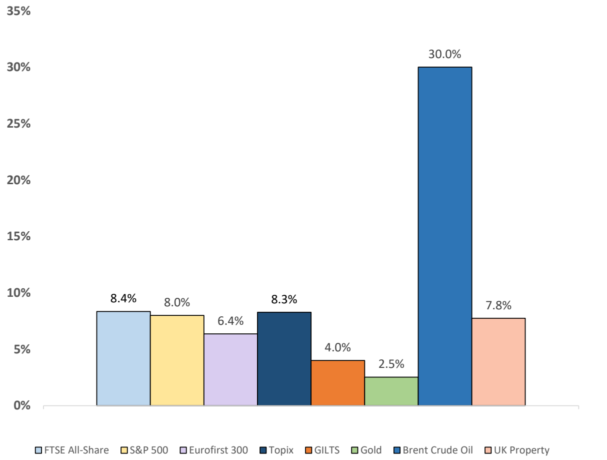
Source: FactSet

FTSE 100 Weekly Losers

Royal Mail	-10.3%
NMC Health	-8.7%
easyJet	-8.1%
Royal Bank of Scotland	-7.7%
Persimmon	-6.8%
Barclays	-6.3%
Aviva	-5.5%

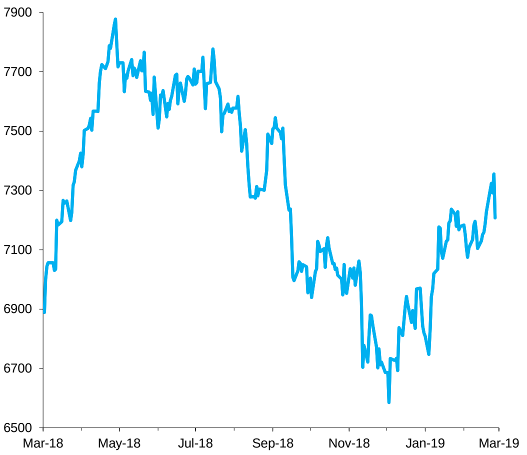
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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