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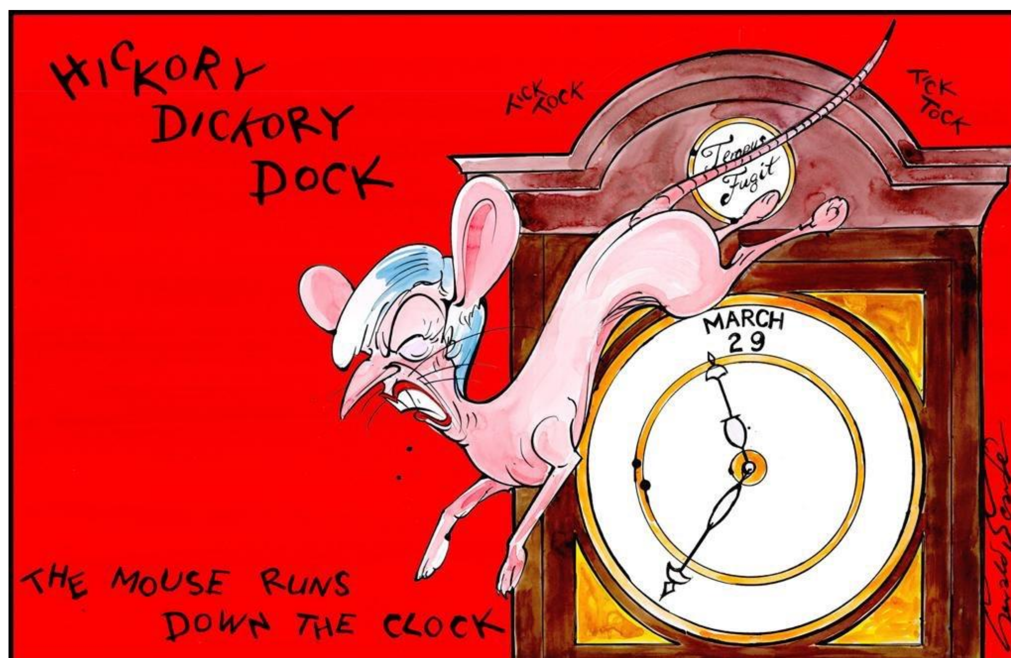


Gerald Scarfe - Hickory dickory dock, the mouse runs down the clock – 15 Feb 2019, Political Cartoon Gallery London

Investment perspectives for different Brexit outcomes

After another week of fairly positive market action, the pattern of last year's global stock market sell-off and ongoing recovery this year is beginning to look more and more like the previous correction episodes of 2013 and 2016. Just as then, the combination of economic growth deceleration and central banks' attempts to put the monetary genie of quantitative monetary easing (QE) back into the bottle caused a more pronounced market upset than many thought possible or rational. At this rate then it seems reasonable to assume that the monetary overhang created by the remedies against the global financial crisis have created capital market 'hangover' potential which will be with us for some years to come.

From such a perspective we could just decide to move on as we did back in 2013 and 2016 and look forward to another extension of economic expansion and rewarding capital market investment returns in this mega cycle. That is if it was not for the Damocles Sword-like threat that is hanging over this recovery in the form of trade politics on either side of the Atlantic.

In the US it seemed that the market upset and economic deceleration has created enough pressure to persuade Trump and his administration to press on with their trade talks with China in earnest and avoid having to impose the threatened penal tariffs from 1 March. As long as a memorandum of understanding can be agreed by then, it seems that an extension of last year's tariff truce will be enacted, with a view to scrapping all tariffs between the two countries soon thereafter.

Speaking of extension, we have entered Brexit territory once again – which is the other potential trade conflict overhanging the sunny recovery prospect. We understand that most of our readers just like most people in the UK would rather we did not have to discuss the dreaded subject here as well, but I am afraid, given the potential economic impact it has, we, as investment managers have to look at it. In the

remainder of this article we will share with you our investment assessment of the different potential outcomes that are beginning to appear on the March 29 horizon.

Looking back over the past two and a half years, you would be hard-pressed to find any investment outlook piece on the UK that doesn't bear the word 'Brexit'. So all-encompassing is Britain's European divorce that you get the impression that UK growth prospects are entirely decided by Brexit gyrations. And yet, just six weeks until we are meant to officially say *good-bye*, Britain's future relationship with the EU remains as unclear as ever. The Prime Minister just lost another vote in the Commons (her 11th!) – not that this one mattered much as it merely asked the House to "reiterate its support" for the last Brexit vote on 29 January. However, to the rest of the EU it must prove once again that the country and its elected representatives are so deeply divided over the issue that it seems unlikely that the UK government could possibly unite either them or the people behind any form of Brexit deal that may realistically be on offer.

Given the tumultuous climate Brexit predictions are rarely worth the paper they are written on. Nevertheless, as investment managers we have to make assessments about what one or the other or third possible outcome may do to the UK economy and in turn to UK investment assets.

So here are four scenarios which we have to consider:

No Brexit: Parliament makes Brexit disappear, we all shake hands and the last two years just go down as a silly mistake. That's the amendment proposed by SNP MP Angus MacNeil, which has gained the support of Tory veteran Ken Clarke. Stock and currency markets would bite your hand off if you offered this to them. However, unless the EU27 suddenly offered to forget about their 'red lines', like freedom of movement or the Irish Backstop, it's about as likely as the fairy-tale Brexit stories printed on the side of buses in early 2016.

May's deal: The Prime Minister's Brexit deal somehow makes it through Parliament. The customs union is extended until we can agree a comprehensive trade deal, which achieves some near-term trading certainty and a sort of acceptable, longer perspective about Britain's future. Markets and businesses would most likely take this pretty well, given the support they have expressed for such an outcome over recent weeks. Just how this could happen in a Parliament split between hard Brexiteers and staunch Remainers is a little trickier. The government would undoubtedly need to make some concessions to the Labour party – and get them approved by EU negotiators. Getting her deal through is clearly what Theresa May is still aiming for and if she can get some side deal to appease the Northern Ireland issue as well, then maybe, maybe this may still happen. Brexit day would very likely need to be postponed a few weeks to allow Parliament to catch up with all the legislation that still needs to be passed to make it happen.

Brexit delay (and possible referendum): B-day is pushed back, the proverbial can gets kicked down the road. But unless there is suddenly some real perspective as to how more negotiating time may resolve the issue(s), then another referendum or even a general election is beginning to look likely. More political uncertainty would be the result and even social unrest is a possibility. Depending on what the perspective is for the delay, markets may take it as a repeat of 2018, when global themes dominated, but if it leads to more political stalemate, then UK investment assets may suffer further international discounting.

No deal: Parliament remains paralysed, and we go over the edge. Given some Brexiteers are trying to block attempts to prevent this, it seems a real possibility – one we get closer to every day. For now, we have to take heart in the fact that this is the least preferred option among both British and European leaders, as, of all available options, it will result in the most economic pain on both sides. We observe that there appears to be a solid majority in parliament that would force an extension of Article 50 rather than experiment with a crash Brexit. However, if it somehow happened in the end, then capital markets are relatively likely to frighten politicians back to a more constructive course in fairly short order. Whether the projected chaos would descend on us would very much depend on whether the two sides want to instrumentalise the suffering of ordinary people on both sides to further their negotiating aims. Last time that happened in the EU was during the Greece crisis – our assumption is that we will not sink that far again.

What has the uncertainty of Brexit meant for the UK economy thus far? Figures released by the Office for National Statistics (ONS) on Monday were shot through with the impacts of Brexit. UK growth last year was its lowest since the financial crisis, and we've now had four consecutive quarters of declining business investment. The results were worse than forecasters had expected, with Britain - during 2018 - underperforming everyone except Italy in the world's leading economies. Most economists agree that Brexit has already cost the UK 1.5-2.5% of GDP, and household incomes are on average 4.1% lower than they would have been if Remain had won in 2016.

A year ago, we wrote that the UK was in a state of delicate equilibrium. Brexit drama was keeping the value of sterling down against the euro, which offered British exporters a price advantage over their European competitors and allowed them to take advantage of strong growth on the continent. Now, that equilibrium has been disturbed. Sterling is still weak, but now so too is the European economy. And price competitiveness is all for naught if your buyers can't afford to buy.

On top of that, Brexit uncertainty has now reached a point where EU businesses refuse to make even short-term deals with their British suppliers unless they absolutely have to, for fear of being disrupted by a sudden change next month. The messy divorce is now hurting UK businesses not just through the lack of investment but also on their bottom line. Our most important trading partners are scared to trade with us, and there is no perspective on which to build future plans.

What does this mean for asset prices? In our outlook for 2019, we wrote that Brexit pessimism had skewed UK assets so much that they were effectively undervalued – and carried a hefty risk premium. But in the first few weeks of the year, two things have happened: Brexit risks have increased (as we get closer to the exit date with no plan in sight) and so have asset prices. In sterling terms, the FTSE 100 is up 7% year-to-date. This means that, while UK assets were undervalued relative to their risk before, this is far less so now. It's entirely possible that the rebound in UK equities has further to go – even if Brexit gets worse. But as we get closer to the 29 March exit date, things will get more difficult.

For now, the economic news flow will continue to be all things Brexit. Hopefully, the next few weeks should give us some much-needed clarity. Until then, we hold our breath and bank on our belief that in the end the political actors want to avoid bringing harm on their electorates.

Corporate earnings: Sunny first, potential for drizzle later

If you had been in hibernation since early December, it would look like nothing had changed in stock markets. Those who remained awake saw the worst December for equities since 1931 and then the strongest January since 1987. This remarkable volatility roller coaster has a lot to do with scarce liquidity being tossed around by the markets' myriad worries, namely: Trump's trade wars, Brexit, monetary policy and a slowing global economy. But for all the dark clouds on the horizon, it's important to keep our eyes on the results on the ground.

That's why this corporate earnings season is particularly important. How well company profits have fared – and particularly how they compare to analyst expectations – could well determine where markets go from here.

On that basis things aren't looking too bad. In the US 73% of S&P500 companies have now reported earnings. So far, 60% of companies have beaten analysts estimates on EPS (earnings/ per share), 53% on sales and 37% on both. The blended rate of growth for all reported firms delivered +14.2% EPS and +6.8% sales growth, surprising by +3.2% and +1.1%, respectively.

In Europe, 45% of EuroStoxx 600 firms have reported. EPS grew on average +7.3% and sales were up +6.3%, surprising by +8.7% on the profit line but sales were generally in-line with forecasts.

In Japan, 94% of Topix firms have reported. EPS declined -16.9% but sales gained +4.2%, surprising by +3.4% for EPS but sales were in-line with estimates. The declines were led by telecommunications (higher costs of 5G roll outs) and consumer goods, which are struggling for pricing power.

Just as important (if not more) for equity prices is what companies forecast about the future. In terms of management's outlook reports, there were three key themes that emerged from current outlook statements:

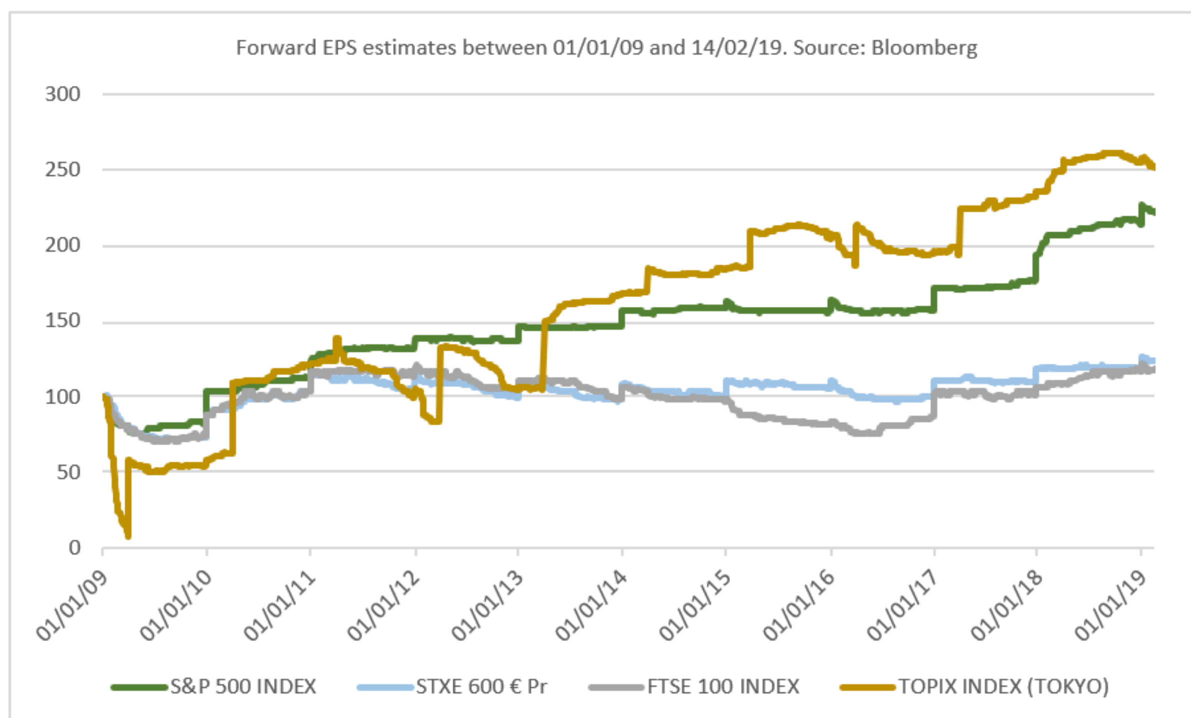
1. **Trade wars made concrete forward guidance harder & complicated capex decisions.** The working assumption of many firms is that the US will increase the tariffs on $200 billion of Chinese imports from 10% to 25% from March 1. Higher costs could negatively impact EPS to varying degrees.

2. **Global growth concerns.** Management remain generally optimistic about US growth despite signs of a slowdown but are unsure how specific issues like Brexit will play out.

3. **Tightening jobs market and inflationary wage pressures.** Some have viewed higher wages as a pricehiking opportunity to drive top-line growth, while for others it's a signal to increase productivity to contain wage-related cost pressures. Positively, Q4 capex growth for reported companies is tracking +11% YoY (vs +13% for the full index in 3Q), suggesting firms are still looking to deploy cash, adding to aggregate demand.

So what has that meant for earnings forecasts?

Over the past few months, earnings estimates have noticeably deteriorated. And yet, markets continue their sharp and broad-based rise. The former is undoubtedly a negative signal. The latter is a positive one. So, who's right?



Well, the scale, breadth and speed of recent earnings revisions across nearly all sectors and regions of the world make it hard to simply brush off. There were many exceptional factors (trade tensions, US government shutdown, Brexit, etc.) but there is a clear trend emerging. The chart above shows forward EPS estimates from 1/1/09 rebased to 100. Net revisions to Full Year (i.e. 2019) are -2.4% lower for the S&P since the start of January, -1.8% lower in Europe, -2.1% in the UK and -2% in Japan.

2019 consensus EPS growth expectations have fallen from 7% at the start of January to approximately 5% today. The momentum is against us and, given the severity and breadth of the revisions to date, it's possible that Q2 and Q3 US-S&P500 EPS growth may dip into negative territory on a year-on-year basis.

Interestingly however, the lowered bar of expectations led to a generally favourable response to earnings reports. Firms with EPS and sales beats outperformed by 2.5% the day after reporting, **the best moves since Q3 2015. M**isses were punished less than the 2.4% historical average, falling by 1.3% the next day.

So, after a tumultuous couple of months, where do we go from here? It's likely that will depend on when earnings expectations bottom out, and how low that bottom is. It's tough to call on either of those at this point.

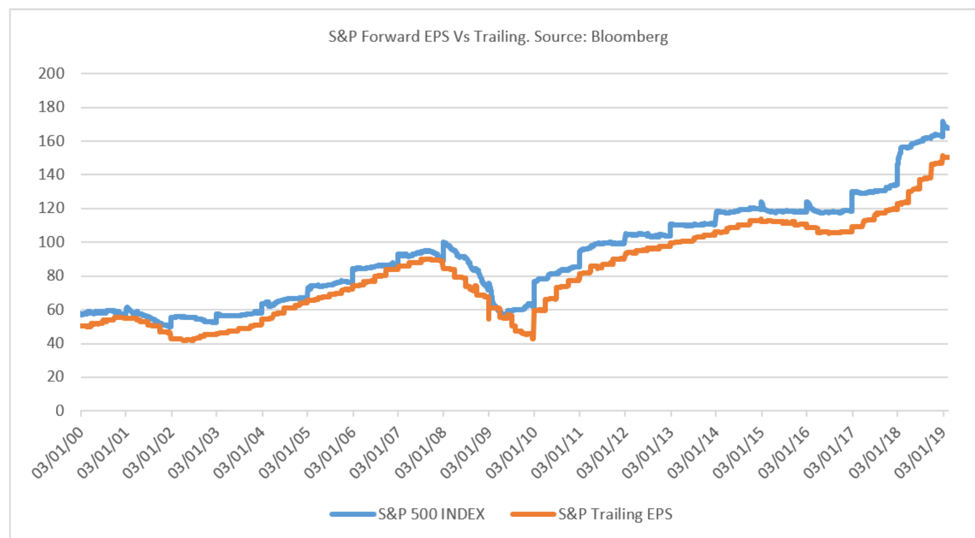
Interestingly, today looks a lot like early 2016. We have a large Chinese stimulus, a pause in US central bank rate rises, negative earnings revisions and a higher stock market. Sound familiar?

There are differences of course: Q1 2016 saw the fourth consecutive quarter of negative year-on-year EPS growth revisions, whereas Q1 2019 is the first negative growth revision quarter. But the comparison could suggest that further negative revisions are possible; we may not have reached the trough yet.

By current estimates, that trough could come in Q2 or Q3 this year at around -5 to -10%. If so, there could be another opportunity to add to equity positions over the coming quarters. Equity markets are now largely flat since the end of 2017, so timing one's allocation changes will be crucial.

Of course, it's worth pointing out that earnings are still increasing, despite the negative revisions, and also that price levels appear to matter more than the trend.

Historically, analysts tend to fluctuate between over- and under-shooting their estimates, rotating between being too optimistic and then overly negative. The chart above shows a persistent gap between what companies deliver and what analysts forecast. Occasionally, they get close, but their estimates exhibit higher overall variability or swings over time. Perhaps therefore, we should take the recent and rapid earnings deterioration with a fair pinch of salt, particularly when there are so many moving parts in play (like trade).



The sudden resolution to current concerns could radically alter analyst forecasts yet again. Its possible Trump could click his fingers tomorrow and the US-China trade war would be over (or get worse). And January's market surge back to early December levels suggests investors realised they had become overly fearful and reversed course somewhat. While both economic and profit growth is slowing, the companies themselves remain cautiously optimistic. Perhaps we should too.

Trump undermining US-Dollar's global trade currency status?

Last year, calling the strength and direction of the US-dollar (US$) was a key factor in producing returns for investors. Since its early rally this year, the dollar has been consolidating around key technical levels. A breakout in either direction will likely have a large bearing on asset returns again this year.

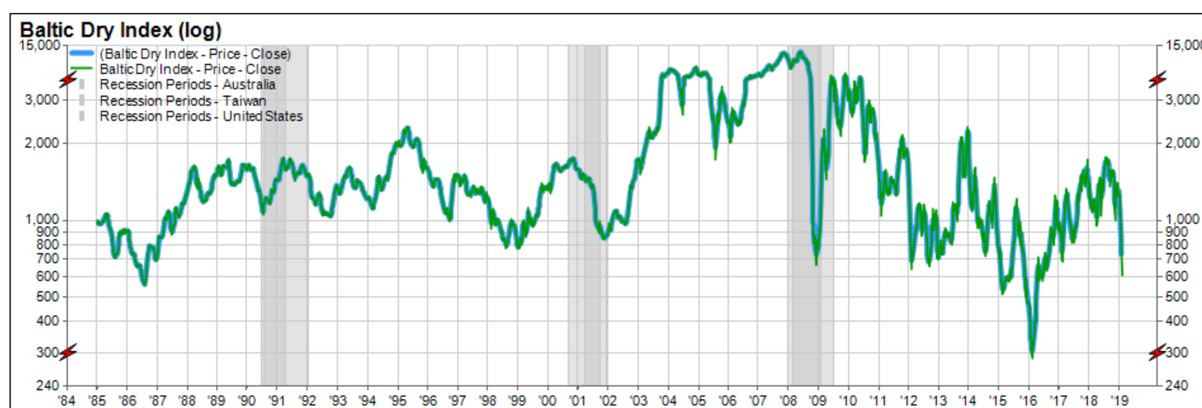
Until now the dollar has been supported by positive interest rate differentials and the relative strength of the US economy. Will this continue? Over the past couple of weeks, US bond yields have risen significantly, with more commentators suggesting that the current slowing of growth is ephemeral, and that the US Federal Reserve's dovish guidance will prove equally transient.

This has not spurred much of a dollar uplift. There are extenuating circumstances: US growth could be under more pressure as a result of January's government shutdown and the deteriorating outlook on trade with China. But beyond the short-term headline numbers, there may be a deeper and more structural change filtering through.

Global trade is currently slowing. That's partly due to stifling US$ strength and declining growth in areas such as China, Europe and the UK. But it's also due to deliberate de-globalisation, through populist trade restrictions such as Brexit and Trump's 'America First' administration. There is also a more structural backdrop to this slow down. The rise of Globalisation from 1990 through to the 2010s was fuelled by a positive deregulatory environment, reductions in tariffs (particularly with China's WTO entry in 2001), and more freely available trade finance from globally-minded banks (up to the financial crisis of 2008). Consumers wanted more choice at lower prices and globalisation helped satisfy this need.

Now, however, production and transport costs have stopped falling and tariffs are rising. China wants to become less dependent on imports and exports. It can now produce more high-value goods and, even more importantly, provide its own consumption. Furthermore, consumers' demand for services (think video games, apps and generally the internet of things) which cross boundaries without the need of a cargo ship has increased. These factors impact long term investment plans as demand structures change and companies become more discriminate about producing where geopolitical risk is low and politics steady. The significant falls in Chinese investment in both Europe and America during 2018 may therefore be more multi-causal than one might have assumed.

This is the background to Trump's trade war and it is not surprising that we have now seen a steep fall in shipping rates since the start of the year. Below shows the Baltic Freight Index:



A single afternoon look at headlines this week across investment media outlets ("US weighs 60 day extension for China tariff deadline, Trump is likely to take his time regarding auto tariffs, EU planning to strike back against possible US car tariffs, US considering sanctions on Russia that could block Russian crude imports") shows how much investor attention is being drawn to trade Not only has Trump triggered a renewed focus on tariffs since becoming President, but the US has also exploited its status as the reserve currency for the world and the benefits this brings through the global payment systems. It is not therefore surprising that we have also seen both central banks and sovereign wealth funds, particularly in emerging markets, look for alternatives where they can diversify currency reserves away from the dollar and avoid taking on another country's credit risk, including that of more developed

economies such as Europe. One alternative, that both central banks and sovereign wealth funds have turned to, is gold. The World Gold Council recently reported that central banks have not bought this much gold since the end of the gold standard in 1971, whilst the Financial Times recently reported that Russia saw a 74% increase in gold purchases on the previous year (2017).

Even if, as seems to be the case, China and US resolve their differences, do the paths of global trade and of gold signal that more underlying damage to the US$ as the global reserve currency has already occurred? Has Trump's America First attitude – with his trade tariffs and exploitation of the US$'s reserve status – triggered permanent damage to the dollar's reputation?

The answer to these questions would provide decisive clues about the likely direction of the greenback in 2019. Will the relative economic strength and the dollar's reserve status prevail? If so, the ensuing US$ strength will continue to be a growth drag on the rest of the world. But if growth momentum elsewhere returns and the world of trade grows tired of a volatile US$ (and president), then the value of the dollar may well break lower.

On balance, we believe that the pulling and pushing forces on the US$ value are currently roughly equal, with perhaps a hint more downside than upside risk. Compared to 2018, we therefore expect the value of the US$ to be as closely watched, but with less potential to generate negative drag effects for the world. That is unless Donald Trump suddenly disappeared or became as balanced and measured as his predecessor Obama. Don't hold your breath.

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7236.7	2.3	165.5	↗
FTSE 250	18987.2	1.8	334.3	↗
FTSE AS	3954.6	2.2	85.1	↗
FTSE Small	5437.0	0.8	45.2	↗
CAC	5153.2	3.9	191.5	↗
DAX	11299.8	3.6	393.0	↗
Dow	25788.0	2.7	681.7	↗
S&P 500	2765.9	2.1	58.0	↗
Nasdaq	7032.6	1.7	119.4	↗
Nikkei	20900.6	0.7	149.4	↗
MSCI World	2047.6	1.3	27.0	↗
MSCI EM	1039.2	0.3	3.2	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.7	16.0x	12.6x	13.2x
FTSE 250	3.6	20.7x	13.2x	14.1x
FTSE AS	4.5	16.8x	12.6x	13.3x
FTSE Small	4	-	10.9x	13.9x
CAC	3.4	15.8x	13.1x	13.4x
DAX	3.2	12.6x	12.2x	12.6x
Dow	2.2	16.5x	15.6x	15.0x
S&P 500	2	18.4x	16.5x	15.8x
Nasdaq	1.1	22.3x	19.4x	17.8x
Nikkei	2.1	15.4x	15.1x	19.8x
MSCI World	2.6	16.7x	15.1x	15.2x
MSCI EM	2.8	12.5x	12.0x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Micro Focus Int.	10.6	TUI AG	-11.4
AstraZeneca	9.6	Standard Life Aberd.	-4.4
Smurfit Kappa Group	8.9	Smith & Nephew	-4.2
Melrose Industries	8.5	Paddy Power Betfair	-2.9
Rolls-Royce Holdings	7.7	Next	-2.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.29	-0.68	OIL	66.0	6.2
USD/EUR	1.13	-0.49	GOLD	1316.5	0.2
JPY/USD	110.54	-0.73	SILVER	15.7	-1.1
GBP/EUR	0.88	-0.27	COPPER	278.9	-0.8
CNY/USD	6.77	-0.41	ALUMIN	1850.0	-2.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.160	0.8	0.01
US 10-Yr	2.668	1.3	0.03
French 10-Yr	0.536	-0.9	-0.01
German 10-Yr	0.101	16.1	0.01
Japanese 10-Yr	-0.021	27.6	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.40
10-yr Fixed Rate	2.64

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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