CANACCORD Genuity
Wealth Management

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1066 and all that

November 2016

It was on an October day in Hastings that one of the most famous events in Anglo-French rivalry took place – and marked a turning point in the history of England. While technically a Norman rather than French conquest, the effects of 1066 can still be felt today in terms of landscape, language and culture.

Some 950 years later, it is perhaps fitting that the UK economy was eclipsed by France last month - purely as a result of Brexit. The corresponding slump in the pound - which has fallen c.18% against the US dollar and 14% against the euro - placed the value of France's 2015 GDP slightly ahead of Britain's (based on current exchange rates). France, by this measure, has become the world's fifth largest economy, with the UK slipping to sixth.

While nowhere near as momentous, will October 2016 prove to be another seminal moment for the United Kingdom and mark a turning point in its relative fortunes moving forward?

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Sterling – falling through the floor

The UK's financial markets have felt the majority of the Brexit impact in the currency pits, although there have been knock-on effects in other areas. The question now is whether the bulk of the adjustment has been made - or will sterling continue to face a long and painful decline?

Given the speed and magnitude of the pound's adjustment, sterling would certainly appear to be oversold in the short term. Consequently, we may expect some recovery. This possibility is lent credence by the fact that - according to a recent Bank of America Merrill Lynch survey - sterling negativity is currently one of the most consensual trades.

Meanwhile, short sterling positioning in the futures market (bets that the pound will decline) has reached an all-time high. History has repeatedly shown that when positioning is this extreme, and sentiment is so pronounced, counter-trend moves often take place. Therefore, could we see a temporary rebound toward US$1.30? Absolutely.

That aside, it is very difficult to make a convincing argument for sterling displaying much long-term strength.

First and foremost, the uncertainty engendered by the Brexit negotiations will not end anytime soon and will likely be heightened when Article 50 is triggered. Regardless of the High Court ruling, this is still likely to be by the end of March 2017 and will mark the formal beginning of two years of exit negotiations.

While markets will crave some clarification on the UK's ultimate objectives and strategy, those involved will do everything they can to muddy matters - lest they give away their bargaining power in the process. To do otherwise would be akin to showing other poker players all of your cards before the betting begins. In such an uncertain environment, sterling will remain relatively unattractive.

Further, we believe that the UK's economic prospects have been fundamentally damaged by the referendum decision. UK Chancellor Philip Hammond was quoted recently as saying that some of the assumptions behind the UK Treasury's negative forecasts about Brexit "have already proved to be invalid". But there is little doubt in the mind of most independent commentators that the UK's growth potential will be lower in the years ahead than would otherwise have been the case.

> Should they prioritise growth by keeping rates low, or raise rates to combat inflation at the expense of activity?

The IMF currently forecasts that the UK economy will expand:

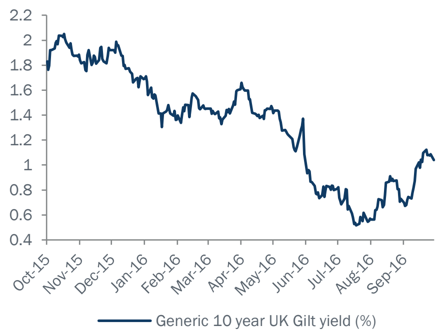
- 1.7% in 2016, 0.2% less than estimated in April
- 1.3% in 2017, 0.9% less than April's estimate.

With anaemic growth, there is a greater likelihood that the Bank of England will feel compelled to further loosen monetary policy. While expectations of a further rate cut have lately receded, it is certainly not out of the question. At the very least, Mark Carney has signalled he is prepared to ignore transitory inflation effects in setting policy moving forward.

If the UK were to succumb to recession – and again this cannot be totally discounted – history would suggest that a total sterling decline in the region of 35% - 40% should be expected. If repeated, this would imply that the pound could test US$1.10. There have even been suggestions in some quarters that - based on a technical analysis of 50-year charts - sterling could slump to US$0.79. While this is certainly not our base case scenario, it does caution that sterling could fall further.

UK Gilts – fundamentally unappealing

Generic 10 year UK Gilt yield



Source: Bloomberg - October 2016

Having initially rallied in the two months following the Brexit decision, Government borrowing costs have recently spiked higher. This is partly in response to the perceived higher risk of investing in the UK. It also reflects the near-term prospect of higher inflation, with import prices set to climb as a result of sterling's retrenchment.

The Bank of England currently expects that inflation will hit 2.8% over the next two years. Meanwhile, the five-year breakeven inflation rate (calculated by subtracting inflation linked yields from their nominal equivalents) has surged to over 3%.

If inflation does become entrenched, leading to higher wage demands at a time of subdued growth, this will raise an interesting policy dilemma for the Bank of England. Should they prioritise growth by keeping rates low, or raise rates to combat inflation at the expense of activity? Either way, the backdrop for Gilts doesn't appear to be particularly enticing at this moment in time.

In some ways, it is curious that despite the UK's many travails, Gilt yields remain below those of US Treasuries, irrespective of US interest rates heading higher at a faster pace than other economies. With 10 year UK Gilts yielding just over 1.2% at present (while US Treasuries offer nearer 1.8%), Gilt prices would fall by approximately 5% at this maturity if yields were to converge at this higher level. Should Gilt investment command just a moderate yield premium of 0.5%, the price fall could equate to near 10%.

UK equities – a ray of hope

The one ray of sunshine in this rather bleak UK landscape has undoubtedly been the performance of UK large cap stocks, as characterised by the FTSE 100. Since the lows of 27 June, this market has climbed nearly 18%. It is no co-incidence that this almost exactly matches sterling's decline over the same period – with these gains entirely attributable to currency weakness.

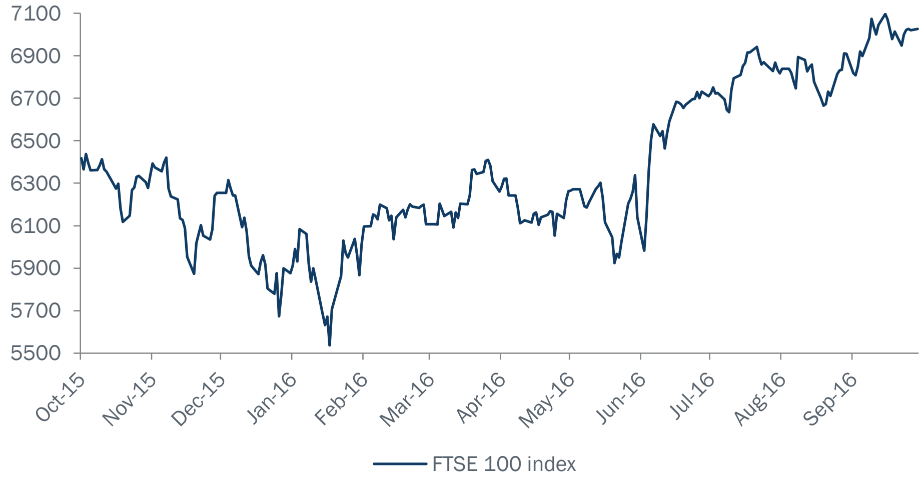
As well as a positive translation effect from revenues and profits earned overseas, over 40% of dividend pay-outs by UK listed companies are in either euro or US dollars. It has been estimated that this will provide a UK dividend windfall of £5 billion, with a further £4 billion to come in 2017 if sterling stays near US$1.23. Should it fall to US$1.10, this windfall would rise to £8.3 billion and would hit £11 billion if sterling and the US dollar were to trade at parity.

Typically, consumer staples and healthcare stocks lead the way during periods of currency weakness, although on this occasion energy and mining companies have also been at the forefront of market moves. While this has been good news and further currency declines will act as a continued tailwind, investors should be wary of extrapolating past trends too far into the future.

Consumer staples (and most bond proxies) are far from cheap. Healthcare may be held hostage to the fortunes of the US election, while energy and mining could succumb to a retrenchment in commodity prices.

At a general level, UK stocks are facing declining relative forward expectations, while the market's return on equity has slumped to near 8%, well below a long-term average of 14%.

FTSE 100 index



Source: Bloomberg - October 2016

Remain cautious

From an investment strategy perspective, it has become increasingly apparent that the driving influence of central banks is beginning to wane. Increasingly, it will be political developments which will be the key swing factor in determining the performance of financial markets.

This is not just about the US election, although clearly this is extremely important in the short term. Like most rational investors, we hope Hillary Clinton will win. But equally important will be the congressional elections – and barring a dramatic turnaround, the Republicans should retain control of at least the House of Representatives. While some might argue this just increases the risk of political gridlock, the checks and balance it provides should ultimately prove to be a positive development.

Investors will also need to consider the nuances of the Brexit negotiations and the forthcoming Italian referendum on 4 December on moves to reduce the power of the Senate. If the vote is no, Italian banking strains would re-emerge which would be negative for risk assets.

Further, the US Federal Reserve is likely to increase rates during December. While markets should take this in their stride, as December 2015 proved, this cannot be taken for granted. Markets will also require evidence that US corporate earnings are supportive of current valuation levels.

The reporting season has been encouraging, but this needs to continue. It is too early to discount risks and we believe it is appropriate to remain cautious.

Justin Oliver
Deputy Chief Investment Officer

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Our investment views as at November 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 unlikely to decline further in the short term and increasing inflationary pressures are a key risk.
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. A positive US earnings season is imperative. Political risks have risen.
Property (direct)			■			→	Yield, rather than capital growth should be viewed as the primary reason for investment.
Cash				■		→	Cash levels reduced gradually over past couple of months. Further setback would prompt further redeployment of liquidity.

Equity allocation	- -	-	=	+	++	Outlook	
Emerging markets				■		→	Emerging markets have been a beneficiary of increased risk appetite since February. A small allocation to India has been established.
Europe		■				↓	Euro area break up fears may resurface; Italian referendum on 4th December very important.
Far East				■		→	Valuations appear cheap; China and global trade are key to the region's outlook. Chinese debt levels and housing bubble are a concern.
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. US election a key consideration.
Sector specific					■	↑	Monitoring for potential entry point for new sectors such as Water and Agriculture.
UK	■					↓	Stockmarket has been boosted by a weaker currency, but company fundamentals have deteriorated.

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 weakness expected to persist.
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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