Weekly Digest

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Investec
Wealth & Investment

The weekly insight into world stock markets

Quantum Politics

At the age of eight I received a dismissive school report which read simply: “No scientist, I fear”. My defence against parental disappointment with bad reports was to complain about the quality of instruction or that the teacher didn’t understand me. Such pleading was usually futile, but I think in this case I had a point! Quantum physics, a subject which we didn’t broach at primary school, is one of the most mind-bending branches of science known to man, with much excitement being generated currently by the advances in quantum computing, which offers the possibility of hitherto unimaginable computing power. I will admit that I struggle to get my head round this.

Some economic writers and academics have proposed a theory of quantum politics to help explain events in the world today. Thanks, in particular, to the transmission mechanisms of social media, small actions in one part of the world can be reflected far away. Those actions are often amplified within the echo chamber of the observers and provide a reinforcing feedback loop. This might all be a clever-dick attempt to create the sort of narrative that humans crave for things they don’t fully understand, but I can see the merits. More importantly, it gets one out of the habit of observing the world in a purely linear fashion, which is helpful when it comes to investing. As we have noted recently, the interaction of multiple factors can produce quite unexpected results. This doesn’t necessarily mean that they are easily predictable, more that sufficient checks and balances have to be put in place to insure against them.

As I understand it, another feature of quantum physics is that a single entity can exist in two states simultaneously. At the risk of pushing this whole metaphor too far, can this be said of the infamous Brexit Withdrawal Agreement that was published last week? Recommended by the Prime Minister as the blueprint for our departure from the EU, it was roundly lambasted by pretty much every other interested party. Indeed it achieved the improbable goal of uniting Remainers and Brexiteers. You have probably had your fill of analysis by now, and I am not going to delve further into that particular hole other than to say that it has emphasised that it is pretty much impossible to craft an agreement that will satisfy all sides. From an investment perspective, that has notably increased the probability of the two most extreme outcomes: a chaotic “no deal” Brexit or no Brexit at all (or at least a second referendum that offers the possibility). That only serves to increase the uncertainty for investors and for the UK economy, which, if experience since the referendum is anything to go by, means a continued dearth of investment in new projects, particularly from overseas, and a higher required risk premium for UK equities and the pound (which means more downward relative pressure).

Our “Hard/Chaotic Brexit” playbook was followed almost perfectly on Thursday following Dominic Raab’s resignation. The pound fell sharply and UK equities (when measured in constant rather than local currencies) underperformed other major indices. Within the equity market, the more internationally oriented FTSE 100 fared better than the domestic-focused mid- and small-cap companies. The impact on sentiment was seen most clearly in the Banks sector (with RBS and Lloyds falling 9.6% and 5% respectively) and in Housebuilders (down almost 7%). Implicit in these moves is that “no Brexit” remains a relatively low percentage probability outcome.

Another notable shift was in the Gilt market, where the 10-year government bond yield dropped 13 basis points (0.13%) to 1.37%. This is down from 1.73% as recently as October 10th. Using data from the futures markets, we can also observe that investors pushed out the expected date for the Bank of England’s next interest rate rise from September 2019 to April 2020. Again, these moves met with our expectations, as we continue to believe that a disorderly Brexit will be detrimental to the UK economy and that the Bank will keep monetary policy loose if required to (even if inflation spikes up owing to a weaker pound as it did in 2016).

Another thing we can infer from the bond market move is that last week’s shenanigans, however disruptive, did not necessarily advance Jeremy Corbyn’s Prime Ministerial ambitions. Labour’s proposed spending plans are negative for public finances, promising an increased issuance of debt. Of course, it’s impossible to measure the trade-off between the supply threat and the safe haven attractions, so this is more art than science. The shares of Utility companies, for example, dropped sharply (around 6%), and they are a prime target for Labour interference.

So now what? I’m sorry to disappoint you, but we have no better idea than anyone else what the outcome of this saga is going to be - and the potential outcomes are now as extreme as they have been since the referendum. The only sensible way to approach this is to weight the various outcomes and construct portfolios accordingly. We have been positioned for the more negative economic outcome of a chaotic Brexit, and so recommending an underweight exposure to the pound and UK equities. At some point the risks will become more balanced. The pound has fallen a long way (although we believe that structural flaws in the economy have been exposed that will prevent sterling returning to its former levels), and equities are getting cheaper, with the 2019 Price/Earnings Ratio falling from 13.2x to 11.8x since January. The prospective dividend yield is a very tempting 4.9% according to Citigroup (with the caveat that the payouts at BAT and Vodafone are under scrutiny). Merrill Lynch’s global fund manager survey shows UK equities to be the most unloved globally. Contrarians are sniffing an opportunity.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Micro Focus International	13.9%
Paddy Power Betfair	10.0%
Vodafone Group	6.6%
Smiths Group	4.5%
Reckitt Benckiser Group	4.4%
Antofagasta	4.2%
RELX	3.9%

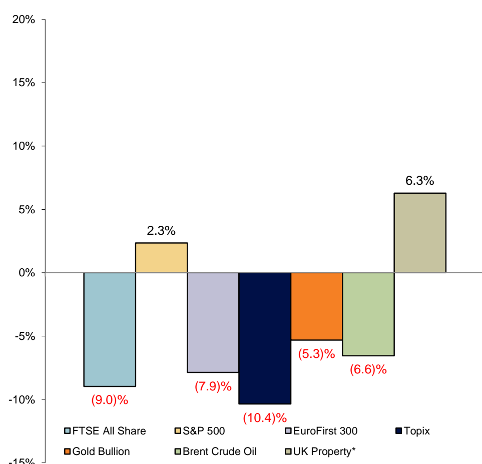
Source: FactSet

FTSE 100 Weekly Losers

British American Tobacco	-18.3%
Royal Bank of Scotland	-13.9%
Taylor Wimpey	-11.7%
Persimmon	-10.8%
Ocado Group	-9.9%
Lloyds Banking Group	-9.1%
Royal Mail	-8.6%

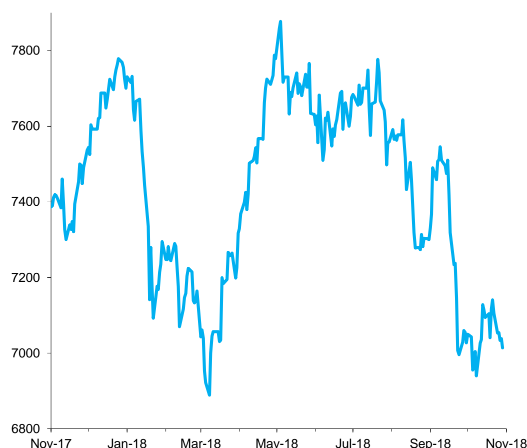
Source: FactSet

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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