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FINANCIAL PLANNING

Market Update

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SQUARE MILE
INVESTMENT SERVICES

As we near Brexit day, which occurs at the end of March next year, Theresa May has finally published how the UK government envisions the ongoing relationship with the EU will be structured. Unfortunately, this was not deemed satisfactory by members of her Cabinet, a significant part of Parliament and all the other members of the EU. There appears to be no obvious solution that meets the requirements of all parties involved and we shall see over the coming months whether some sort of compromise can be found. The Brexit process has undoubtedly held back growth in the UK economy, as businesses avoid committing to long term plans with this overhanging. Against this backdrop it has been a poor quarter for UK asset prices which have been weighed under by the uncertainties. We don't know what the outcome will be nor frankly do we know what the impact will be on UK asset prices, other than to point out that sterling is likely to weaken further if we end up with a 'hard' Brexit. We have recently surveyed some of the best UK fund managers on the issue and got such a disparate set of responses that we can safely conclude they don't know either. Given that the majority of revenues of the largest listed UK companies comes from abroad, determining what combination of currency moves, business confidence and economic growth would be best for the market performance is virtually impossible given the complexities of the Brexit process. As such, our strategy has been to hold much less exposure to UK risk assets in the portfolio than we would normally have. This has worked well over the quarter, though if UK assets become cheaper and therefore better value in the run up to Brexit day, this is a position that we are willing to change.

The UK held back by Brexit worries

The portfolio has made progress over the quarter largely thanks to the performance of the US stockmarket. President Trump's policies are showing signs of invigorating the US economy, at least in the short term. We have a sizeable exposure to this market principally through the position in the Vanguard US Equity Index fund, up by 8% over the quarter, as well as some indirect exposure through funds such as Polar Capital Global Insurance, which climbed by over 10% during the period. The American market is an expensive one but recently companies have managed to do even better than expected. We do have some doubts about the medium term sustainability of Trump's economic policies, which come with some very real risks associated with them, but for the moment we are happy to participate in the upside.

Trump is gradually ratcheting up the trade war. Months of tweets and threats are finally moving onto action. Trump is trying to improve US trade conditions and so far he has achieved some minor successes such as with Mexico and Canada. However, his principal target, China, has so far displayed little willingness to bend. For now the size of the tariffs are relatively small in what are enormous economies, however, Trump is showing every sign of wishing to escalate the matter further. This is certainly unhelpful for businesses although the impact on the stockmarket largely has been muted. Elsewhere the emerging markets have been hit this year, however, trade issues are only one of a catalogue of woes affecting the region, ranging from dollar strength, domestic political issues and in the case of China, the curbing of private debt levels. Nevertheless, we are retaining our positions here, both in equities and fixed interest. Valuations are cheap, which is not something that can be said about developed markets, and the region traditionally does well when global growth is strong as currently is the case.

The portfolio's progress this quarter demonstrates the benefits of diversification. Troubles in the UK and emerging markets have been more than offset by the buoyant US stockmarket. However, we should caution that diversification has its limits. We think one of the principal risks currently facing investors is a pickup in inflation. Consumer prices have been subdued since the financial crisis but there are signs that pressures are building. Unemployment rates in the UK and US are approaching levels not seen in over a generation and the oil price has been quietly climbing to over $80. Inflation has picked up slightly but remains low. If prices do start to rise in an unacceptable manner, central banks such as the Bank of England may be forced to lift interest rates much quicker than markets currently expect. Given that most financial assets are priced on the basis that interest rates will remain low, this could have an unpleasant impact across all markets, which would be difficult to avoid. For this reason we continue to hold more cash and near cash instruments than we would normally. However, if inflation keeps at bay, and global growth continues to lift company profits, this should allow the portfolio to make further progress.

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