DELMORE
ASSET MANAGEMENT

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All change please, all change!!

"I believe in confronting the issue… Not simply hoping a difficult situation will go away" said David Cameron on the EU referendum in January 2013. Well, following the result of the EU referendum, the difficult situation has not gone away… it has arrived!

In the immediate run up to the referendum, global equities rallied 4% and sterling rose 5% against the dollar (one of the strongest gains on record!). The subsequent flight to safety post the Brexit decision caused bank stocks to crash, along with insurers, housebuilders and real estate. In the two weeks since the outcome, a number of property funds have been gated after getting themselves caught in a 'vicious circle of redemptions' (Don't be alarmed; it is against Delmore policy to hold such funds!)

The UK government is in disarray, Cameron has stepped aside and left the problem of Article 50 to his successor, who we now know will be Theresa May. Mrs May was, somewhat counterintuitively, quietly in the remain camp; however she has pledged to fulfil the wishes of the British public and negotiate Britain's exit from the EU. She will have to decide what is more important in the negotiations – access to the single market or tighter controls on immigration? The UK has been forewarned that they will not be able to have their cake and eat it.

EU member states are refusing to negotiate with the UK until Article 50 has been invoked and Theresa May claimed she will not invoke Article 50 until the beginning of next year. This would mean the UK faces an initial six-month period of uncertainty at a minimum before negotiations even begin. This would then be followed by a further two years of uncertainty while agreements with the EU are ironed out. It is important to note however that the UK will remain a member of the EU until Article 50 expires, at least 2 years after it is invoked.

So how bad is it? The economic outlook has clearly worsened for the UK and Europe. UK GDP growth has been revised down from 2.0% to 1.5% in 2016 and substantially down from 2.0% to 0.2% in 2017. Investment in both the UK and Europe will likely contract in the second half of this year and many analysts believe the contraction will be severe enough to lead the UK into a recession. Simultaneously, sterling looks set to depreciate further and consequently inflation will pick up meaningfully towards the end of 2016 and well into 2017.

The Bank of England seems to be the one institution that has behaved responsibly throughout. The markets are predicting a cut in interest rates and the resumption of quantitative easing in the coming months to ease the economic pain inflicted by Brexit. This was the market assumption because there was no government, now that Mrs May will take the helm in the next few days we could also see a programme of fiscal adjustment to help cope with the crisis.

The economic growth forecasts mentioned above are no more than best guesses, as this situation is unprecedented given the popular determination to control immigration at the expense of stronger economic growth. The other big question relates to the speed which businesses will react to this new situation by reducing their UK presence and beginning to increase their European and global footprint.

The big question now facing us is where will the effects of the Brexit vote be felt most keenly over the next 12 months and how can we position the portfolios to take advantage of the volatility in the markets. Most asset classes appear expensive at present. Since the Global Financial Crisis, the joint rally of equities and bonds means that both remain expensive whilst cash provides a minimal return.

Equities will probably remain volatile and defensively positioned over the next six months. We expect the FTSE 100 to benefit from the c.80% of revenues that are generated outside the UK. Defensive, international companies and those with high dividend yields may provide some stability during this volatile period, but payout ratios are becoming stretched so we will focus on companies with sustainable dividend yields and good cash generation.

Volatile markets also create pricing opportunities and we will look to take advantage of them where we see fit. We could easily see an uptick in UK M&A activity from foreign buyers as happened on previous occasions with substantial sterling weakness in 1992 and 2008, but like the rest of this saga we do not have a definitive map.

Over the last five years the total return from the FTSE 250 has marched away from the FTSE 100 index by over 25%, however recent events have hit UK domestic stocks badly and the current revaluation could be exacerbated by falling domestic earnings. Banks in continental Europe may have access to adequate liquidity but they are still carrying too many poor quality loans and persistent low bond yields are affecting the banks' profitability. We could see a number of profit warnings and subdued confidence during the forthcoming results season. The speed of the commercial adjustment across Europe and the size of the fall in UK consumer confidence will be the key factors to watch.

Many businesses have started to examine carefully their scope for reducing activity in the UK and the best locations available in terms of qualified labour and modern infrastructure within the EU. As wealth managers we would dearly hope to give our clients some protection against the expected fall in UK activity caused by the Brexit result whilst identifying those areas and businesses outside the UK which should benefit from some of the relocation traffic.

The above scenario suggests that continued uncertainty in the UK and a fall in both consumer spending and confidence is clearly on the cards. Identifying those areas and businesses which are set to gain most from the UK's folly will be a longer term task. Most of our portfolios had a significant exposure to US dollar stocks for some time and we have increased this further relative to other locations over the last few months thereby benefitting from the continuing durability of the US recovery and the strength of the US dollar.

Another factor which will need continued monitoring is the value of the pound and the strength of the UK bond markets. At present bond markets, both government bonds and corporate bonds, have held up well, but we are concerned that the Bank of England's current inflation forecast is too optimistic (and not high enough) given the UK's high propensity to import goods and services. As the pound consolidates around these levels, or even moves lower, the cost of living, particularly food and energy, will be discernibly higher. This might result in a further fall in the value of the pound as overseas confidence is hit.

Source: Financial Times

If inflation starts rising meaningfully we will need to increase further our holdings in real assets. Namely; shares, alternatives, index linked securities and even some carefully targeted property exposure. Such a scenario will have a clear effect on asset markets, it will create problems for the Bank of England, and ultimately the Government; when it is back in business.

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