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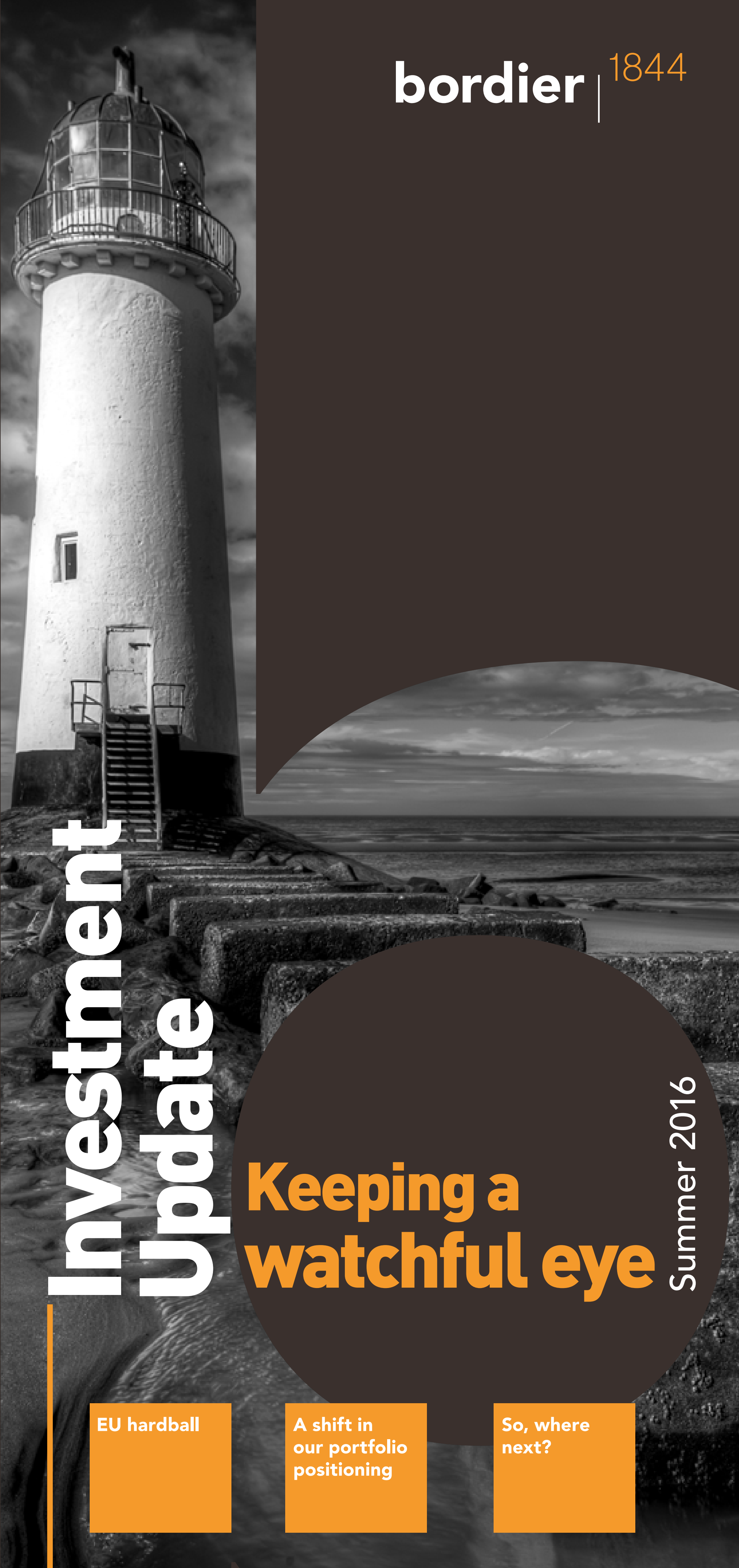

Investment Update

Keeping a watchful eye

Summer 2016

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Overview

It is clear that we are entering a period of heightened uncertainty for financial markets. Uncertainty not just for the UK, but the whole of the EU and probably the global economy as a whole: businesses will not know how politicians will tackle some of the difficult negotiations ahead, bond markets do not know what the policy responses will be and we do not know how consumers will respond either.

We can therefore expect an extended period of intense uncertainty at both a political and economic level. This is likely to translate into further market volatility and a backdrop that means proceeding with more caution than usual.

The initial response from global markets has been reasonably measured so far, with the exception of currencies and continental European stockmarkets, but it is the second response to the enormity of this vote that could be quite protracted, and possibly more acute. Despite Mario Draghi-like reassurances from Mark Carney, the Governor of the Bank of England, that the financial system and banks' capital requirements have been stress-tested against scenarios more severe than the ones currently being faced (and further reassurances from the Chancellor, George Osborne), the reality is that this is precisely what one would expect them to say. Frankly, we are in completely uncharted waters and those making these pledges have few clues at present as to how much support or intervention might be required, and when.

1 July 2016

EU hardball

As several initial statements and discussions indicate, other EU countries are expected to play hard-ball with the UK and press for an early triggering of Article 50 of the Lisbon Treaty, which sets out the conditions and timetable for EU exit.

EU leaders are understandably worried that UK's departure from the EU effectively gives a free pass to other countries in the EU family with similarly disgruntled factions to engineer something similar. It may be too soon to be calling this the start of the end of the EU, but whatever happens the UK's departure will make the EU a very different entity and further reform within it now seems a distinct possibility. It is therefore not surprising to see some of the larger stockmarket falls initially revolve around European bourses. The fact that the UK needs to sort out its political mess first before invoking Article 50 buys some time for markets and allows investors to assess the situation in a slightly more controlled manner. But it also gives more time for the uncertainty to persist, something which markets generally dislike.

A shift in our portfolio positioning

The global economic scene had already been facing several challenges ahead of the EU referendum and this backdrop had caused us to move to a more neutral stance on stockmarket positioning ahead of the vote.

Many of these challenges have probably become even more acute as a result of the referendum outcome: the decision probably stokes some of the fires that were beginning to burn, and risks testing policymakers' physical resources at a time when they can least afford it. From a UK perspective it is quite possible that the decision will threaten business investment and trade over the coming months, and possibly longer, to the point where the economy flirts with recession, even if this is temporary. Similar economic brakes are likely to be applied across Europe, whilst for other economies the impact could be less obvious initially but could filter through via currency movements and disrupted trade flows in due course. Japan, for example, may be forced to weaken its currency and the situation adds to the US dilemma over interest rate policy.

So, where next?

One thing seems certain in the coming months, which is that central banks will continue to act as shock-absorbers: monetary policy will surely be looser than it otherwise would have been had a 'Remain' vote been returned. It is quite possible that UK interest rates will now be cut rather than increased, as was the likelihood a few weeks ago.

Whilst a weaker pound should ultimately provide a much needed boost to the UK's export markets, it will equally increase the cost of imported goods. Higher UK inflation can therefore be expected. Under normal conditions some level of inflation could be considered positive for the economy, but these are not normal conditions and the risk of stagflation – even lower growth or stagnation in the economy, together with rising inflation – during the next part of this economic cycle is now a distinct possibility. The UK's Monetary Policy Committee, though, will probably look through any overshoot on inflation in the near term and not respond with higher interest rates. Inflation-linked bonds and gold are likely to see renewed appeal in such a scenario, so it is to these two asset classes that we are increasing and reintroducing exposure respectively. Having more assets, such as gold, linked to the US dollar also seems appropriate whilst sterling and the euro in particular face headwinds, and the prospect of higher US interest rates beckons.

In summary, having already toned down equity exposure and taken a more neutral stance during the second quarter, we are responding to the political and economic questions thrown up by the EU referendum outcome by further reducing stockmarket risk. This is principally focused on reductions in continental European, and to a lesser extent the UK, stockmarkets, where we expect the more challenging conditions to prevail in the near term.

We are also addressing the exposure to commercial property, which has been a solid diversifier of risk in recent years and delivered attractive and uncorrelated returns to equity and bond markets. Whilst the prospect of lower interest rates should help the property sector generally, the referendum result does create some significant uncertainty at a time when valuations in several sectors were already quite stretched and growth was beginning to slow. Weaker demand for property is likely to be seen in a number of areas, but particularly the London office sector, as businesses look to relocate operations and multinational workforces. Most impacted is likely to be the financial services sector, together with the professional services firms that have close ties with it, many of which rely heavily on skilled workers from overseas. Overall, the referendum result, and the expected decline in economic activity that surrounds it, is likely to create a more uncertain backdrop for commercial property as transactional activity slows and tenant risk rises. Whilst the longer term attractions and diversification benefits of commercial property remain, we are nonetheless reducing exposure to this asset class.

In conclusion

In the coming weeks and months it will be important not to become too distracted by the twists and turns in this specific political and economic debacle, but equally consider the significant overlap with, and impact on, the wider global economy:

economic growth in both developed and emerging economies was already facing several headwinds for the latter half of 2016 and beyond, and these have now been joined and accentuated by fresh EU and political risks. Before we know it, for example, the media and market heat on the Clinton-Trump pressure-cooker will have been turned up: the threat of higher US interest rates, and the complications of divergent global monetary policy, could therefore be firmly back on the agenda. The second half of the year could be just as lively as the first, but just because we are taking a more cautious stance with stockmarket and property positioning, does not necessarily mean that opportunities for making progress in the months ahead have been restricted. We are monitoring the position closely and, just like the underlying managers with whom we are entrusting day-to-day investment decisions for our clients, we will remain as active or inactive as is necessary in these unpredictable and challenging times.

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