Weekly Digest
17 September 2018

Investec
Wealth & Investment

The weekly insight into world stock markets

May Way, or No Way?

Once again the headlines are full of Brexit stories, with the focus very much on Mrs May's opinion that the process will either follow the path set out in the Chequers plan or that it will be a "no deal" departure. While we all have our personal opinions on the merits of either outcome, from an investment perspective our responsibility is to assess the facts that are available to us (which are, admittedly, few), judge the risks and rewards and then take appropriate action in portfolios. We are receiving an increasing number of enquiries from clients who are worried by the "hard Brexit" headlines, especially as these are being used by the Remain/"soft Brexit" camp to stir up fears of severe economic dislocation. Understandably, people are worried that this could have a deleterious effect on their investments. "Hard Brexit" is not our central case, but hopefully our analysis will help to sooth some fevered brows.

I should initially point out two big differences between now and the Brexit referendum in 2016. First, Brexit itself is a process, whereas the referendum was an event. Thus whatever consistency of Brexit we end up getting should become clear over the months leading up to March 29th next year. The shock factor that accompanied the referendum result will be materially reduced - markets tend to act better when they have time to absorb new influences rather than being confronted with them in the small hours. Furthermore, the Brexit process comes in two parts. First the separation agreement must be reached, and that will (we hope) be done by March. Then comes implementation, which will take at least until the end of the proposed transition period (ending 31st December 2020) and possibly longer by mutual agreement. We are also of the opinion that even if there is a risk of "no deal", the circumstances will be important: if it's the UK government being petulant, then that promises trouble; if it's more a failure to dot 'i's and cross 't's owing to the sheer complexity of the process, then the EU (and markets) might cut some slack.

Second, the world is a different place now. While there are plenty of things to concern global investors, not least the potential negative effects of nationalism, isolationism and trade wars, we no longer appear to be in the grip of "secular stagnation" fear as we were in 2016. The US 10-year Treasury yield hit its all-time low of 1.358% on 8th July 2016, with the last leg down starting as the referendum result emerged. It is currently 2.99%, with rising inflation potentially seen as the greater threat. Germany's 10-year Bund yield (now 0.45%) bottomed on the same day at a remarkable minus 0.18%. The UK 10-year Gilt yield (today 1.53%) troughed at 0.518% on 12th August. Brexit currently has less capacity to put the wind up global markets.

For the purposes of our scenario analysis, we define a "no deal hard Brexit" as the one with the greatest negative economic impact on the UK, without necessarily having to be specific about the details (eg food shortages, queues of lorries stretching back from Dover to the M25, etc). We then look at the potential impact on the main asset classes within a balanced investment portfolio. To a great degree the playbook is based on the experience from 2016, but with the caveat of those differences outlined above.

The big mover last time was the pound, which fell sharply, and although it is by many measures a lot cheaper now, it still looks vulnerable, especially if investors price in a negative adjustment to our terms of trade with Europe and the rest of the world. Even some pro-Brexit economists are prepared to acknowledge that "no deal" means pain initially. Foreign exchange markets remain the easiest and most liquid forum for traders to express their opinions, and so sterling will be in the front line. The consensus opinion is for a further fall of around 10% against the dollar and the yen, with a 5% fall against the euro, as the Eurozone will itself be affected. As in 2016 this will cushion UK equities owing to the high proportion of overseas earnings (@75% for the FTSE 100, @50% for the Mid-250). European equities might come under a modicum of pressure, but US and Asian markets will not be affected. Put that all together, and a globally diversified equity portfolio measured in sterling should rise in value.

UK bonds will be subject to opposing forces. On the one hand higher inflation (thanks to the weaker pound) and the threat of larger fiscal deficits call for higher yields (tax receipts would come under pressure, and either a chastened Tory government or a potential newly installed Labour government would be urged to spend more). On the other, gilts would serve their purpose as "safe haven" assets, and we are inclined to believe that the Bank of England would react by reversing recent interest rate increases and possibly restarting asset purchases (Quantitative Easing). On balance, as in 2016, we see the bond bulls winning.

Alternative assets (hedge funds, absolute return funds, infrastructure vehicles, structured products, etc) should provide a welcome counterweight to any increased volatility, but the majority of any returns will probably come as a result of their currency exposure.

Overall our conclusion is that a typical balanced portfolio will not correlate with the UK economy (but will be highly influenced by events in, say, the US or China). A "no deal" Brexit could result in a higher valuation, but that must be put in the context of diminished purchasing power owing to higher domestic inflation and more expensive trips overseas.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Ashtead	6.0%
Antofagasta	5.4%
Anglo American	4.7%
Shire	4.7%
DCC	3.9%
Royal Mail	3.8%
Reckitt Benckiser	3.5%

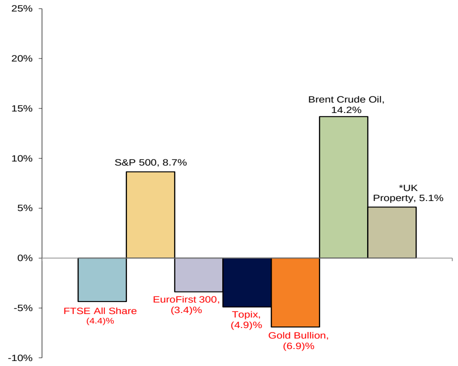
Source: FactSet

FTSE 100 Weekly Losers

SSE	-13.5%
Pearson	-6.6%
Ocado	-6.4%
Fresnillo	-5.9%
Smurfitt Kappa	-4.1%
RELX	-3.7%
Severn Trent	-3.6%

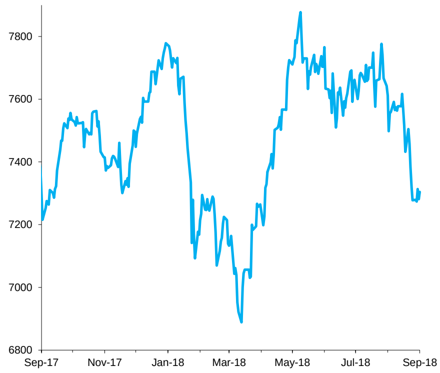
Source: FactSet

Year to Date Market Performance



Source: FactSet
*IPD Total Return to July 2018

FTSE 100 Index, Past 12 Months



Source: FactSet

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