bordier 1844

Investment Update

Spring 2016

Steady as she goes

Brexit – headwind for markets

Oil price keeping inflation at bay

So, where next?

Overview

The eventual outcome of the first quarter of 2016 has certainly been a lot more encouraging than it had looked in its first few weeks. During the sell-off few commentators would have predicted that we could have recovered virtually all the lost ground so rapidly.

Mark Robinson
Director
Chief Investment Officer

A recovery in the oil price from $27 a barrel to around $40 has been a significant influence behind the recent rebound in stockmarkets, with the energy and commodity-related shares that led the market down during 2015 being generally responsible for leading it back up again so far in 2016. Reaching the end of the quarter with values virtually unchanged from the year-end position is certainly an encouraging result, even if the journey to get here has tested nerves to the full. Keeping calm during this heightened period of market volatility, as we have done, and being in a position to benefit from the rebound has certainly paid off.

This recent rebound in markets is still set against a general backdrop of opposing forces. On the one hand we have the continued supportive backstop of central bank policy, which has cushioned market falls and restored some confidence, whilst on the other we have what appear to be more expensive valuations, particularly when viewed against a rather uninspiring backdrop for economic growth and corporate earnings forecasts. The latter influences are likely to act as a natural cap on markets pushing into significantly higher territory this year, whilst an extended period of monetary stimulus should continue to tilt the scales in favour of some risk taking. But as this update will go on to note, some scaling back in risk does now seem sensible.

Mark Robinson

31 March 2016

Brexit – headwind for markets

As far as a potential exit of the UK from the EU is concerned, this is seen as one of a number of risks facing markets over the coming months. The US election, for example, could be equally problematic for markets, and the possibility of the Chinese government weakening its currency remains alive.

Other emerging market currencies (and markets) could also come under pressure if US inflation begins to pick up and policymakers revert to a more progressive rate-tightening programme than the cautious one they are currently adopting. We continue to be wary of emerging markets, despite more attractive valuations relative to developed markets.

It is not for us to comment on whether the UK should remain in the EU or leave it – that decision will be left to voters in June – but there is a worry that the uncertainty over the vote will in itself cause some damage to the UK's economy, and possibly economies further afield, as business decisions are postponed ahead of the vote. The latest CBI/PwC Financial Services survey, for example, notes the concerns over China and the volatile start to the year, but also draws attention to certain investment decisions which are being placed on hold or scaled back ahead of the EU vote. Even the Bank of England's Financial Policy Committee, supposedly independent in its views, has issued a warning about financial stability, noting that heightened and prolonged uncertainty has the potential to increase the risk premia that investors require on a wide range of UK assets, which could lead to a further depreciation of sterling and affect the cost and availability of financing for a broad range of UK borrowers. It is not clear what damage is already being inflicted on the economy through the uncertainty surrounding the outcome of the EU referendum, but there is little evidence at present to suggest the economy is benefitting from it. Whilst the risks of an exit remain, we are likely to continue to see volatility in currency markets in particular.

Oil price keeping inflation at bay

Despite its significant recovery, the generally lower oil price is likely to keep inflationary forces at bay and the 'lower for longer' monetary policy backdrop is expected to be extended yet further, providing a supportive backdrop for investors. The latest comments from the US Federal Reserve reinforce the general market view that US interest rates are going nowhere in a hurry - these tempered expectations have in themselves been a calming influence on stockmarkets, but equally the Fed has acknowledged that, with rates so low, it now has little scope to stimulate the economy should it run into trouble.

This more recent dovish rhetoric from the Fed is in contrast to the messaging just before Christmas when it made its first move to raise interest rates. Then, the Fed signalled that we could expect four rate rises during 2016 – in a very short space of time, this guidance has changed quite markedly, despite some reasonably encouraging economic data. The Fed has therefore decided to err on the side of caution regarding rate increases, citing what it sees as "continued global economic and financial risks".

The Fed certainly needs to be careful in going it alone on changing policy, particularly at a time when the rest of the world is still in need of some significant stimulus. China, for instance, continues to take steps to sustain its ambitious growth trajectory, whilst the authorities in Japan and Europe are continuing to adopt loose monetary policy in response to weak conditions. The recent move by the European Central Bank to increase its monetary stimulus package received a mixed reaction from markets, particularly since negative interest rates and the collapse in European inflation could place European banking profits in particular under greater pressure: generally speaking, it would be difficult for the Eurozone economy to do well if, at its core, we have a weak banking system. Despite greater stimulus, risks have probably risen slightly in Europe although these are generally reflected in the cheaper valuations relative to other developed markets.

Although the forces inhibiting the Fed in raising interest rates look as though they are getting a little stronger, and the US economy (and markets) will undoubtedly benefit from this extended period of stimulus, this reprieve cannot last for ever. The longer it goes on, potentially

Oil price keeping inflation at bay

the more difficult the adjustment will be, particularly if the required monetary adjustment is markedly out of line with the rest of the developed world. That could prompt a flow of capital into the dollar when the economy needs it least, causing inflation to rise well beyond a point that is healthy to sustain the current momentum in activity – put another way, the longer the Fed leaves things, the greater the probable pressure build up and the greater the chance that transient capital flowing back into the dollar will damage the good work that has been done in recent years. Withdrawing the monetary medicine was never expected to be easy, and similarly, it is unrealistic to expect the world's policymakers to be synchronised in their action. These divided loyalties could bring some further issues for financial markets to grapple with as the year unfolds.

So, where next?

Overall, we see a number of headwinds facing markets over the coming months, including broad economic fundamentals which appear generally to be degrading rather than improving.

Additionally, whilst opportunities for active stockpickers remain, stockmarkets are no longer considered cheap and when overlaid with the various political events this year we feel that several things could remain an unsettling influence on markets over the coming months.

Our current stance of having full allocations to stockmarkets for each strategy has been in place for several years – this strategy has generally proved to be right during a period of post-financial crisis recovery and a backdrop of significant monetary stimulus that has favoured risk taking of some form. But we now feel that it is appropriate to take some stockmarket chips off the table and move to a more neutral stance given the different and somewhat more uncertain phase for the global economy that we appear to be entering. This should not be viewed as us becoming negative on market prospects for the remainder of this year. Similarly, it should not be seen as a stance taken surrounding the forthcoming EU referendum: it merely reflects greater prudence, recognising the slightly more unsettled and challenging backdrop for economies and markets. Markets are, after all, still expected to be supported by the extended period of monetary stimulus. We are not applying the brakes, but we do feel that it is prudent to press the accelerator with slightly less force than we have done in recent years.

Bordier & Cie (UK) PLC
23 King Street, St James's
London
SW1Y 6QY

Telephone: +44 (0)20 7667 6600
Facsimile: +44 (0)20 7930 2911
Email: enquiries@bordieruk.com
Website: www.bordieruk.com

Risk Warning, Disclaimer and Authorisation