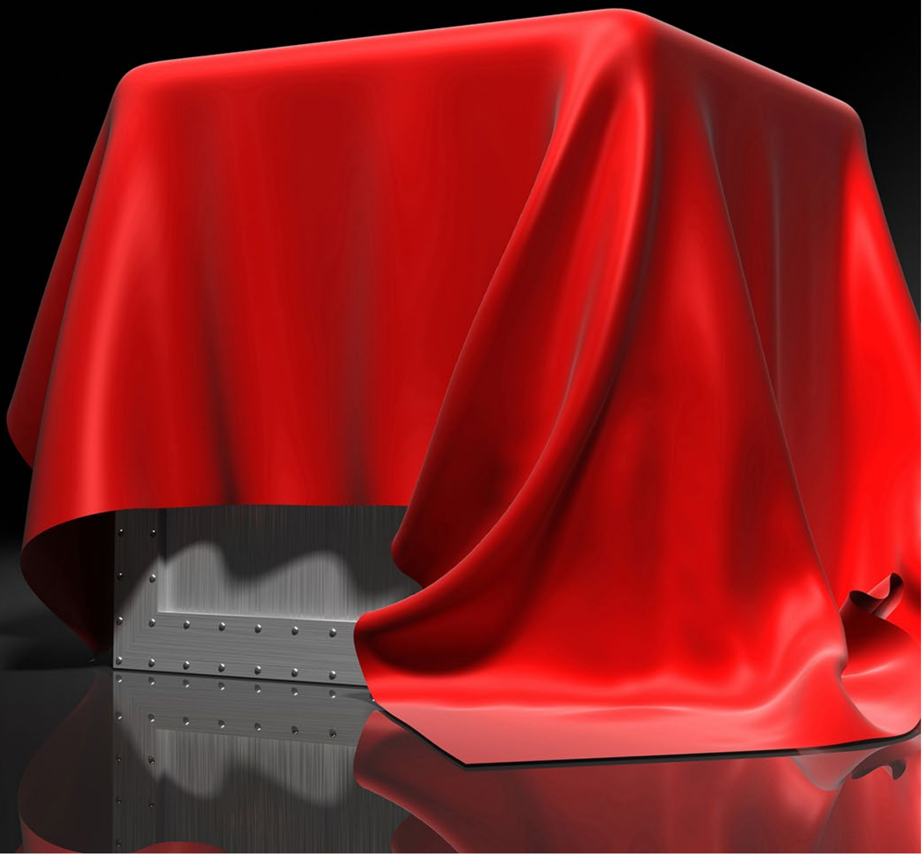

Investment Newsletter

March 2019

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Deal or no deal?

Writing about Brexit is always a difficult challenge as anything I write will almost certainly be out of date by the time it is published!

For example, earlier this week (Tuesday 12 March) I attended our monthly management team meeting. That morning had seen the pound go up, and by the time I left my desk to go to the meeting it had hit $1.32 against the US dollar.

When I left the meeting two hours later, the exchange rate was $1.30! Moving two cents in a couple of hours used to be highly unusual. Nowadays it happens relatively frequently.

We're often asked for our views on Brexit and we're always happy to share. However, the truth is that we don't have more of an insight into how things will play out than anyone else watching as closely as we are.

I'm writing this on the morning of Thursday 14 March. On Tuesday, Theresa May's Brexit deal was rejected by parliament. Last night saw an extraordinary turn of events where the government's own motion against a no-deal Brexit, which Mrs May had said she would vote for, was amended by pro-European MPs.

The government then whipped its MPs to vote against its own motion. Many MPs including cabinet ministers defied the whip and the motion passed. The pound is now $1.33.

So, parliament has rejected a no-deal Brexit but it remains the default option. It is likely the government will ask the EU for an extension of the Article 50 period, but of course the EU may not agree to this. They have said they would only do so with good reason (perhaps for a new referendum or election). It also only takes one of the 27 countries to say "non" "nein" or "le" (Maltese for "no"!) to a request for delay and we're back to a no-deal Brexit on 29 March.

In that instance, if parliament still wanted to avoid a no-deal then they would have to vote to revoke Article 50, which the UK is able to do unilaterally. Where we end up if that happens is anyone's guess. It could involve a second referendum or election, or we could immediately re-invoke Article 50, re-starting the two-year clock!

My best guess is that May's deal passes at a third reading, backed by Brexiteers faced with the choice of May's Brexit or no Brexit. However, much can still change, and the point remains that we're two weeks from 29 March and we still don't know whether we'll eventually end up with a no-deal Brexit, no Brexit at all, or something in between.

Portfolio management

You would imagine that this would make running an investment portfolio extremely difficult.

Whilst it would be nice to have a crystal ball and be able to predict the outcome of Brexit, the US/China trade talks, or just which direction the market's going to go, we don't need this to manage portfolios.

Instead we rely on forward planning, quick reactions, and balance.

Balance is perhaps the most important aspect. Within portfolios we will always have a mixture of assets and regions and these will all react differently to different scenarios.

For example, more than half of the equities we hold in portfolios are overseas. If there is a no-deal Brexit, our UK equities may well fall. However, the pound would almost certainly fall too, possibly very sharply. Clearly that has a long-term impact on the UK economy, but in the short term it cushions the blow to portfolios because the overseas assets would go up in sterling terms.

We still think no-deal is the least likely outcome and some form of deal after a delay is more likely. However, as you may know, we've had a written Brexit planning document for some time which details what we think might happen in various scenarios. This is still a "living" document and subject to change, but I thought we could share some of the points in table one.

We've very simply divided the document into "deal" and "no-deal" although there are, of course, a multitude of actual outcomes! Many of the possible outcomes under the "deal" heading would also be true in a "no-Brexit" scenario. A delay typically prolongs the uncertainty but might result in a "softer" version of some of the outcomes we'd expect in the event of a deal.

Of course, this table is not an exhaustive list, and we may well be wrong about some of the potential outcomes but knowing what we might do in advance can save valuable time.

What	Deal	No deal	Portfolio implications / actions
Sterling	Up above USD $1.35 or even $1.40?	Falls to $1.20 or below	Overseas equities fall/rise in value due to currency movements
Monetary policy	At least one rate increase to 1%. Possible second increase in six months.	Initial rate cut to 0.5%, possibly to 0.25%? QE? But if sterling fall becomes a crisis then might be forced to increase rates – what if <$1.10???	
Fixed interest	Gilts sell off due to better sentiment and likely rate increases. High yield outperforms as credit outlook more stable.	Gilts rally in flight for safety trade and due to rate cuts. Index linked gilts outperform due to inflation element. UK high yield could suffer due to perceived credit risk.	Deal - sell index linked gilts immediately. No deal - reduce high yield– longer term.
Property	Market as a whole stabilises. Retail sector stabilises (though long-term challenges remain) Flows return to asset class? Funds eventually move from bid back to offer?	Slow downturn in market continues / accelerates. Likelihood of large outflows lower than after referendum but gating still a risk. Retail sector and London office market hit hardest.	Deal - considering add to exposure longer term. No deal – sell funds most exposed to retail and those already on a bid basis.
UK domestic equities	Stocks likely to jump on deal. Continued longer term increase as overseas investors see value.	Stocks fall sharply 10%+?? But stocks already cheap and factor much of this in already?	Deal – consider adding to holdings to take advantage of momentum. No deal – depends on extent of fall - potential top up if down 10%+ due to valuation.
UK multinational equities	Stocks rally somewhat (but not as much as domestic). Overseas buyers perceive them more attractive.	Stocks fall initially. But fall in pound cushions this due to international earnings.	Volatility trade purchase of FTSE tracker if market falls sharply. Sell existing vol trade FTSE tracker on rally.

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Brexit hedge

For some time, we've held a position in index linked gilts (typically 3% of portfolios). We've always described this as a "Brexit hedge". In a no-deal scenario the combination of rate cuts, rising inflation, and the flight-to-safety appeal of gilts means we think it would go up sharply.

The problem is that the opposite is true. This asset class has done very well since the referendum and tends to jump whenever concerns over Brexit rise. However, it would likely fall sharply should these concerns go away.

Chart one shows how volatile this asset class can be. Whilst we still want some exposure in this sector, we have also been trimming our position recently to bank the gains we've made and guard against a drop. The chart shows the returns of the index linked fund we hold in portfolios over 12 months, and shows where we've made sales, totaling around half of our holdings.

Of course, the above actions only describe what might happen in the short-term around the period we get Brexit certainty (if we ever do!). Longer-term implications remain to be seen and we will, of course, adapt portfolios accordingly.

However, it is important to remember that Brexit is by no means the be all and end all for investment portfolios. We invest all around the world, and what happens to the US and China, the world's two largest economies, is probably much more significant for portfolios in the long-term.

We must also always assess the balance between valuation and outlook. When the outlook seems dark and nobody wants to invest, stock markets can become relatively cheap, and that can often be a great buying opportunity.

Likewise, markets can get pretty expensive when the outlook is rosy. Markets therefore tend to overshoot fair value in both directions, which can give rise to opportunities as well as risks. Our job is to weigh up valuations against outlook before we decide how much to hold in a particular asset.

Right now, we think that most stock markets are reasonable value. We also think the global economic outlook is ok but not fantastic and that growth will probably slow this year. However, we also think it's unlikely we'll see a global recession.

As a result, taking a medium-term view, we expect market returns to be roughly in line with long-term averages. Volatility in the short-term is just something we have to live with.

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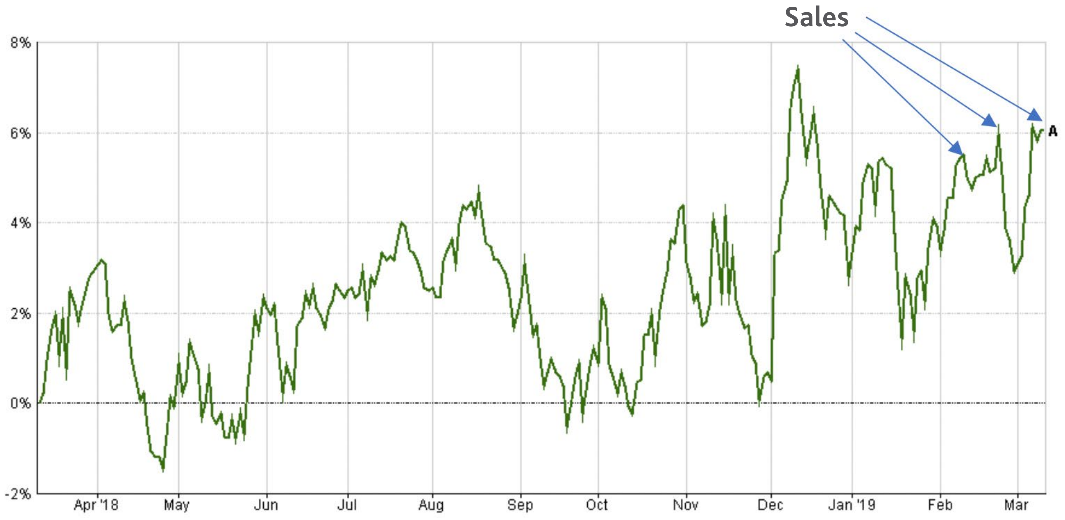
Chart one: Returns of All Stocks Index Linked Gilt Index Trust over the last 12 months



A - L&G - All Stocks Index Linked Gilt Index Trust (6.04%)

Source: Data from FE 2019. 12/03/2018

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General economic overview

Economic data remains mixed with global manufacturing indicators showing signs of weakness, especially in Europe, Japan and China. These are major exporters that have been hit by the ongoing trade war. Much depends on the outcome of US/China trade negotiations.

Having said that, there are signs that China may have turned a corner after acting to stimulate their economy. Services have also held up much better than manufacturing, and whilst we expect the global economy to slow this year, we also expect that it will still grow.

In the UK, Brexit dominates the outlook for the economy, inflation and interest rates. In the US, interest rate increases appear to be on hold for the time being.

Equity Markets

Stock markets have clawed back some of the ground they lost during the latter part of last year, but most remain below their peaks. This has left some areas looking decent value, notably in parts of Asia including Japan, and in the more domestically focused end of the UK stock market. Many international investors continue to avoid the UK due to Brexit concerns, but may reconsider should we get more certainty on the outlook.

Fixed Interest

We expect that any interest rate hikes will be small both in the UK and the US. Credit conditions also remain relatively benign at the moment and so we expect reasonable but not spectacular returns from fixed interest. We generally prefer corporate bonds to gilts.

Commercial Property

The UK property sector is struggling for momentum with the current uncertainty over Brexit. The retail sector has structural issues driven by the switch to online shopping, however this same trend has driven growth in the industrial sector. We remain underweight property and relatively defensively positioned.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced Asset Allocation

For a typical balanced portfolio, we are underweight fixed interest and property, and slightly underweight traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent the collective views of Equilibrium Investment Management (EIM). The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.