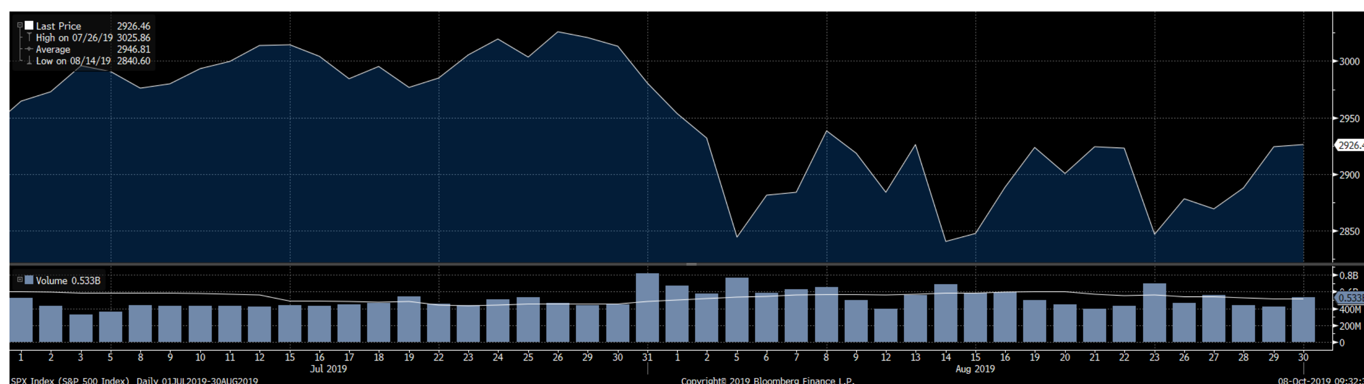
Market Review – Global Growth and Brexit

We had anticipated some weakness in global equity markets to occur over the summer period, which traditionally can be a weaker period for markets. This weakness would arise mainly due to lower liquidity levels and we covered this in our previous letter to you. These market jitters duly occurred from early August, this following renewed and unwelcome trade tensions arising between the US and China as Donald Trump stated he would impose a 10% tariff on $300 billion of Chinese imports that were not already subject to U.S. duties imposed in previous trade spats. The new tariffs announced were to take effect from 1st September 2019.

This helped to increase volatility in global equity markets in August, with the S&P 500 falling around 6% from a new all-time high of 3025.86 established in late July.

At around the same time, corporate profits in the US - which were expected to cool in the second quarter of this year - rebounded as companies cut investment spending. This then helped to negate some of the negative impact of the continuing trade tensions with China in August. Again, at the same time, strong U.S. consumer spending figures were released which indicated that the US consumer (who drives about two-thirds of total U.S. economic output) continued to be a positive driver of U.S. economic growth. This together with an improving U.S. labour market has provided a solid underpinning to ongoing US growth, giving the MPL investment team sufficient confidence to increase the allocation to US equity in August.

US S&P 500 Index July to August 2019



Source: Bloomberg

Lacklustre economic data emanating from other major regions of the world however has heightened concerns regarding global economic growth overall, which increases the focus upon those economically sensitive and cyclical holdings within our client portfolios, these sectors being the consumer services, financial services, and industrials.

Even the U.S. Manufacturing PMI (Purchasing Managers Index) as reported by The Institute for Supply Management fell to 47.8 (where any reading below 50 indicates a contraction of activity) for September, the lowest in over a decade. The far larger services sector however is still growing, albeit at a slower pace than previously predicted and at a three-year low at 52.6.

The UK economy continues to struggle according to the Markit/CIPS forward-looking Purchasing Managers Indices. The Services PMI here dropped to 49.5 points which is below the 50-point threshold which separates a sector that is expanding from one which is contracting. The contraction of the UK services sector (by far the largest) has now joined simultaneous contractions in the Manufacturing and Construction Sectors. Brexit-related concerns continued to dominate the September PMI surveys, which companies indicated had led to falling sales, cancelled and postponed projects, a lack of investment, and job losses.

On Brexit, UK Prime Minister Boris Johnson has finally laid out his plan for a resolution, which basically includes keeping Northern Ireland aligned in some aspects with the EU, and at the same time also with the

UK. Importantly, both the Democratic Unionist Party in Northern Ireland (who currently help to prop up the minority Conservative Government in Parliament) and most of the Conservative hardliners pushing for Brexit, have now publicly backed this plan, a major move forward from Theresa May's earlier solution.

In Europe the reception to the plan has been mixed, with European Council President Donald Tusk quickly declaring himself to be "unconvinced" by it, but tentatively positive comments received elsewhere. This makes the MPL investment team's current underweight stance in UK equity markets more intriguing – it seems clear we are probably and slowly edging closer to some form of defined (positive) outcome in respect of Brexit. This will provide more certainty (which market participants absolutely want) one way or another. What is most intriguing is the impact that Sterling will have upon UK markets if this Brexit-related uncertainty were to cease. Furthermore, there would be a removal of the significant Brexit discount which has been applied to UK equity market values since the referendum.

If the Prime Minister can find common ground with Europe sufficient to agree a deal, the Pound will rally against other global currencies in the interim. Yet in the short term a Sterling rally would be a headwind to the valuations of companies within the FTSE-100, whose earnings are largely derived overseas; FTSE-250 stocks would also be affected but to a lesser extent. However, the resultant certainty which may result from a deal could see the removal of the current UK-wide value discount, which will probably outweigh the negative impact of Sterling strength, with the result being a net positive rally in UK equity markets under this scenario.

If however delays persist with Brexit then the value discount will remain, and if we add in the prospect of another general election in the UK then political risk increases, which would be a negative for Sterling, although a positive in the short term at least for the FTSE-100 and 250 companies given that a weaker Sterling would enhance their overseas earnings.

Portfolio Allocation

On the global front, we cannot ignore the wider economic picture. In August, whilst we allocated higher weightings to Information Technology and US Large-Cap equity sectors, this was done with slower economic growth in mind and with a focus upon non- or super-cyclical companies which will continue to thrive in a slower growth environment. An increased allocation was also made to UK Commercial Property which had been sold off unjustifiably due to Brexit concerns.

The continued impasse in the US / China trade talks and the impact of this on economic growth in Asia and the Emerging markets, have forced us to delay any plans to increase exposure to Asian and Emerging Market equities. While valuations remain compelling and especially so in Emerging Markets, economic growth there remains muted due to the continued trade issues between the US and China and the negative effects on regional and global investment spending and growth that this is causing.

As set out above we also cannot ignore UK equity valuations which remain distinctly weak in comparison to equivalent companies in both the US and Europe. Our investment team have had numerous debates as to how to approach the dilemma of these current low valuations and the outstanding Brexit issue here - and have formed the opinion, in line with the above comments, that we will slowly increase the existing exposure to the undervalued UK market as political events unfold over the next few months.