CANACCORD Genuity
Wealth Management

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Brexit – the aftermath

July-August 2016 – Investment Market Update

“
If you want to see the sunshine, you have to weather the storm
”

– Frank Lane

Prepared for our discretionary and managed advisory services clients in order to give them a better understanding of the current outlook in the UK equities market.

As we continue to assess the economic climate following Brexit, it's clear we're not through the storm just yet. In our view, the impact of Brexit will be to reduce economic growth in the UK and Europe, push back expectations for interest rate rises in the US and the UK (and even set them into reverse in the UK), dampen corporate profits in constant currency and create an extended period of uncertainty, which, as we all know, markets loathe.

However, with every cloud there is a silver lining - and from a wider capital markets perspective, this is driven by the liquidity central banks often provide during such periods, or at least expectations thereof.

Sunshine and showers

After a very sharp drop initially after the referendum result became known, UK listed equities have since recovered strongly, driven higher by the weight of internationally oriented companies in the FTSE 100. It is now close to an all-time high (including dividends) having rallied by more than 12% from its post-result lows.

Conversely, sterling is now down around 10% in trade-weighted terms since then, and may be set to test all-time lows against the US dollar should worries over potential Scottish independence and difficulties over the actual terms of the UK's exit from the EU create further uncertainty. Anything deemed to have UK exposure has suffered, in stark contrast to international companies; housebuilders, broadcasters and banks have all been hit hard, while insurers have been hurt by their exposure to falling bond yields.

However, the fall in the pound has an almost automatic translational effect on revenues and profits earned overseas, which has helped UK-listed overseas oriented companies. It also helps UK-based exporters, although sadly there aren't that many of these listed on the London market. Anything deemed to be safe has also benefited from a rise in equity risk aversion.

Fixed income investors have also done well, as UK 10-year government bond yields have plummeted well below 1% - a level almost inconceivable even a year ago and completely out of touch with the UK's historically less than scrupulous track record of combatting inflation - 30% of world 10-year bonds now yield less than zero.

At least in the UK, the political vacuum that opened up after David Cameron's resignation has been rapidly filled, and the new administration can get on with the urgent business of framing the UK's terms for the impending exit negotiations. There are also signs that the new guard may be less masochistically wedded to the previous focus on fiscal austerity and may seek to stimulate the economy with increased spending, especially on infrastructure, a theme that may well develop in the US and possibly even Europe.

Preparing for all weathers

Immediately after the Brexit vote, we implemented our 'leave' contingency plan and cut portfolio risk by selling down both UK and European equities. At subsequent meetings we reappraised our long-standing underweight to fixed income and added slightly to UK-facing corporate bonds, on the basis that we now expect more Quantitative Easing and lower interest rates from the Bank of England.

However, we remain cautious in our short-term outlook with a good amount of liquidity and a large exposure to alternatives, with the aim of defending portfolio values in the periods of volatility we see as likely over the coming months. There are many conflicting pressures on global policy makers - and potential moves to perform an about turn on austerity through increased government spending (as discussed above), may have a very destabilising influence on asset prices. A cautious approach appears sensible to us.

This comes alongside an increasing flow of evidence that the UK economy is slowing down as a result of the decision to leave the EU - we now expect a shallow UK recession towards the end of this year and possibly drifting into early 2017. We acknowledge that elsewhere the US continues to move robustly ahead and Chinese growth has been rekindled by stimulus measures last year.

However, with an increased probability of additional government spending in the UK and Europe – due to economic weakness after the referendum result - and as Donald Trump and Hillary Clinton compete for votes in the US presidential election, the stage looks set for a growing conflict between ultra-easy central bank monetary policies on the one hand and less fiscal austerity from governments on the other.

Searching for warmer climates

As we seek out returns for our clients, our feeling is that in Europe and the UK the economic outlook is dimming, while in the US valuations are rather extended. What's clearer to us in the aftermath of Brexit is the range of emerging investment opportunities. For Europe and the UK, the economic outlook may not be so bright, but with lower interest rates for longer and strong secular momentum, there will be investment considerations away from the old continent and we continue to monitor these carefully.

Richard Champion
Deputy Chief Investment Officer

Our investment views as at July 2016

The view in this table refers to our balanced, risk profile 5 model portfolio. This risk profile has a benchmark with 57.5% in equities, 35% in bonds, 5% in alternatives and 2.5% in cash.

Asset class positioning	- -	-	=	+	++	Outlook	
Alternatives					■	↑	Viewed as a way of moderating portfolio risk.
Bonds (Govt)	■					→	Yields likely to decline further in the short term but worsening inflation outlook will need monitoring.
Bonds (Other)			■			→	Greater opportunities would appear to be available for strategic bond managers, but liquidity in certain segments needs to be monitored.
Commodities			■			→	US dollar strength, reduced demand and supply side response will restrain prices although a partial recovery has taken hold.
Equities	■					→	Equity markets will likely remain volatile in the short term. Brexit is a game changer.
Property (direct)			■			→	Yield, rather than capital growth should be viewed as the primary reason for investment.
Cash						→	Cash levels raised following the Brexit result. A continued rally would likely prompt a further increase in cash weightings.

Equity allocation	- -	-	=	+	++	Outlook	
Emerging markets			■			→	Valuations are now registering as attractive, but too early to buy. Monitoring potential for Indian equities.
Europe	■					↓	Euro area break up fears may resurface following Brexit vote.
Far East			■			→	Valuations appear cheap; China and global trade are key to the region's outlook.
Japan			■			→	Recent economic developments have been disappointing but stock market offers value and corporate Japan in good shape.
North America			■			→	Relative valuations are least appealing in a global context; but a safe haven market at present.
Sector specific					■	↑	Monitoring for potential entry point for new sectors such as Water and Agriculture.
UK	■					↓	Stock market likely to be a relative underperformer despite benefits of a weakening currency.

Currency allocation	- -	-	=	+	++	Outlook	
US dollar				■		↑	Close to previous highs. Interest rate backdrop and safe haven status continue to argue for the dollar moving higher.
Euro		■				↓	Euro as much at threat as sterling following Brexit result.
Sterling		■				↓	Sterling likely to remain weak for foreseeable future.

Indicative positioning of £ "balanced" portfolio.

'=' Weighting within 1% of benchmark. '+ / -' Weighting between 1% to 5% away from benchmark. '- - / + +' Weighting in excess of 5% away from benchmark.

** The outlook arrows indicate our expectation of future trends.

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