

# Market Overview

During the three month period to the end of September, Sterling weakened still further following the surprise 'Leave' result in the UK's European Union referendum in June. Generally, UK listed companies with significant overseas earnings made good gains and those domestically focussed companies, whose share prices had fallen sharply at the tail end of June, rebounded as the near term economic outcome of the Referendum has not been as bad as first feared. The FTSE All-Share Index returned 7.8% over the period. The fall in Sterling helped boost international equity returns for UK based investors. The FTSE World Ex UK Index returned 8.4% in Sterling terms, although in local currency terms, the return was 'only' 4.8%.

The best performing major equity region was Asia ex-Japan where the MSCI Asia ex-Japan Index returned +8.8% in local currency terms and +13.4% in Sterling terms, whilst US equities lagged (S&P500 Index, +3.9% in local market terms, +6.9% in Sterling terms).

Gilts continued to perform well as the Bank of England relaunched quantitative easing and its bond buying program (FTSE Gilts All Stocks Index, +2.3%). UK investment grade and high yield corporate debt outperformed gilts (BAML £ IG Index, +7.3%, BAML £ HY Index, +6.2%) as investors sought income further up the risk curve and the Bank of England announced that they would purchase corporate debt as part of their quantitative easing program.

The Brent crude oil price was relatively stable during the three month period to the end of September, falling just 1.2% to \$49/barrel. Towards the end of the quarter, OPEC surprised the market by announcing that it had agreed to limit output and that details of the decision would be released following the next meeting.

The gold price marked time following its strong performance during the second quarter. The gold price fell 0.5% to \$1316/oz by the end of the three month period. This translated into a 1.8% gain for UK based investors due to Sterling weakness against the US Dollar.

*Source: Bloomberg, Morningstar*

# Investment Outlook

Teresa May has, somewhat unexpectedly, announced at the Conservative party conference that Article 50 will be triggered before the end of March 2017. This establishes a clear timetable for negotiations and, assuming everything goes according to her plan, the UK will leave the European Union at the end of March 2019.

Whilst we now have certainty over the timetable, we have no clarity over what the UK's 'deal' with the European Union post Brexit will look like. However, with the control of migration at the centre of the Government's Brexit commitment, it looks as though the country's access to the European single market will come with conditions. Should an agreed settlement not be forthcoming, in the limited time available, then World Trade Organisation (WTO) tariffs will be applied from April 2019.

With the timetable now clarified, any suggestion that there may be a Brexit fudge seems limited and therefore companies weighing up investment decisions are unlikely to choose the UK over other European Union countries in the near term, particularly if there is a threat that tariffs could be applied to exports in just two and a half years' time. Furthermore, competition to attract financial services away from London will intensify.

These outcomes of Brexit, allied with increased imported inflation (due to a depreciating currency) will have a moderating influence on economic growth. The government is, therefore, right to flag that increased budget deficits are likely going forward, thus reducing the economy's resilience to further external shocks.

Whilst this is a rather gloomy prognosis of the near term impacts on the UK's economic growth, manufacturing (although small in proportion to the overall economy) is becoming more competitive as Sterling depreciates and activity should be well supported in the near term.

Thankfully, however the composition of companies listed on the UK stock market is highly international in nature and, given Sterling currency weakness, sales and profits which are generated overseas are worth more in Sterling terms. This is resulting in upgrades to estimates for companies with sizeable international operations and is helping support the market.

The weakness in Sterling is a symptom of international investors' concern over the outlook for the UK economy but it has been exacerbated by the nonsensical introduction of quantitative easing by the Bank of England. Quantitative easing increases the stock of money and therefore devalues the currency.

Currency devaluation works as an economic pressure valve by mitigating the day-to-day impact of an economic shock and increasing international competitiveness. However, if the devaluation is too great it can be detrimental, as it also ensures that goods brought into the country will go up in price and consumers' buying power will, all things being equal, be diminished. It is important that currency weakness doesn't overshoot.

We, therefore, do not support the Bank of England's renewed quantitative easing program and see it as further proof that central banks across the developed world are hooked on the provision of 'cheap money', despite the policy generating perverse outcomes which is throwing financial orthodoxies upside down. Several companies (let alone governments) are now able to issue debt on negative yields. This means that investors are happy to pay these organisations to hold their money for them.

We believe that the advent of extreme monetary policy (negative interest rates and quantitative easing) is justified should economic depression threaten (as per 2008/09), but is an unwise policy tool in all other circumstances. Indeed, we believe that it is hindering economic growth by failing to allow the economic cycle to take hold and flushing out unproductive, highly indebted companies from the system. By not doing this, productivity remains low and therefore economic growth potential also remains low.

Given that extreme monetary policy seems to be failing to stimulate robust economic growth, is there an alternative? The use of fiscal policy stimulus is gaining ground across developed markets and we would not be surprised to see the governments of developed economies utilise their cheap funding costs to accelerate fiscal spending. This is a credible response so long as it is done incrementally, and not in a 'big bang' as per Japan and China.

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*Source: Bloomberg, Morningstar*