May provides welcome leadership
The new prime minister has formed a cabinet from both sides of the referendum debate, which is good news for the UK economy and stock market

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In the aftermath of the European Union (EU) referendum, our politicians seemed to suffer a collective meltdown. A lovers’ tiff destroyed the leadership hopes of arch-Brexiteers Michael Gove and Boris Johnson and left us facing months of political uncertainty until the Conservatives elected a new party leader.

Fortunately reason and national interest prevailed: in just a few days, Theresa May was elected and took over as prime minister. Her decisive leadership in forming a cabinet from both sides of the referendum debate caps the political uncertainty, which is good news for the UK economy and stock market.

Financial markets fell sharply following the referendum result, but quickly started to evaluate the implications. The FTSE 100, whose constituents generate most of their revenues from abroad, bounced back strongly, whereas many FTSE 250 stocks remained in the doldrums, discounting the risk of a recession in the UK.

To mitigate this risk, the Bank of England is likely to cut its base rate and may unleash more quantitative easing, albeit not until the economic picture is clearer in August. Our lead article explores these themes in more detail, although in our view a recession is by no means certain.

Sterling weakness is good news for British exporters because it makes the cost of their goods more competitive abroad. It also boosts companies’ overseas earnings. Additionally, as we explore in an article about indices on page 7, most large firms predominantly operate outside the UK, so the impact of Brexit on the FTSE 100 should be limited.

Looking beyond the UK and Europe, on page 6 we take a closer look at the US economic recovery, which we believe remains on track. On page 8, we explain why there are plenty of positives associated with Japanese equities even though the market remains unpopular with many investors. Lastly, on page 9 we examine globalisation, which has changed substantially in nature since the 2008 financial crisis.

I hope you enjoy this edition of Investment Insights. Please visit rathbones.com to keep abreast of our latest views on Brexit and other issues.

Julian Chillingworth
Chief Investment Officer
May provides welcome leadership

The unexpectedly swift transfer of power from David Cameron to Theresa May and her impressive decision-making in forming a cabinet from both sides of the referendum debate cap political uncertainty, which is good news for the UK economy and stock market.

It took financial markets several days to absorb the ramifications of the vote to leave the EU, but British politics was shocked to its core and it seemed that the leadership vacuum in both major parties would drag on into the autumn with negative consequences for the economy.

Instead, following the unexpectedly quick resolution of the Conservative Party’s leadership election, Theresa May has taken office. Her decisiveness in forming a new cabinet and initial guidance mean it is likely that the UK will leave the EU by early 2019 without another referendum.

Philip Hammond is a good choice as chancellor: he was George Osborne’s number two in opposition and brings a calm authority to the Treasury. David Davis is a much riskier appointment as Secretary of State for Exiting the European Union (‘Minister for Brexit’), given his lack of recent cabinet experience.

There will be challenges but this welcome leadership from the government greatly increases our chances of navigating the months and years ahead without suffering a painful recession.

Assessing the impact of the referendum

The UK’s decision to leave the EU may be the most politically disruptive event for decades. Yet investors should consider the global context when assessing the implications for financial markets.

At Rathbones, even though most of the companies we invest in are domiciled in the UK, the majority of their sales originate from abroad. For example, more than 70% of FTSE 100 revenues come from overseas and a substantial share of this is from outside Europe.

Before the referendum, global macroeconomic data suggested growth was set to end 2016 at a decent pace — even approaching the long-term average rate of expansion (figure 1). Brexit is softening that outlook, but the starting point is important.

June’s consumer sentiment surveys were buoyant and harder measures of consumer confidence, such as car sales, were similarly optimistic. Even the long-awaited recovery in household consumption in Europe has gathered considerable upward momentum over the past 12 months.

In May, a disappointing first estimate of US GDP growth for the first quarter unnerved markets, as did a terrible employment report at the start of June. However, one data point does not make a trend. Subsequent revisions to the GDP estimate doubled the original reported rate of growth. Our analysis suggests the US economy is on track to report strong growth figures in the second quarter.

Employment data has always been unpredictable and subject to revisions. Even with the poor June report, the three-month average increase in jobs still equates to a tightening labour market. Business surveys suggest acute skills shortages in some sectors, and upward pressure on wages is likely to build as the economy starts to bump up against full employment, driving consumption spending. Besides, as exports to the UK and to the broader EU equal just 0.3% and 1.5% of US GDP respectively, the US is relatively immune to political uncertainty across the Atlantic.

Is Brexit a systemic event?

By itself, Brexit is not a global systemic event: it was not an ‘unknown unknown’.

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**Assessing the impact of the referendum**

*Source: Datastream, Rathbones.*

**Figure 1: Rathbones’ leading economic indicator of global growth**

Macro data suggested decent global growth for 2016. Brexit is likely to soften this pace, but it is important to remember the favourable starting point.

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It is unlikely to put at risk the global financial system. In terms of GDP, the UK accounts for just 2.4% of global output and a mere 1.4% share of output growth since the global financial crisis. A UK slowdown does not deal the hammer blow that a slowdown in China or the US would.

If Brexit affects economic confidence in the EU, however, spiking risk premia could cause another financing crisis at a number of European banks, particularly in Italy. In February, renewed focus on the abiding fragility of the eurozone banking system – triggered by the European Central Bank’s negative interest rate policy – reminded investors that European banks are still sitting on an enormous stock of bad loans that are yet to be written down. If confidence is lost and banks’ financing costs spiral, the financial fallout would be felt throughout the world.

It is here that investors should be vigilant. Thankfully, current market risk premia remain benign. Government bond yields in Spain and Italy have barely moved – the credit spreads demanded from European banks for their senior debt remain hundreds of basis points below the levels reached in 2009 or 2011.

The UK business cycle
Our measure of economic uncertainty had already risen sharply in 2016 and we expect it to rise considerably higher. Uncertainty affects hiring, investing and spending. Our analysis suggests uncertainty is likely to lower growth relative to what it would otherwise have been by around 0.5% to 1% per year over the first two years.

Such forecasting is subject to considerable error: the effect of uncertainty could be double our forecast, perhaps even tipping the economy into a shallow recession. However, a recession is by no means certain and investors should keep this in mind when assessing whether falls in asset prices represent the abiding fragility of the eurozone banking system – triggered by the European Central Bank’s negative interest rate policy – reminded investors that European banks are still sitting on an enormous stock of bad loans that are yet to be written down. If confidence is lost and banks’ financing costs spiral, the financial fallout would be felt throughout the world.

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The greatest beneficiaries have been consumer defensives, healthcare, energy and materials companies. In the uncertainty of a new post-Brexit world, these sectors should remain in demand despite the high valuations of some consumer defensive stocks.

The banking sector is likely to struggle. While the new chancellor’s position is not yet known, London may be just as keen on banking regulation as Brussels. With ultra-low interest rates for the foreseeable future, it will be difficult to envisage ratings anywhere near book value in the near future. Within financial services, fund management companies need to adjust to changes in regulation and compliance to continue selling their products into Europe. While demand for savings products should not diminish, increased regulatory costs could hit margins.

Sterling and UK interest rates
Meanwhile, sterling has fallen by 15% against a trade-weighted basket since the peak in November, necessitating a very accommodative monetary policy stance from the Bank of England (BoE). Indeed, although the monetary policy committee unexpectedly left rates unchanged at its July meeting, this was only because of the limited number of economic indicators since the referendum and it indicated that rates would almost certainly be cut in August. Against this backdrop, the so-called ‘bond proxy’ equity sectors, such as utilities, should also outperform.

If markets stay calm, sterling is likely to strengthen slightly from its recent lows; changes in expected interest rate differentials between the UK and its trading partners have explained the vast majority of changes in the trade-weighted
Over the medium term, the trend of Britons spending proportionally more of their income on dining out and other leisure activities should continue, and we believe this sector is less susceptible to a tougher economic climate than some investors suggest.

Conclusion

Now the political vacuum has been filled, we are starting to see how the government will proceed with the challenge of leaving the EU. The long-term economic impact will depend on the deal that Mr Davis can agree with the remaining EU countries, but in the short term Mrs May’s leadership greatly improves our chances of avoiding a recession. If this transpires, some FTSE 250 companies offer good value at current prices.
The US recovery remains on track despite recent weakness

US stock markets have had a mixed year so far, following the Federal Reserve’s decision in December to raise interest rates for the first time since 2006. Renewed fears about the fall in oil prices and the effect of the slowdown in Chinese GDP growth on the world economy led to a 12% fall in the S&P 500 between late December and mid-February. Since then, US equities have recovered steadily and the S&P 500 reached a new peak in early July.

US economic data added to the uncertainty, including June’s weaker-than-expected non-farm payrolls data. Yet although the seven-year economic expansion may be long in the tooth, business cycles die of heat exhaustion rather than old age. As such, it is important to consider economic indicators relative to their long-term average rate.

Of the four most commonly used gauges of the business cycle – payrolls, personal income, the output gap and industrial production – only the last is turning down, while the others are arguably still to reach even late-cycle territory (figure 4). Industrial production is skewed by the oil and gas sector and this should help if the oil price recovers slightly. $50 to $55 a barrel is considered to be a viable level for most US shale producers.

Bears and recessions
The 1987 ‘Black Monday’ crash aside, there has never been an equity bear market without an economic recession. The probability of recession implied by the leading economic indicators remains very low. In periods of heightened uncertainty, investors should reward those markets with more stable revenue streams by lowering the equity risk premium used in their valuation.

The market-implied equity risk premium on the S&P 500 came close to reaching financial crisis levels in February. It remains high and even a slight retracement would realise further upside in stock prices. That this premium remains so high while the S&P 500 has rallied past its record high of May 2015 means valuation multiples are lower.

The next big event
Now the UK’s EU membership referendum is settled, attention will move to the next big political event – the US presidential election on 8 November, which will pitch Hillary Clinton against Donald Trump. This may seem an invidious choice. Many have concerns about Mrs Clinton’s candidacy given her controversial approach to email during her time as secretary of state.

Meanwhile, Mr Trump may not fit the traditional Republican Party template, but grassroots voters have responded to his populist pot pourri of small government, nationalism, anti-immigration and protectionism. He has emerged as an unlikely man of the people, benefiting from disillusionment with mainstream politicians.

Between now and November, investment companies will produce reams of analysis about the election. However, presidents tend to have little impact on the US economy. Most of them, including President Obama, have followed centre-right economic agendas.

It is too early to tell what Mr Trump’s actual policies will be – they should start to become clearer following the Republican National Convention when his and Mike Pence’s (his vice-presidential running mate) nominations were confirmed. For now Mr Trump seems committed to an anti-immigration and protectionist ‘Make America Great Again’ agenda, even though such policies would almost certainly be negative for economic growth.

However, the US political system has an elaborate system of checks and balances that would prevent Mr Trump from unilaterally imposing many of his populist, but damaging, policies. Instead, with appropriate guidance, he could boost US self-belief and emulate the successful presidency of another unlikely candidate, Ronald Reagan.

Time will tell. In the meantime, while speculation will be rife about what a Trump or another Clinton presidency would mean, we see little need to worry and maintain an overweight position in US equities.
Investors should be aware of the ‘hidden’ exposure of index investing

Shock at the EU referendum result hit the FTSE 100 hard after global investors reassessed their exposure to the UK. On the day of the announcement, futures trading and the indiscriminate selling of passive tracker funds dragged down prices across the board.

The market’s behaviour was illogical, however, given the index’s constituent companies generate an average of 70% of their revenues outside the UK, much of this from outside Europe. For example, with its heavy weighting in resources stocks, one of the key drivers of the FTSE 100 is economic growth in Asia. Many other sectors also have significant US or Asian exposure.

This episode highlights how misleading indices have become in terms of their geographical exposure. Even the S&P 500, the bellwether of the US economy, has a sizeable international profile with 36% of its revenues generated outside North America (figure 5). The figure is considerably higher for certain sectors, such as semiconductors and electronic components.

The country in which a company lists its shares is becoming less and less relevant from an investment perspective. Many businesses operate globally – making it increasingly challenging to make country-level or even regional asset allocation decisions, supported by national economic data. It is by no means impossible, but requires investors to consider the geographical exposure of the companies which comprise an index.

This exercise is harder still when currencies are taken into consideration, particularly when they are volatile. The collapse of sterling following the referendum result was a major boost for dollar-earning UK stocks: after the initial indiscriminate selling, such market inefficiencies started to be ironed out as active investors took advantage of mispriced stocks.

In navigating such challenges, active management has a critical advantage over passive investment, which necessarily tracks indices – stocks can be selected on merit, based on their actual geographic exposure, rather than because they are in a particular index.

It is not impossible that global indices could be flat over the next five years as companies struggle in a lower-growth environment. Yet performance would only be flat on aggregate. There would still be winners and losers – only active investors, however, will be able to generate positive returns.

The value illusion

The valuation gap between growth and value stocks is at an extreme level as investors pay up for growth. However, value can be illusory and ‘value traps’ (a bargain stock or even market that fails to perform) must be avoided because they are unlikely to reach previous levels.

The EU referendum was a one-off event. Technology is disrupting many sectors – from robotics and driverless cars to energy efficiency, genetics and finance. This will have far-reaching consequences for index-based investing: while it will play out over a much longer period, the impact on performance is likely to be far greater than the referendum result.

The composition of the FTSE 100 has changed dramatically since it launched in 1984. Which of today’s companies will still be there in 32 years? Picking the winners is irrelevant if you are simply tracking the index.

This situation raises profound questions about how to look at stock market indices in the future. An investment manager looking to exploit these longer-term disruptive trends may need to accept an increase in the difference in performance against the underlying index over different time periods – these are known as tracking errors.

Again, this is no problem for an active manager, although they would need to be open with clients about the increased variability of returns against the index. Is it time for good active managers to be less focused on short-term benchmarks when there are so many long-term opportunities for significant outperformance?

Figure 5: Facebook, Amazon, Netflix and Google

These four US technology firms have increased their market value relative to the S&P 500 substantially over the past decade.

In a globalised world, the country in which a company lists its shares is becoming less and less relevant from an investment perspective.
Japanese equities have been testing investors’ patience this year, although their lacklustre performance stretches back 12 months. Having anticipated the Japanese renaissance when Shinzo Abe was elected as prime minister in December 2012 – which saw the TOPIX rise from its torpor around 500 to over 1100 last summer before falling back to around 800 recently – we have had to ask ourselves if our overweight position in Japanese equities is still valid. Perhaps it isn’t different this time?

Until Mr Abe’s recent success in the upper house elections, in which he won a renewed mandate for his programme of reforms, global investors appeared increasingly unconvinced by Japan’s grip on its economy. The stock market only seems to respond positively to sentiment about Chinese, and therefore global, economic growth and yen weakness, which is discouraging compared with the fundamental value that we originally identified. Should we call time on our positive view?

Japan’s macroeconomic recovery has floundered and many investors have lost faith in ‘Abenomics’ (Mr Abe’s economic strategy), although first-quarter GDP growth rebounded from a contraction in the final three months of 2015 (figure 6). The second-quarter Tankan (the Bank of Japan’s (BoJ) business confidence poll) was disappointing, although it did not suggest contraction: firms’ inflation expectations weakened, although they remain positive; wage growth is lacklustre; and leverage is not accelerating.

However, we continue to see value in Japanese equities, largely driven by microeconomic factors. Four key secular drivers of outperformance are still intact:

- A radical improvement in return on equity as a result of the revolution in corporate governance.
- Increasing shareholder focus should lead to the return of a cash mountain by way of dividends and buybacks.
- The huge potential for multiple reratings as pension funds (and now the BoJ) allocate to equities.
- The huge potential for multiple reratings as positive inflation expectations and the hunt for yield lead households into equity ownership.

While share prices have struggled this year, operating margins have held up well and buyback announcements totalled ¥4 trillion by the end of May. To put that in context, total buybacks for the whole of 2015 were a record ¥5 trillion. Goldman Sachs estimates that Japan’s four major public pension funds are underweight by ¥9 trillion compared with their new government-directed target for domestic equity exposure. Meanwhile, the BoJ is widely expected to increase purchases of equity exchange trade funds (ETFs) over the summer. Following the recent elections, any additional BoJ macroeconomic stimulus would be a bonus.

Committed but unfashionable

We remain committed to Japanese equities, but acknowledge that they are unfashionable with many global investors. To mitigate this, we prefer exposure to domestic stocks rather than the ‘weak yen, export-driven’ behemoths. As active investors, we can favour better-quality, higher-growth stocks with a commitment to corporate governance rather than simply buying large-cap index exposure. Third-party funds more attuned to this approach have performed much better than the TOPIX and other international indices.

In time, the prevailing wisdom that equity gains require yen falls may also be challenged. First, there have been prolonged periods in which corporate profits had a positive correlation with the exchange rate. Second, of the four major TOPIX rallies since 1990, only one was accompanied by significant yen depreciation (1995–96). The S&P 500 also has a strong negative correlation with the yen and the exchange rate cannot logically benefit both.

Given the recent yen strength against sterling, we believe it will resume a downward trajectory against the pound now the UK has voted to leave the EU. That said, if additional purchases of Japanese equity ETFs by the BoJ spur overseas investors, this would strengthen the yen and we could enter a period of both positive equity and currency performance. As we have discussed, this situation is not nearly as unusual as recent history might imply.

**Figure 6: Japanese GDP**

Japan’s economy has continued to expand this year despite some concerns about the government’s ongoing ability to stimulate growth.

Source: Datastream, Rathbones.
Is globalisation reversing?

Technology and politics are changing how the world interacts

Globalisation is a highly contentious issue with many advocates and detractors. Nonetheless, throughout history, free trade has generally been good for prosperity, whereas periods of protectionism, such as those of the Corn Laws and Great Depression, have not.

The UK’s decision to leave the EU, a bloc based on the free movement of goods, services, capital and labour, has been portrayed as a vote against globalisation. This is seen to represent a wider shift: low growth and rising income inequality have resulted in the rise of inward-looking politics and nationalism across the developed world. New populist parties and candidates on the left and right are fuelling the belief that globalisation is not increasing prosperity.

Protectionism is on the rise. Donald Trump has promised to impose a 45% tariff on all Chinese imports, but he is not alone. The World Trade Organisation has warned of a slowdown in trade liberalisation and the number of restrictive measures introduced by its members is rising. Is globalisation, which requires free trade, in retreat?

The rise of globalisation

Globalisation has ebbed and flowed throughout history, but advanced sharply in the modern era. Global trade increased 27-fold between 1950 and 2008 – three times more than global GDP. This was driven by the absence of global conflict, including the end of the Cold War; the integration of emerging markets into the global economy; falling trade costs and technological advances; and even more division of labour. As a result, global trade openness – the ratio of trade to GDP – rose to a record high of 64.3% by 2007–08.

However, minimal growth in trade since the global financial crisis has caused this ratio to decrease (figure 7). In itself, this need not be alarming. Yet there are other signs that globalisation has stalled, such as weaker foreign direct investment flows, the decoupling of the major global economies, currency wars, and populist opposition to free trade and economic migration.

Out-of-step economies, however, are the norm rather than the exception – GDP correlations generally spike during financial crises. Since early 2009, the major economies have slowly decoupled, signalling more normal times rather than the end of globalisation. However, this has coincided with a slowdown in global trade, which is more pertinent.

Slowing international trade growth lowers global economic growth. If this is prolonged, it leads to lower potential growth and lower inflation. A downward shift in global economic growth can increase nationalism, leading to territorial disputes, opposition to immigration and a rise in protectionism.

The global financial crisis

Some commentators have blamed the apparent reversal of globalisation on the financial crisis, but some factors were slowing well before 2008. For example, after the Cold War ended, the emergence of lower-cost eastern European economies enabled companies to reorganise their supply chains globally. However, this trend started to decelerate in the 2000s.

In addition, rising incomes in emerging markets relative to developed countries have reduced their labour cost advantage. Sharp falls in the cost of technology, such as robots and 3D printers, have further eroded this cost competitiveness and resulted in ‘reshoring’ to developed countries.

We believe globalisation is changing, rather than reversing. Labour and physical capital were previously considered to be the main engines of growth, but knowledge-based capital has become more important, boosted by technological change and the internet. Trade in services grew to 12.5% of global GDP in 2014, overtaking its pre-crisis peak. A McKinsey Global Institute report from February found that “the world is more connected than ever, but the nature of its connections has changed in a fundamental way. The amount of cross-border bandwidth that is used has grown by 45 times since 2005.”

Globalisation is an extremely complex issue, but in our view reports of its death are greatly exaggerated. We should, however, be vigilant and prepared to challenge the simplistic rhetoric of populist politicians – the 1930s show us where nationalism, protectionism and beggar-thy-neighbour economics can lead.
Financial markets

At the start of the year, there were widespread fears about China’s slowdown, and the plunging price of oil and other commodities seemed to validate these concerns. However, during the second quarter, data suggested China’s economy is slowing, rather than crashing, and commodity prices rebounded. Meanwhile, the US Federal Reserve was expected to tighten rates repeatedly this year, but has since realised it would have to move more cautiously. As a number of trends reversed, the market’s mood improved.

Government bond yields around the world continued to fall, suggesting investors were becoming more pessimistic about future growth and concerned about political upheavals. The ECB’s subsequent entry into the markets as part of its quantitative easing measures helped push the yield on German 10-year government bonds below zero for the first time.

The impact of Brexit
The risks associated with the EU referendum loomed over UK markets throughout the second quarter, pushing 10-year gilt yields to a new low below 1% and causing share prices to slide. The initial market sell-off following the UK’s decision to quit was global, but the FTSE 100 and sterling suffered the sharpest falls in value, exacerbated by a cut in the UK’s credit rating. However, share prices recovered in the following week.

General political and economic uncertainty helped gold prices rise above $1,300 per ounce. Oil reached an eight-month high in June thanks to a weaker dollar and continuing supply disruptions, such as in Nigeria where attacks by militants reduced the country’s output. Brent crude, the main global benchmark, rose above $50 a barrel. The price is up by two-thirds since January and could bring some US shale-oil production back into the market although it has been weaker recently.

Source: Datastream and Rathbones.

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