NAVIGATING THE AFTERMATH

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Investment Management

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Although the result of the referendum was clear, the future is still very uncertain. Political risk dominates the near-term outlook to an unusually high degree – for UK investors at least. The movements of currency markets are the key channel where that political risk is playing out. Although a clear frontrunner is emerging to lead the Conservative party, it will take time before we have a clear picture of how the new leader will navigate a course between a Parliament and party that leant towards Remain and an electorate that voted to Leave; or between the imagined future of free trade without free movement of labour that the Leave campaign held out, and a European Union (EU) that appears unlikely to offer any such compromise. Our future leader may be able to negotiate an elegant compromise, but there is still a chance the UK will be forced to choose between prioritising immigration controls or free trade: this could have profound implications for the country’s future growth trajectory.

In the meantime, the UK economy faces more immediate pressures. Most independent forecasters had pointed to likely weakness for the UK economy in the event of a Leave vote: anecdotal evidence and surveys already point to headwinds for capital investment, employment and property markets; the massive current account deficit is exerting its pull on Sterling – which has fallen to forty year lows against the Dollar; and the weakness of the currency will increase the price of imports, crimping disposable incomes and contributing to at least a temporary rise in inflation. Public opinion may yet shift decisively if the economy weakens as sharply as some expect, but that would still present a political challenge for the new Prime Minister. At the very least, we should expect the incoming leader to delay before formally triggering the UK’s exit process from the EU.

Political developments will play out in currency markets – the outlook may be challenging for the UK. Our high allocations to overseas currency have worked well, but we need to be flexible in our views: to judge when Sterling has fallen far enough to reflect the risks, and be alive to possible scenarios that fall short of “full BREXIT”, which could drive a rebound for the Pound.

However, we must be careful not to allow domestic political risk to overtake all our views. After the initial shock, markets have taken a rather rational and nuanced view of the impact of BREXIT – perhaps a surprise in itself, given the tendency to panic that we have seen so often in markets over the past year or so. So far, markets are regarding BREXIT as a largely localised problem: a headwind for the UK economy, a problem for the Pound and for sectors most exposed to the domestic UK economy; a problem with some spillover impact on our Continental trading partners, with concerns in particular for banks and economically-sensitive sectors in Europe. Enough overall to slow, but not to derail, the modest European economic recovery. But in the main, the economic impact for the US and Asia is seen as quite limited – and, to the extent that the referendum result keeps the Fed pausing a little longer before raising interest rates, there may even be a silver lining for global investors. The American economy continues to perform well, with household spending continuing to rise and manufacturing showing signs that the worst may be over. This suggests better times ahead for Asian economies tied into the global supply chain. After marking time for a year or more, undermined by the bear market in commodities, the outlook for corporate profit growth in these economies seems a little better. While BREXIT risk remains relatively contained and localised, stocks exposed to the US and Asian economies (and that includes many large FTSE 100 companies!), can enjoy some support.

With considerable uncertainty still facing us, it’s right that portfolios still have a healthy allocation to US Treasuries, US Dollars, gold and cash as buffers against risk. But there are opportunities as well as risks in the current landscape: European and domestically-oriented UK companies look cheap on many measures, but may struggle to make headway until a clearer path for the UK’s relationship with Europe emerges. A low allocation is appropriate for now, with a tilt within our equity holdings towards the US and Asia.

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