

A PUZZLING POST-BREXIT BOUNCE

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Consideration of Brexit still dominates market thinking in London – what it will really mean, what shape negotiations will take, when (if ever!) it will happen and what impact the lingering uncertainty will have on the UK economy. The complexity of separation is becoming dauntingly clear and the phony war will likely continue for months.

It's worth a quick review of our Brexit preparation – what worked and what didn't. We didn't expect Brexit, but we felt it was a big enough possibility not to be able to dismiss altogether, and that portfolios should be structured to reflect the risk. We expected currency to be the market's focal point on a surprise Brexit outcome, and this has largely been correct: we expected Sterling to weaken sharply, and it has – our tilt towards the US Dollar worked very well. We expected US and Asian equities to be insulated from Brexit risk, and that's been about right – our overweight allocations here have been helpful. More interesting perhaps are the markets which have behaved differently to our expectations: for European equity and the Euro, we saw some risk that a Brexit outcome could cause problems, but it was not clear cut. We saw a plausible scenario in which Brexit raised new questions about the integrity of the EU project as a whole, undermining the Euro and European equity; in the event, our caution on Europe was unwarranted, and markets are – perhaps surprisingly – shying away from the most extreme political conclusions.

We also believed that UK equities would suffer initially, before rebounding as investors priced in support for corporate earnings coming from the weak Pound, and that domestic mid-caps would suffer more. Around 80% of revenues for FTSE 100 firms come from overseas, and even for the more domestic FTSE 250 mid-cap index, around half of sales are foreign.

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Currency weakness means that these foreign revenues are worth more in Sterling terms. It's true that the FTSE 250 has lagged the FTSE 100 since referendum day, but the rebound in both markets began surprisingly quickly and both now stand at highs for the year. It remains to be seen whether slowing UK growth curbs enthusiasm for UK mid-caps.

While this might seem like a puzzling post-Brexit bounce, we must be careful not to look at global markets through too parochial a lens. UK equities have recovered strongly, in Sterling terms, but it certainly doesn't look that way from other global financial centres: measured in US Dollars or Euros, UK equities are still around 20% below their highs of early 2015. Brexit uncertainty is obviously still weighing on minds: we clearly cannot say that markets aren't worried about the risk as it applies to the UK economy. It's just hard to see it in the market (even the FTSE 250) when we measure in devalued Sterling terms.

For the rest of the world, there is further evidence that the economic expansion continues – notably the confirmation of strength in the US labour market, with healthy payroll data released in early July and August. Central banks have also confirmed that they are in a highly supportive mode which is very helpful for risky assets. Markets are responding, and investors (many still disposed to caution after the shocks of the past eight years, with high allocations to cash in portfolios) may be regaining risk appetites: flows of funds back into emerging markets suggest some confidence is returning.

Equities are enjoying a moment in the sun, and the rally in risk assets has clearly benefited our portfolios. But we note the ongoing tension between economies and stockmarkets. At times over the last year we have highlighted when markets have seemed unjustifiably pessimistic against a fairly resilient global economy. While markets are not necessarily over-optimistic yet, it's vital we aren't blind to the risks. In particular, while the global economic environment is fairly positive, and hopes for future corporate profits growth are building, we haven't yet seen companies delivering enough. S&P 500 earnings for example have been stagnant for the last 18 months.

As headwinds from the oil market disruption and the US Dollar's 2014–15 surge fall out of the comparisons, a degree of optimism on earnings seems reasonable, but we are vigilant against excessive exuberance.



The recent fall in equity market volatility may be sustained a while yet, but we have seen in recent years that volatility can spike viciously with little reason. Insurance against equity falls (or spikes in equity volatility), in the form of put options, is currently as cheap as it's been for several years. As ever with insurance, one hopes it's not needed, but adding some protection now at low cost, after a surge in equity indices, looks to be a reasonable step.

We still expect inflation pressures to build, notably in the US, and are positioned accordingly. Wage increases will push services inflation higher and the US is no longer seeing such strong deflationary impacts from oil price falls and the strong US Dollar. Core inflation is already over 2% and it seems assured that headline inflation will follow later in the year. The Fed remains in super-easy policy mode and has deferred rate hikes again, seemingly comfortable with a probable overshoot on inflation over the next year or so. Yet long-term inflation expectations remain stubbornly depressed – this looks unsustainable.

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