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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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A Plan For Brexit

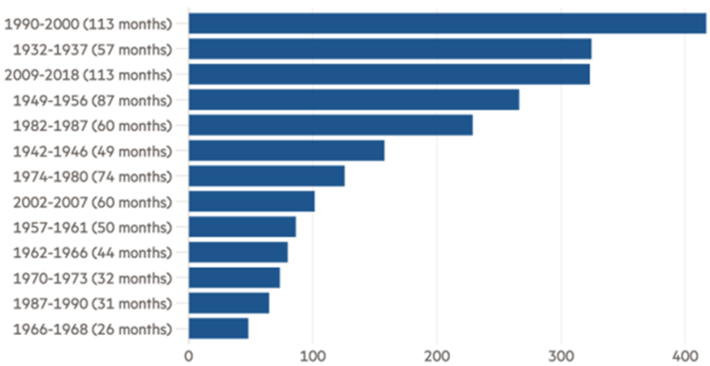
In what proved to be a mixed bag for equities last month, the US continued in its relentless ascent and in so doing marked up the longest bull run in history. Positive economic data, driven by surging exports and strong employment numbers, combined with a benign outlook for interest rates are clearly overcoming any worries that might stem from the trade tariff battles. In contrast, emerging market equities have been unable to shrug off these issues and the mood has been nervous, not helped by idiosyncratic events that led several currencies to plunge in value. The Argentinian peso had one of its worst monthly falls on record (-34%) as did the Turkish lira (-25%) and many others struggled including the South African rand (-10%). Continental European markets also faltered somewhat on trade war fears, with auto stocks notably selling off and Italian banks lower on parlous domestic conditions. Nevertheless, some support came from the headline Eurozone GDP statistic that was revised higher, along with improving purchasing manager index data and buoyant German industrial confidence numbers. UK equities were weak, particularly toward the end of the month, for few clear reasons other than a sense of ennui over the Brexit saga. More on this below.

Bond returns also varied markedly over the month with emerging market government debt down around 6% but conventional UK government debt (gilts) ticking higher despite the quarter point rate rise. Ten-year Italian government bond prices fell by 5% as investors panicked over the ability of the newly-formed coalition to solve the country's fiscal crisis. Over the last twelve months, bond returns in virtually every category are now in negative territory. Elsewhere, gold continued its slide , and is now down more than 8% for the year.

So with the US and many other stock markets now enjoying the longest upward move without a 20% retracement, we are frequently told by the media that 'this can't last forever'. This truism is just as useless an observation as 'we are in unchartered territory, now' – we are *always* in unchartered territory when it comes to the stock market.

The chart below shows how the profile of bull market returns has varied at the point of breaking the record on 21st August.

S&P-500 Bull Market Returns (%)



What actionable conclusion one draws from this chart though is difficult to say. All it shows is what has happened and probably has the effect of triggering an understandable, but flawed, natural human response of 'looks like time to get out!' Though quite interesting, this information really has no predictive value at all.

More information might be helpful. What if we said that the average annualised run from each period in the table above was 22%, yet the current rate is 16.5%? In other words, it may be the longest, but is far from being the most lucrative. The foundations for this rally were laid by the financial crisis and the trajectory of recovery has been incredibly shallow and still is, with interest rates still not expected to return to 'normal' levels anytime soon. With valuations reasonable, economic growth still gathering momentum, we believe this run still has legs and expect it to easily surpass the 10 year mark next March.

We completely understand the temptation to bank profits though and recognise it as a classic example of risk aversion. This is a common behavioural human trait where an investor prefers to take a known, albeit low return, in preference to an unknown payoff that could be negative but also substantially higher. Another great example of loss aversion has appeared more and more in recent months: the phrase "I'll invest after Brexit".

Below, we attempt to break down this short sentence to try and understand what it means, but one point needs to be made from the outset. We in no way want to appear dismissive or to ridicule this line of thought. We simply think that there are so many moving parts, if it so happens that all financial markets are lower in a few weeks or months, and there is a subsequent rally, Brexit will have been just part of the story.

The phrase "I'll invest after Brexit," we take to mean, "I have cash in the bank, but the uncertainty over Brexit makes me nervous and I am concerned that it will be an event that that could send most if not all financial markets lower, providing an opportunity further down the line".

Dealing with each part in turn we raise the following points, which are mainly questions:

1. What return are you getting for the cash deposit? Is this all of your investable wealth? Financial planning issues and the need for security is crucial, but the chances are that after inflation, returns are guaranteed to be negative.

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2. Brexit uncertainty stems from sources including:

- Officials directly involved in the negotiations who may benefit from a sense of confusion

- Opportunist politicians, particularly those in opposition

- Supra-government agency officials trying to manage their own agenda, despite being completely wrong in their previous predictions. Neil Woodford picks out some recent gems in his monthly note found here.

- The media who run stories with alarmist terminology often meaningless, that focus on a nightmarish outcome

3. Is Brexit the single most important factor that will drive global financial markets over the next few months? Are the mid-term elections in the US not more important, and the scope for Trump to lose control let alone get himself impeached? Or the implications of US imposition of tariffs? Or the fate of Italy?

4. What exactly is a *negative* Brexit outcome?

5. How will a negative Brexit outcome impact the key financial asset classes, such as equities in the UK, US or Japan, for example? Or emerging market debt? Or Asian property? Or the gold price?

6. Finally – when is '*after*'? Is it likely that at some precise point in the future, the whole issue will be immediately resolved? Or will the full consequences not really be known for years?

So yes, it is complicated, it is messy. But to conclude that cash is best off in the bank is erroneous. We are not going to be drawn into the 'what-if' game of speculating as to what a hard or soft Brexit will lead to because it does not lead us to any actionable investment decisions.

What we are prepared to say is that a 'bad' outcome, presumably one in which no practical deal is struck, all parties are at war and Theresa May is ousted would be negative for sterling – probably. However this is good news for UK companies with high overseas earnings, and the table below shows what happened to five of the largest UK listed in the month after the referendum result on 23rd June 2016.

Company/Asset Class	Price Change 22 June 2016 – 22 July 2016
HSBC	+11.2%
AstraZeneca	+18.7%
RD Shell	+15.5%
Unilever	+12.6%
Diageo	+16.1%
UK Conventional Gilts	+ 5.2%
Sterling/US$	-10.9%

So a 'bad' outcome could well be good news for UK shares. Is there a case for arguing that a 'good' outcome would lead to sterling rallying and putting pressure on UK share prices? Quite possibly, but it could also trigger an inflow of overseas in domestic buyers as confidence returned to the region. A win-win scenario? This is something one doesn't read in the press, because it doesn't make for good copy. As for the impact on equities in other regions, one can see how it may impact Continental Europe but is Brexit relevant to the direction of share prices in the US, Japan or emerging markets?

Also, we cannot see why any outcome would impact overseas bond markets, other than some very specific cases. Granted, the UK property market could be affected, but internationally it shouldn't register. So what is our position, what is our Brexit strategy? Stay diversified, it really is that simple.

The broader subject of market timing is one that has attracted much academic interest over the years and the conclusions seem to be that by trying to second-guess market moves and to catch the perfect moment, leaves one as a hostage to fortune.

Legg Mason explains the story very clearly here where they say that "*money out of the market in down periods may reduce long-term returns. When the market rebounds, it may happen quickly and suddenly. And missing even a few trading days could mean missing some of the market's biggest gains. If an investor missed just 10 days, in the 5,052 trading days from January 2, 1998–December 31, 2017, returns could be cut in half.*" This evidence strongly supports the argument that it is risky to keep money out of the market.

Last week we met up with Kevin Johnson, a senior analyst at Dodge & Cox, a major US fund manager based in San Francisco and we asked him how his company viewed Brexit and the investment implications. We were surprised to hear that in their International fund, they had used the recent weakness to top up exposure to Barclays and European banks in general where valuations were 'looking increasingly bombed out'. Maybe the smart money is already moving in.

So in conclusion, we regard the Brexit issue as just one factor amongst countless others in the investment decision-making process. We take the matter seriously but not so seriously as to let it dominate our overall process, which has remained practically unchanged – buy quality, try not to overpay, be flexible and don't put all your eggs in one basket. We are sceptical when we hear of investors with a detailed plan for Brexit. As Mike Tyson once so eloquently put it, "everybody has a plan … 'till they get punched in the mouth".

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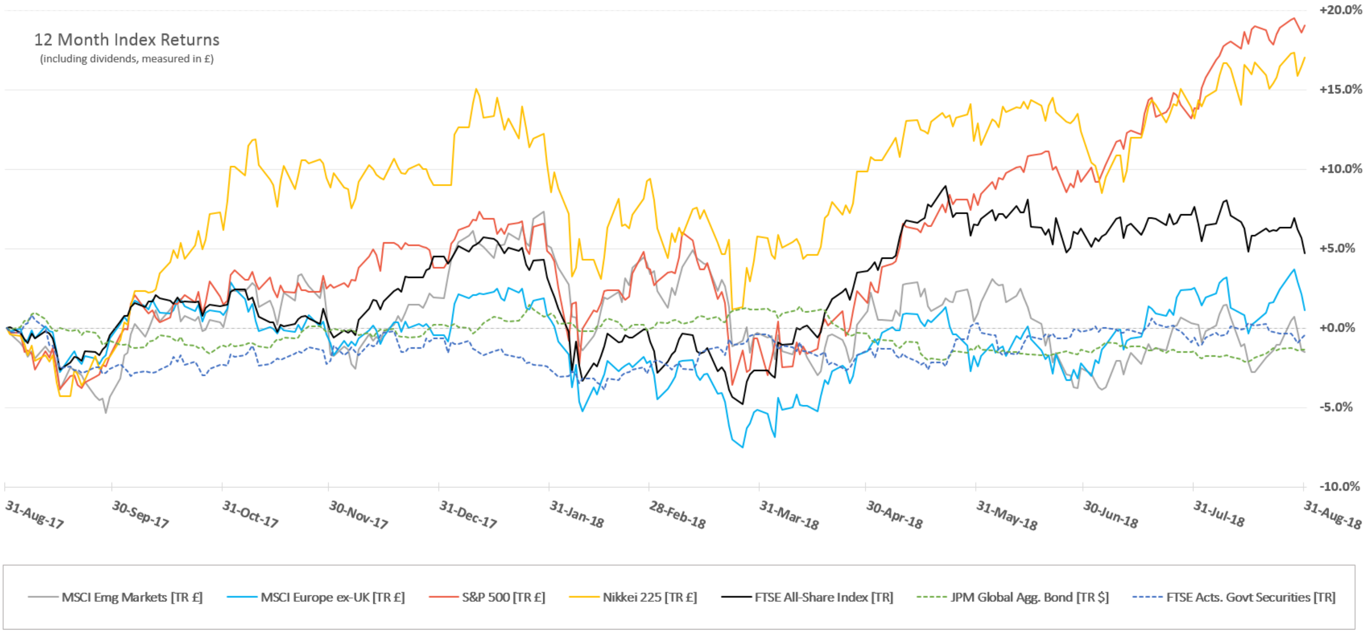
INDEX RETURNS

Index	Region/Asset Class	31 Aug 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,432.4	-4.1%	+0.0%	+9.6%
UK Mid Cap	UK	565.0	-2.1%	+1.7%	+8.0%
UK Small Cap	UK	5,837.3	-0.7%	+2.1%	+19.2%
Dow Jones Ind Avg	USA	25,964.8	+2.2%	+18.3%	+41.1%
S&P 500 Index	USA	2,901.5	+3.0%	+17.4%	+33.7%
NASDAQ Comp.	USA	8,109.5	+5.7%	+26.1%	+55.6%
Nikkei 225	Japan	22,865.2	+1.4%	+16.4%	+35.4%
Euro Stoxx 50	Europe	3,392.9	-3.8%	-0.8%	+12.2%
CAC 40 Index	France	5,406.9	-1.9%	+6.3%	+21.8%
DAX Index	Germany	12,364.1	-3.4%	+2.6%	+16.7%
Milan Index	Italy	20,269.5	-8.8%	-6.5%	+19.6%
MSCI Emg Mkts (£)	Emg Mkts	556.3	-1.8%	-1.5%	+24.6%
IBOVESPA Index	Brazil	76,677.5	-3.2%	+8.2%	+32.4%
IMOEX Index	Russia	2,345.9	+1.1%	+16.0%	+19.0%
S&P BSE SENSEX	India	38,645.1	+2.8%	+21.8%	+35.8%
Shanghai SE Comp.	China	2,725.3	-5.3%	-18.9%	-11.7%
Hang Seng	Hong Kong	27,888.6	-2.4%	-0.3%	+21.4%
UK All Property	UK Property	134.6	+0.4%	+6.2%	+14.9%
UK Conv Gilts	UK Gilts	3,596.9	+0.2%	-0.4%	-3.7%
UK Index linked Gilts	UK IL Gilts	4,856.0	-0.6%	-1.7%	-2.2%
JPM Glob Agg. Bond ($)	Global Bonds	561.1	+0.1%	-1.4%	-1.1%
iBoxx Non-Gilt	UK Corp Bonds	338.0	+0.4%	-0.8%	-0.5%
WTI Crude ($/barrel)	Oil	69.8	+1.5%	+47.8%	+56.2%
LMEX	Base Metals	2,928.3	-3.8%	-9.0%	+24.7%
Gold Spot ($/oz)	Commodities	1,201.40	-1.9%	-9.1%	-8.2%
S&P Agri & Livestock	Agriculture	706.34	-4.1%	-5.8%	-10.0%
£1 = US$	Currencies	1.30	-1.2%	+0.2%	-1.4%
£1 = €	Currencies	1.12	-0.5%	+2.9%	-5.1%
£1 = Yen	Currencies	143.92	-1.9%	+1.2%	+5.9%



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