Weekly Digest
12 November 2018
The weekly insight into world stock markets

Investec Wealth & Investment

War and Investing

The weekend's commemorations of the end of the First World War served as a poignant reminder of the pain and suffering such conflicts bring. For those of us born since World War II – I was born in 1961, when memories of the war were still remarkably fresh; let's face it, I can remember the Tech boom and bust as if it happened yesterday – it is easy to underestimate how lucky we are to have lived in a world of relatively limited global strife. Furthermore, when wars have broken out, they have generally been geographically contained (Korea, Vietnam, Middle East, for example).

In the summer of 2017, when tensions between the United States and North Korea were rising sharply, I was asked to speak at a conference session with the theme "Will it end in war?" My fellow speakers were a former Secretary of State for Defence and a journalist with expert views on the subject. My brief was to approach it from an investment perspective - after all, equity and bond markets keep trading through wars.

My initial observation was that we are already fighting wars on a number of fronts, even if my definitions are somewhat wider than military engagement alone. They are all having an effect on politics, markets and our daily lives. The War on Terror has been an ongoing battle since the destruction of the Twin Towers in 2001. It is an extremely nebulous concept owing to it being a clash of ideologies rather than a fight for territory, and thus, perhaps, a useful smokescreen for any number of engagements with perceived enemies. Equally difficult to define are Cyber Wars, mainly as they are often fought invisibly. I am not talking about criminal enterprises, such as the daily "phishing" e-mails we have to contend with, more about attempts by state-sponsored entities to sow uncertainty, undermine our faith in the democratic process and thus create social and political upheaval. There is also the constant risk of attacks designed to disable, say, power grids or communications networks. I think we would be unpleasantly surprised by (and entirely unprepared for) the effects of a successful attack. Investment legend Howard Marks of Oaktree Capital cited cyber-attacks as the single biggest short-term risk factor when I heard him speak at a conference last year, owing to the magnitude of their possible effects.

In the commercial world, we are now firmly in the throes of a Trade War, with the United States and China the main protagonists. It is difficult to estimate exactly the effect so far, but it would appear to be negative, with several companies reporting a downturn in business owing to the uncertainty. This has been created mainly by the imposition of tariffs by the US in (what we believe to be) a misguided attempt to redress America's large trade deficit. Having said that, we do agree that Trump has some justification for his actions owing to China's cavalier approach to Intellectual Property rights and the anachronistic application of World Trade Organisation rules, which favour China as it is still defined as an Emerging Economy (despite being on course imminently to overtake the US in Gross Domestic Product terms). But we think he could have gone about things in a more constructive manner.

At the extreme, some commentators define the trade war between the US and China as a symptom of something much deeper and more serious, namely the struggle for world leadership. The US appears to be extremely concerned about its loss of hegemony, and, worryingly, it is one policy matter on which both Democrats and Republicans seem to be united. I have read plenty of articles highlighting the risk of military conflict between the two nations, with the South China Sea being the most probable arena, thanks to China's persistent attempts to assert territorial rights. There was a little-reported "near miss" (45 yards!) between American and Chinese warships in September, the sort of incident that, by accident, could have sparked something much more serious.

What does history tell us about war's effect on investments? The good news is that wars do not preclude stock markets from making positive returns. If, for example, one looks at the S&P500 after the US entered WWII or after the invasion of Iraq, market returns are very healthy. The bad news is that markets first have to discount the potential negative effects, so they perform dreadfully in the run up to the fighting. "Buy on the bullets" is one of those heartless sounding stock market adages that does, in fact, seem to have a ring of truth. Of course, this presupposes that there is a gradual build-up of tension, featuring troop movements and legislative discussion. Something unanticipated would be much more disruptive.

Although war might be deemed to be a risk, it doesn't really meet that definition in investment terms. Risk, for investors, means a known distribution of potential outcomes. War could be categorised more as creating uncertainty – or an unknown distribution of outcomes. Thus, from an investment perspective it would require an increased "risk premium", which, all other things being equal, points to lower valuations.

An economic feature of major wars is that resources (both financial and human) are recruited, leading to strong demand for labour and goods, this at a time when supply chains are under stress. Accepting that future wars might be different, these shortages, financed by big government deficits, would tend to create higher inflation. One element of the "Peace Dividend" enjoyed by investors since the end of the Cold War has been lower inflation. That trend is under threat. To be clear, we are not predicting the outbreak of a serious war. However, it is as well to consider what the some of the implications might be were it to happen.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

AstraZeneca	7.7%
Associated British Foods	7.6%
Centrica	6.3%
GlaxoSmithKline	6.1%
United Utilities Group	5.4%
Imperial Brands	5.0%
Severn Trent	4.9%

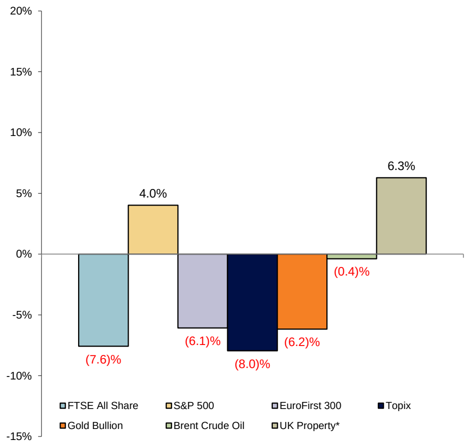
Source: FactSet

FTSE 100 Weekly Losers

GVC Holdings	-11.8%
Just Eat	-8.4%
Smurfit Kappa Group	-8.3%
DS Smith	-8.2%
Paddy Power Betfair	-6.9%
WPP	-6.2%
Antofagasta	-6.0%

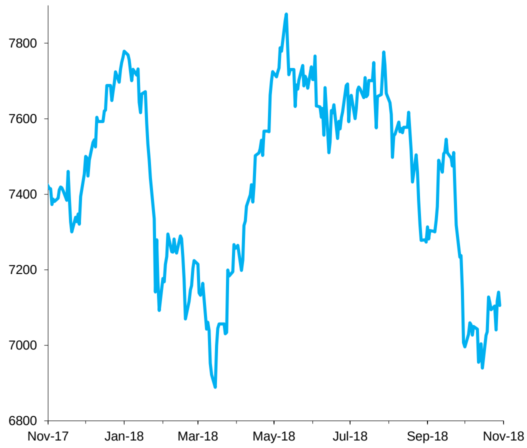
Source: FactSet

Year to Date Market Performance



Source: FactSet
*IPD Total Return to September 2018

FTSE 100 Index, Past 12 Months



Source: FactSet

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