Weekly Digest
25 June 2018
The weekly insight into world stock markets

Investec
Wealth & Investment

Risk Assessment

Last week we had a meeting of our Global Investment Strategy Group. This is the committee that suggests the "Risk Budget" for client portfolios. Under suitability rules all client portfolios bear a certain underlying level of risk dependent upon individual tolerance and circumstances. This is usually measured in terms of expected volatility and maximum drawdown (industry-speak for capital loss). The GISG proposes the divergence away from those levels, leaving other groups to decide how to allocate the risk budget and which stocks and/or funds to invest in. We believe that separating these functions is a more efficient process, although there are several people who sit on more than one committee. For example, it means that our best stock-pickers can focus on that role without having to spend all their time worrying about, say, what crazy politicians might do next!

We are committed to taking a long-term view of investments, trying not to be swayed too much by short-term fads and fears, but we also acknowledge that economies and markets are subject to powerful cyclical forces, and so the realistic investment horizon for GISG is eighteen months. And it's fair to say that we spend quite a lot of time looking for things that might trip us up. Committee members are asked before the meeting to evaluate a number of threats (or "Icebergs") based upon the probability of them occurring and their market impact. Thus something that has a very low probability of happening but an enormous potential impact (nuclear war, for example) is not overstated as a risk.

Top of the Pops, as it were, in terms of current perceived threats are Trade/Currency Wars and a Developed Market Policy Mistake. The former obviously refers to Donald Trump's tariffs and the retaliation against them; the latter to the changing direction of monetary policy being pursued by central banks: after years of very loose policy we are entering a tightening phase. The reality is that so far the Trade War is but a skirmish. Only 2% of total imports and just 0.5% of global trade are affected, but it's the escalation that is worrying, with more trade blocs and countries being sucked into the battle. Nothing is helped by the fact that the main protagonist's motives and aims are not entirely clear. There is broad agreement within the economics community that Donald Trump fundamentally misunderstands the nature of trade deficits and surpluses, but it is also agreed that China exploits the existing system and is something of an expert in circumventing intellectual property rights. It is less clear that the US President is on a moral crusade, and quite probable that he is playing to the gallery of voters ahead of crucial mid-term elections in November. The fact that his standing in opinion polls has, if anything, marginally improved will only serve to encourage him. But he is so capricious that he could easily declare victory based on some marginal gain in trading terms and move on to his next obsession like a dog chasing squirrels in the park. As for China, President Xi appears to be acting rationally for now, making some concessions in pursuit of a more influential long-term position while also fighting back enough not to be seen to be bullied. One powerful weapon he has not yet armed is to urge a domestic consumer boycott of American goods. This has been used before with good effect against both Japan and South Korea, and, as far as we can see, does not break any rules. We do not doubt the loyalty of Chinese citizens to comply if requested. That would be an extremely unhelpful development.

The change in the monetary environment has been on our radar for some time. Mapping of aggregate central bank balance sheets has centred on the expectation that they will begin to shrink around the beginning of 2019, reversing the creation of excess liquidity that has been so supportive of financial assets since the financial crisis. We have never experienced a monetary cycle like this before, so by the very nature of this journey we are sailing into the unknown. One thing I have learnt over the years – sometimes the hard way – is that the provision of liquidity to the financial system has the capacity to overwhelm earnings trends or valuations, and therefore we must pay enormous attention to central bank policymakers. The good news is that the key players, Jay Powell of the US Federal Reserve and Mario Draghi of the European Central Bank, do appear to be sympathetic to markets. Mr Powell's early utterances since his appointment have been refreshingly free of the gobbledygook favoured by some of his predecessors; Signor Draghi recently managed to pull off a "dovish tightening" by confirming the glide path to the end of Quantitative Easing by the end of this year while promising no interest rate rises until the end of summer 2019. Even so, policy direction is set, so even in the best case scenario we are looking at reduced tailwinds for investors.

Overall, GISG has been flirting with a marginally "risk off" stance for about eighteen months already, and, although there is no set path, we aspire to be substantially underweight risk when the cycle turns down. This inevitably means leaving the party early (and by the same token we will probably arrive at the next party while they are still setting up the bar). More positively, we see this as being a more "normal" cycle, with few of the excesses evident that set up the conditions for the Tech Bust or the Great Financial Crisis.

John Wyn-Evans
Head of Research

FTSE 100 Weekly Winners

British American Tobacco	5.9%
Sky	5.8%
RSA Insurance Group	4.6%
Just Eat	4.4%
ITV	4.0%
BT Group	4.0%
Imperial Brands	3.9%

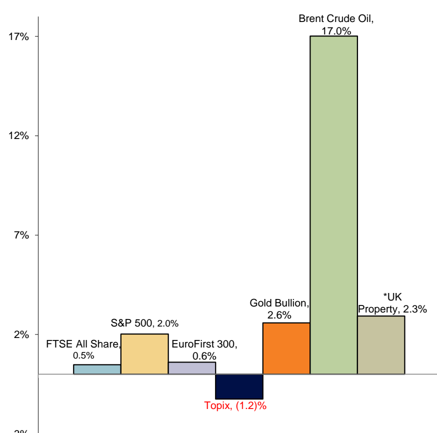
Source: FactSet

FTSE 100 Weekly Losers

Berkeley Group Holdings	-8.6%
DS Smith	-8.2%
Melrose Industries	-5.9%
Barratt Developments	-5.1%
Ashtead Group	-5.0%
Coca-Cola HBC	-4.4%
Sage Group	-4.4%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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