QUARTERLY MARKET OVERVIEW – JULY 2016

"There are decades when nothing happens, and there are weeks when decades happen" – Vladimir Iiyich Ulyanov (Lenin)

I have been thinking of how to describe the last few weeks and the quote from Vladimir Ulyanov to me best sums it up:

> *"There are decades when nothing happens, and there are weeks when decades happen"*

The decision to leave the EU caught many by surprise, and we have seen events that would normally take months or years to play out occur in days!

Political uncertainty has been created most recently with campaigners on both sides exiting. How the political landscape might look over the next few days or weeks is perhaps anyone's guess, but what is clear is that strong leaders are needed across all parties to take the UK to its next stage.

Financially you could argue that if the FTSE 100 was a barometer of how robust the UK is then we seem to be in pretty good shape. But there is a real split of performance in those companies with overseas earnings like, for example, BP which is up approximately 15% on sterling weakness. Whereas sectors like house builders, banks and other financials are significantly down, due to worries about the economy and the effects of being domestically focused.

The Bank of England has been quick to react with easing of capital requirements for banks, and has given an indication that interest rates will come down.

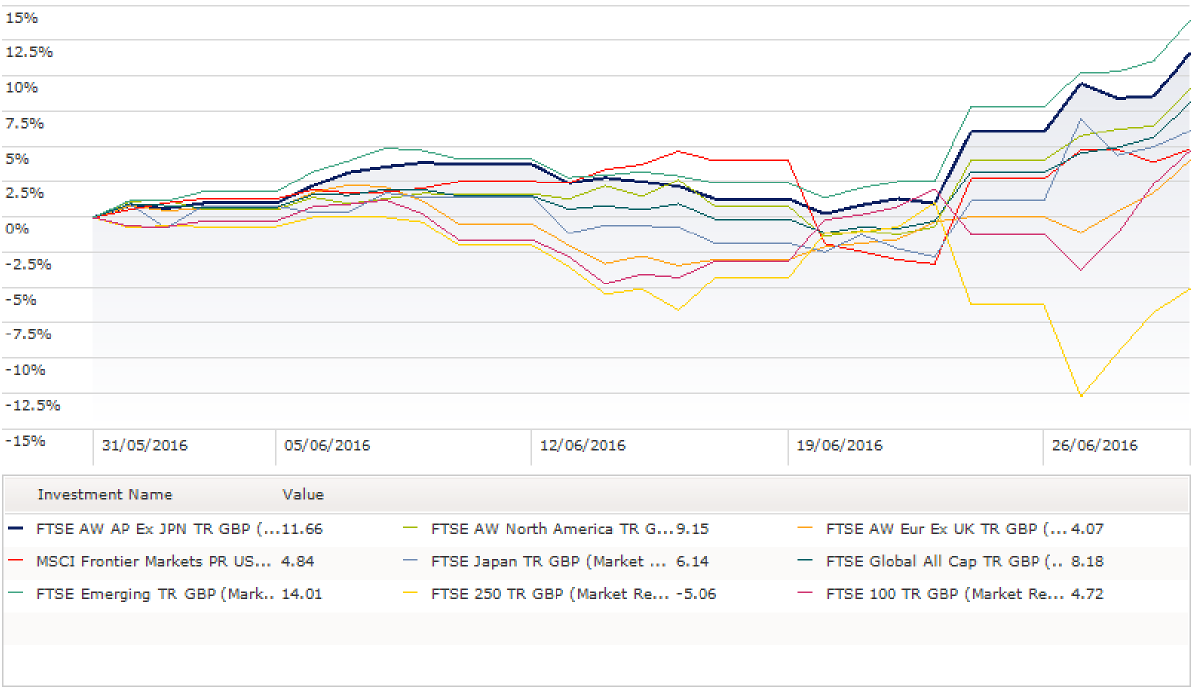
Everything is playing out quickly and we don't know exactly what this means going forward. The basis of this update is to look at BREXIT, the global economy and where to look for "safe" assets.

George Ladds

George Ladds,
Director, July 2016

GLOBAL IMPLICATIONS

<u>One month returns 1 June – 30 June 2016</u>



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The markets, and those offering betting odds did not see BREXIT happening. In fact, with the death of Jo Cox there was a feeling that perhaps people would side with caution rather than uncertainty. The markets responded to this and we saw strong gains for sterling and FTSE All Share in the week preceding the vote.

Without a shadow of a doubt those gains then over emphasised the falls. At the end of Friday 24th June, the FTSE All Share Index was trading 2% higher than the middle of June and 9% higher than mid-February. Sterling was also trading higher than in February. Today the FTSE All Share is trading higher than at the start of the year, although Sterling has hit a 31-year low against the dollar.

Over the coming days and months people will predict various future scenarios but in reality we are entering uncharted territory. It is true that there is the potential for things to be as bad as the experts have predicted but equally it could be a lot better. The point is "nobody knows anything", and if we think we know how it will turn out, then we are likely to be wrong.

What facts can we get from all of this?

David Cameron has resigned; this was not a surprise as he was never going to admit during the campaign that he would quit if he lost, as that would have given more people a reason to vote leave! We assumed we knew the successor but with Boris Johnson resigning the race for the Prime Minister remains competitive (we can't assume Theresa May will be the next Prime Minister).

Perhaps by the time you read this Jeremy Corbyn will have resigned; it is very difficult to stay when there is a such a movement against you but he is determined to remain. Without the support of your party you are in an untenable position but as no-one seems in a rush to challenge him he may just hang on. Clearly both parties require effective leadership.

Scotland will debate whether they have a second referendum. The challenge is that the EU has already indicated it would not allow them to join, so where do they go? The oil which drove their economy does not exist.

Northern Ireland could also unite with the South, but that depends on sufficient agreement between the two to do this. But this causes its own difficulties and appears to be a step backwards.

There is no hurry to enact Article 50 of the Lisbon Treaty which must come from the UK. This feels like a cat and mouse game; the longer we take, the more likely EU members realise they need the UK and its markets, not to mention our monetary and banking prowess. But on the flipside, it creates uncertainty in the markets and causes problems in the economy. Businesses have to make decisions about whether to move to mainland Europe to have unfettered access to EU markets. It also gives a false hope to those that voted remain that we may not enact Article 50!

Of course the EU wants the UK to move quickly and they want to be seen to punish the UK to discourage other member states following. We shouldn't forget this is a divorce, and very few divorces end happily!

In Europe, the Spanish Election result did not secure an absolute majority for one party. This and the referendum reflects an evolving picture of political uncertainty. Growth has been slow, migration growing, austerity deeper and longer and it has a fuelled a rise in populism and Euroscepticism. We don't know what this will mean in the long term, but eyes will turn to France, Holland and Italy where there are further calls for referendums to leave the EU.

Are there positives from uncertainty? This is something that we will discover gradually. This has come at a time when the global economy is vulnerable to unexpected shocks and therefore we will enter a period of instability and volatility. It reduces the outlook for growth in the UK in the short term, but it is worth reflecting on investment returns historically.

In October 2008 the All Share Index dropped 8.3% in one day, those holding investments at the time saw returns of over 80% over the next five years. In September 2011 the markets dropped 5.2% in one day but investors returned 44% over the next five years. History shows that a hold strategy, (however painful) does work.

There are sectors of the markets which are suffering, especially financials (banks and real estate). It is worth adding that banks are a lot stronger than they were, and much of the selling may be an overreaction. Some have considered this a buying opportunity; time will tell but at the moment the move is to safety.

The BOE will do something if it needs to, to protect the economy, and we have already started to see this. Further measures could include more QE which can be good for stock markets! It may also reduce interest rates to zero although it may stop at 0.25%. This will be positive for home owners who could secure record low mortgages in the coming months. The downside is for holders of cash where they will effectively see no returns for their money.

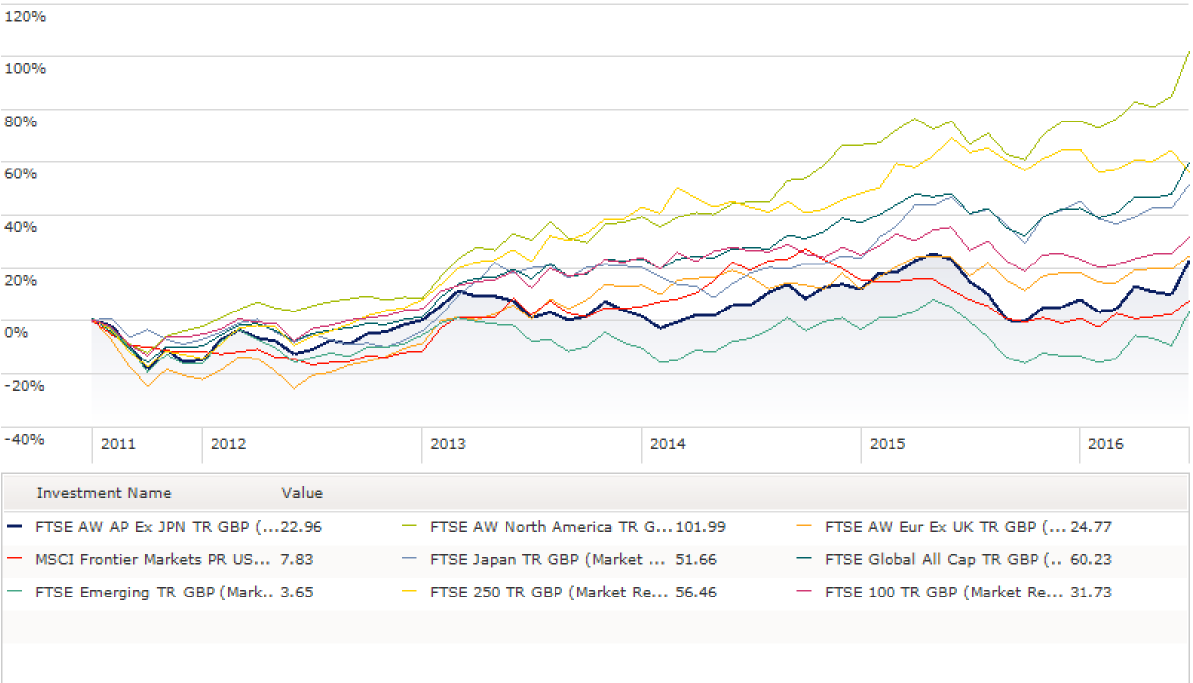
Inflation is likely to rise as we import more than we export; estimates are around 4% by the end of 2017. Although the fall in sterling is bad news for imports, it is good news for exports as it makes us more competitive (and good for diversified investments with overseas holdings).

Turning to housing there is likely to be a slowdown in London, whether this spreads across the country is something to watch and may not really unfold for a few years. We have seen people backing out of property transactions recently so it remains to be seen the longer term effects. On the flip side some argue that any slowdown might be protected, as overseas buyers take advantage of a weakness in sterling.

We shouldn't underestimate the impact of BREXIT, the majority has spoken and there is a chance that everything that has been said could be true. There is equally a chance that it could be positive for the UK. Much will depend on what happens in the coming days, months and years and this needs strong leadership across the party divide.

AROUND THE WORLD

Five year returns 1 July 2011 – 30 June 2016



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I recently read an article which talked about what the world might look like in twenty or thirty years' time. Will it be a period where the EU flourishes or breaks? Will it be a golden era of US politics even if Trump is at the helm? Will the UK have survived and prospered? How will the companies of the future change our lives in terms of technology and health advancements? We could be entering a golden era; we just don't know.

The environment today is that 40% of the world's government debt is at negative interest rates, there is $10 trillion of dollar-denominated emerging market debt; global growth is averaging 2%, unemployment is below 5% and interest rates in many places are negative. This climate is not changing anytime soon.

Economies need to adapt to this. Europe's debt to GDP ratio is 90% and it must consider mutualising it, by putting it on the balance sheets of the ECB. If they do this, it means giving up more sovereignty rights to Brussels. If they do nothing it gets worse. Europe has big challenges with unfunded liabilities especially in France, with pensions and subsidies to farmers and this brings us back to wider political unrest and uncertainty.

For all of this countries in Europe are seeing improvements – Germany, France, Spain and Austria all experiencing growth with Ireland being the standout economy. This is important but debt is a drag and with weak oil prices this is pushing Europe into deflation.

In the UK the economy has been growing but in recent months we have seen companies holding back on investment. A good starting point for getting returns is low valuations and volatility. We are seeing attractive opportunities arising compared to other countries. The UK will continue to trade; and it has an opportunity to move forward but in the short term there remains uncertainty. Inflation will hurt bank balances as there is less purchasing power to spend but if interest rates fall this could act as a counterbalance. Sterling falling can appear negative because we import so much but for exporters it makes products more attractive.

A snap election in the Autumn is a possibility but strong leadership across the parties is needed. Domestic stocks will suffer in the short term as investors turn to safe havens. But the message remains; the UK is a lot stronger than it was in 2008, and the banking sector is more liquid. There are concerns about foreign investment and this will impact GDP growth, however if the UK can build on the positives of the economy it has the potential to ride this through.

Turning to Emerging Markets and especially China; Xi Jinping has 5 years left as leader, he has a clear vision and is determined to succeed. This means removing corruption and cronyism and building a more consumer focused society. Like many global economies it is challenged by debt, and a lot of this has been raised recently to pay interest on existing debt which has to be a worry. However, they can print money; they have the new silk road, they have ambitions to be the world's reserve currency and want to be the world's most powerful economy.

There are concerns that if the dollar strengthens this will hurt EM countries as they pay back dollar debt with local currency. But it is not all bad. Valuations are at the lowest they have been in any US tightening cycle since the mid-90s. There is clearly value to be found in emerging markets. India is clearly the standout growth story but they need the reform to move quicker, Russia is benefiting from a weak currency and a rise in oil prices and in Brazil a change in government has been seen positively.

In the US there are concerns that the number of jobs added in May were fewer than expected. The election in November brings uncertainty; a Trump victory could bring trade wars but as we have seen nothing is guaranteed. The US like other economies is hampered by debt and this is growing by about $2 trillion a year. This constrains growth, restricts wages and hits labour participation rates. The world is interconnected and a slowdown or recession in the US is not good for global economies. But there are no signs yet that we are at this stage.

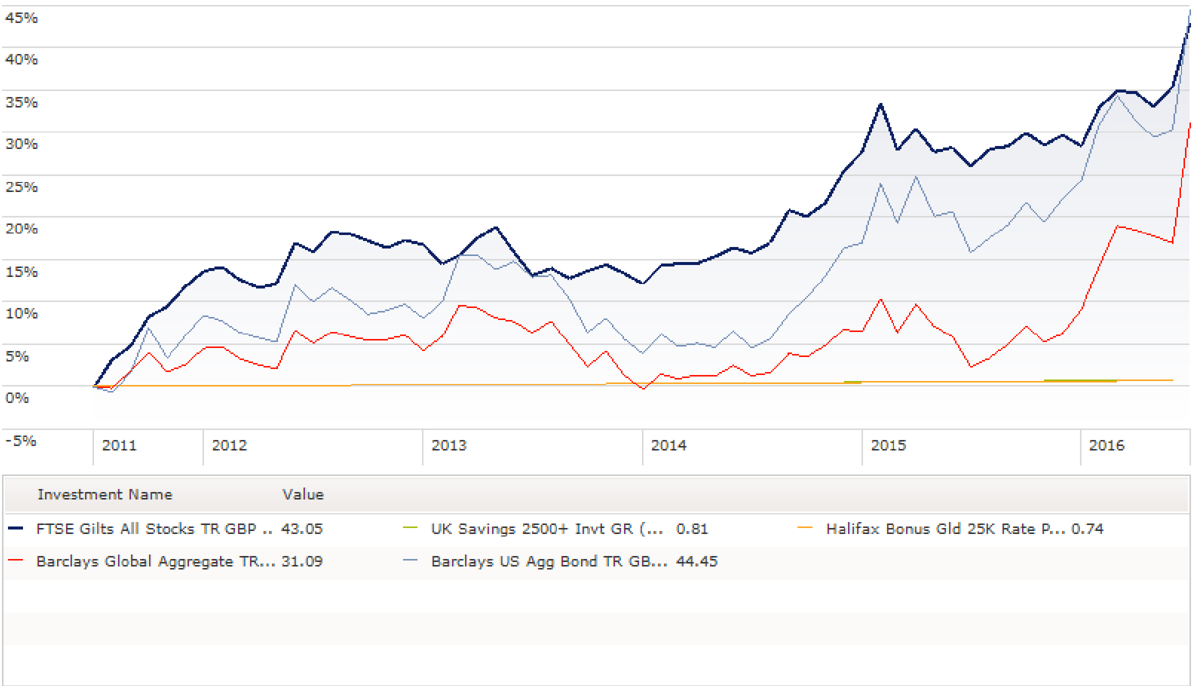
Elsewhere Japan has delayed the implementation of consumption tax increases, which is really important. Despite the stimulus it has failed to achieve its 2% inflation target, and the economy is too fragile to take this. The challenge is to encourage people to spend, which is difficult when people see a slowdown in wage growth.

Debt globally is a big issue as it impacts all of us whether in fixed interest holdings or banks etc. But the message remains despite recent events in the UK, we are in a slow growth environment and not in a global recession. Volatility has returned and this has to some extent been hidden because of QE. In a slow growth environment markets will be susceptible to shocks like BREXIT, US elections and political uncertainty in Europe, but these are often short and sharp and reflective of a fragile world.

Global diversity in terms of countries and asset classes remains a key element to investment as does currency. A decrease in sterling helps exporters but it also acts as a hedge for investments overseas, effectively the value of US holdings increases to reflect a stronger dollar.

CASH

Five year returns 1 July 2011 – 30 June 2016



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We have struggled to find positives in cash. Obviously for those who held cash prior to the sell-off there are benefits, especially if they decide to re-enter the market. There is a strong argument that if you look at any recent sell-off, these have proved to be good entry points into the market.

For those using cash as a safe haven there are two concerns on the horizon; firstly, interest rates could drop to zero (although 0.25% seems the likely option). If it went to zero, this would effectively mean cash would return nothing. The capital would be protected but would not be growing. In a low inflation environment this would not be a negative but if inflation goes to 4% then cash with no interest added will be losing 4% a year in real terms.

An alternative to cash seen as a safe haven is property; even before BREXIT we started to see the property market slow with houses taking longer to sell and often at a discount to the asking price. There is potential for house prices to fall further especially in London. On the other side of this, if interest rates drop, borrowing will cost less so lower house prices and cheaper mortgages may present an opportunity, but it will be about calling the bottom of any potential fall in the market.

Long term cash remains a difficult asset class, and this will get worse if interest rates go down and inflation rises.

CONCLUSION

The world economy prior to BREXIT was fragile but growing. A lot of the positives within the global economy remain. The challenge with delicate economies is that small shocks can create massive volatility – we just need to look back to last year, at the start of this year and now with BREXIT. We don't know what the world will look like in 5 or 10 years' time but there are some interesting things on the horizon.

We shouldn't lose sight of the fact that many positives and opportunities remain in the global economy. The political uncertainty makes us uncomfortable, but over the years we have seen this time and again.

Our message remains that having a diversified portfolio of assets is the way forward; because not only are you spreading assets across sectors and regions but you can also hedge in terms of currency. It is worth adding that after short, sharp falls there are often strong corrections. In January we saw negative returns but up to 31 May positive returns were posted month on month.

Going back to Vladimir Ulyanov's quote "There are decades when nothing happens, and there are weeks when decades happen". It seems like we have reached that point right now, and the next few months will be crucial to how things play out in the future.

Source: Charts have been sourced from Morningstar. Other data sourced from Mauldin Economics, Schroders, Templeton, Threadneedle, and JP Morgan. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.