Weekly Digest

Week ending **25 June 2017**

Politics provides the noise, fundamentals the returns

First anniversaries are generally a time to celebrate and reflect on the past 12 months fondly. Last week saw the one year anniversary of the UK's decision to leave to European Union and few in government would likely have such a rose tinted view of the intervening period. One year on from Brexit there is arguably greater uncertainty about the likely path of the extraction of the UK from the European Union than there was at the time. This is not least thanks to Theresa May's disastrously run snap general election which has resulted in a chastened minority government and a resurgent labour party under Jeremy Corbyn. A majority government speaks more credibly for the will of the people than a minority one. As a result it is likely that the government will face many scraps at home which risks distracting from the job in hand; namely securing the best deal possible. It is ironic that the general election was seemingly called in order to secure a greater Conservative majority thus reducing the influence of Tory backbenchers aiming for a 'hard' Brexit. While the negotiations are progressing it is unlikely that we will be treated to much of the detail, as both sides will be reluctant to give away their stance on critical issues. As an investor, therefore, we cannot anticipate having enough information to be able to make high conviction positions in portfolios. Indeed that may be the case once the two year time limit for negotiations has elapsed.

Making investment decisions on the basis of politics is a dangerous game. We have seen in the past twelve months how difficult political outcomes can be to predict and as a result making investments on the back of speculation over political moves is a low quality bet. As outcome based investors the portfolio managers focus on generating an outcome for the investors and making the journey to that outcome as palatable as possible. In order to identify attractive asset classes they use a robust and repeatable valuation process that produces expected returns for a large swath of asset classes, sub classes, styles and sectors to see where the best risk adjusted opportunities lie. As a result, even where there is political uncertainty work can be undertaken to identify investment opportunities.

The UK stock market has performed well post Brexit. The main board is up over 20% in the intervening year. This performance is often attributed to sterling weakness with the argument being made that because approximately three quarters of UK revenues come from overseas, UK companies benefit when sterling weakens because these foreign currency earnings are enhanced by being translated into a weaker sterling. If the UK were a performance outlier over the past year, that would be a reasonable assertion, but in local currency terms the global stock market is up a short 19% and Japan and Europe have both also produced returns in excess of 20% and the US is just behind at 17.7%. There are some examples of a currency boost in the UK such as the materials sector which has performed well, with returns of over 40% in sterling compared to 19% globally. This return is due both to the currency translation impact (a lot of dollar revenues in materials) and also thanks to the fact that these stocks had been unpopular for a number of years as raw materials prices came under pressure. The energy sector is also something of an outlier; the UK energy names are up 13.0% over the year, whereas globally they are down 3.8% in local currency terms. The pressure on energy stocks in understandable given the recent 20% fall in the oil price down from their recent peaks in February.

Economically the results so far have been mixed. The extremely negative scenario painted by Remainers prior to the poll have proven to be wide of the mark but it is also fair to say that the UK (and the rest of Europe, arguably) is in a sluggish growth mode. Whether that is a direct consequence of the political uncertainty or broader issues such as still modest inflationary levels, huge amounts of outstanding debt and businesses that show little propensity to invest can be argued either way.

Political noise such as Brexit negotiations will cause market moves from time to time and when the market falls The manager's bias will be to add to attractively valued markets. This is because the companies that they invest with in this region are global businesses that happen to be listed in Europe. The UK main board, for example, achieves approximately three quarters of its profits outside of the UK and so it is a global roster of companies. Their management is paid to make money for shareholders regardless of the political weather and as a result while Brexit may be a distraction for all of us from time to time even a 'bad' outcome for one of the parties need not translate into bad business prospects for a diversified basket of companies. Diversification is an important tool in general and in times like these its value is thrust to the fore. Now is not a time to have overly concentrated sources of risk in a portfolio. It is sensible to keep a wide and global suite of returns drivers in portfolios to ensure the path to the return outcome is not derailed by a single political (or market) event.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

The **Marketplace**

- Oil prices continue to decline
- Brexit negotiations begin
- Bank of England split over policy rate moves
- MSCI adds China A shares to All Country World Index
- Brexit bills dominate UK Queen's speech

Market **Focus**

US

- Current account deficit rises to the highest level in a year at USD 116.8 billion, up 2.4% from Q4 2016. The current account deficit to GDP ratio remained in line with eight year averages at 2.5%.
- Existing home sales rise 1.1% month on month versus expectations of a 0.5% decline.
- Four Republican senators immediately opposed the recent US healthcare proposal indicating an additional USD 50 billion in spending over four years. The bill could potentially be voted on this week.
- All 34 major US banks passed the first round of the Federal Reserve's banking stress tests.
- The Dow Jones Industrial Index fell 0.62% over the week whilst the NASDAQ composite rose 0.42%.

UK

- Brexit negotiations began on Monday, with the UK agreeing to EU sequencing of confirming divorce payments prior to beginning trade negotiations.
- On Friday, UK Prime Minister Theresa May proposed an offer to guarantee the rights of EU citizens who have lived in the UK for more than five years. The citizens would be granted 'UK settled status', which reportedly entails lifetime rights to education, healthcare, benefits and pensions.
- The Bank of England's Monetary Policy Committee (MPC) is seemingly split over policy rate moves. On Tuesday MPC Governor Mark Carney stated 'now is not the time to raise interest rates' with the UK now entering negative real wage growth and mixed signals on consumer spending. In contrast to these comments, Bank of England Chief Economist Andy Haldane believes it would be prudent to raise rates in the second half of 2017 to ensure a smoother rate normalisation process.
- UK public sector net borrowing for May stood at GBP 6 billion, falling from GBP 9.7 billion in April and beating expectations of GBP 7 billion.
- On Wednesday the Queen's speech was presented with 8 of 27 bills relating to Brexit. Non-Brexit bills included bans to landlords charging letting fees and a High Speed Two Bill, authorising the second leg of the rail link.
- UK Equities fell 0.5% over the week.
- Brent crude continues falls, declining 3.9% during the week.

Europe

- EUR 5 billion of taxpayer money was approved to rescue Italian banks Banca Popolare di Vicenza and Veneto Banca. The Italian government confirmed that a further EUR 12 billion in guarantees will be made available.
- Euro area composite Purchasing Managers' Index fell to 55.7 in June 2017 from 56.8 in May.

Asia

- MSCI announced China's A-shares will be included in the MSCI All Country World Index (MSCI ACWI). 222 large cap China A stocks will be added to the MSCI ACWI with an aggregated weight of 0.7%.

James Klempster (CFA) & Oliver Cooper

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Week ending **25 June 2017**

Asset Class/Region	Currency	Currency returns			
		Week ending 23 June 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.2%	1.2%	9.7%	17.1%
United Kingdom	GBP	-0.5%	-1.1%	6.2%	21.6%
Continental Europe	EUR	0.0%	0.2%	11.3%	19.2%
Japan	JPY	1.0%	2.8%	7.2%	26.8%
Asia Pacific (ex Japan)	USD	0.7%	1.6%	19.6%	24.5%
Australia	AUD	-1.0%	-0.1%	2.9%	13.0%
Global	USD	0.1%	0.8%	11.1%	16.0%
Emerging Market Equities					
Emerging Europe	USD	0.2%	-1.7%	2.5%	12.7%
Emerging Asia	USD	1.5%	1.9%	23.4%	28.6%
Emerging Latin America	USD	-1.6%	-1.5%	7.7%	15.2%
BRICs	USD	1.0%	0.6%	16.7%	26.7%
MENA countries	USD	3.8%	3.0%	4.1%	12.8%
South Africa	USD	1.4%	-1.8%	10.3%	10.1%
India	USD	-0.1%	-0.1%	24.1%	22.3%
Global emerging markets	USD	1.0%	0.9%	18.3%	23.8%
Bonds					
US Treasuries	USD	0.2%	0.6%	2.7%	-0.2%
US Treasuries (inflation protected)	USD	0.6%	-0.2%	1.8%	1.5%
US Corporate (investment grade)	USD	0.3%	0.9%	4.4%	4.2%
US High Yield	USD	-0.4%	-0.1%	4.6%	12.0%
UK Gilts	GBP	0.4%	0.1%	2.4%	6.4%
UK Corporate (investment grade)	GBP	0.2%	0.4%	3.9%	9.3%
Euro Government Bonds	EUR	0.3%	0.9%	0.4%	-0.3%
Euro Corporate (investment grade)	EUR	0.1%	0.2%	1.4%	2.4%
Euro High Yield	EUR	0.1%	0.5%	4.4%	8.8%
Japanese Government	JPY	0.0%	0.0%	-0.1%	-3.0%
Australian Government	AUD	0.2%	0.1%	3.7%	1.9%
Global Government Bonds	USD	0.1%	0.2%	4.5%	-3.0%
Global Bonds	USD	0.1%	0.2%	4.6%	-1.1%
Global Convertible Bonds	USD	0.2%	0.1%	7.4%	6.5%
Emerging Market Bonds	USD	-0.2%	0.2%	6.9%	6.1%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 23 June 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	0.0%	3.2%	3.3%	1.6%
Australian Property Securities	AUD	-4.1%	-1.5%	-1.2%	-5.8%
Asia Property Securities	USD	-1.1%	0.4%	16.7%	18.2%
Global Property Securities	USD	-0.7%	1.9%	8.9%	5.9%
Currencies					
Euro	USD	0.1%	-0.4%	6.4%	-1.7%
UK Pound Sterling	USD	-0.5%	-1.3%	2.9%	-14.5%
Japanese Yen	USD	-0.4%	-0.6%	5.1%	-4.6%
Australian Dollar	USD	-0.6%	1.9%	5.3%	-0.5%
South African Rand	USD	-0.8%	1.8%	6.0%	11.6%
Swiss Franc	USD	0.5%	-0.1%	5.1%	-1.2%
Chinese Yuan	USD	-0.3%	0.0%	1.9%	-3.5%
Commodities & Alternatives					
Commodities	USD	-2.3%	-4.6%	-9.8%	-8.2%
Agricultural Commodities	USD	-3.3%	-1.4%	-3.3%	-7.4%
Oil	USD	-3.9%	-9.5%	-19.9%	-10.5%
Gold	USD	0.0%	-1.2%	8.9%	-0.1%
Hedge funds	USD	0.1%	0.3%	2.7%	5.9%

Source: Bloomberg

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Important notes