





FINURA
PARTNERS

Points of View

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The global market impact of Brexit

June has been dominated by the UK referendum on whether the country should stay in the EU or not. The UK voted by 52% to 48% to leave the Union and thus sparked one of the most interesting weeks in capital markets for some time. Not only did the outcome of the vote raise interesting economic questions, but it has impacted politics and diplomacy. Whilst the implications are potentially profound for both the UK and Europe, the ramifications also have scope to impact other world markets.

UK

The outcome of the referendum was first felt in the sterling currency markets. The 24th June saw one of the most violent overnight swings in the value of sterling for a generation. From a high of \$1.50 at midnight when the UK was still expected to remain part of the EU, the value of sterling began to slide, dropping below \$1.33 as evidence mounted that the City had been wrong and the country had voted "Leave". The stock markets promptly followed with dramatic falls for the FTSE100, but even greater falls for the domestically orientated FTSE250 (ultimately falling 6% for the month).

However as the implications of sterling's weakness began to be absorbed (exports are more competitive and overseas earnings worth more in sterling terms), the FTSE100 rallied from its low and ended the month higher than its pre BREXIT level (up 4.7% in June). However many now expect the UK economy to slow down as imports become more expensive, consumers rein back spending and companies delay investment until the outlook becomes clearer, most notably our trading relationship with the EU. Already the Gilt market is anticipating interest rates to fall in the next couple of months (the 10 year Gilt has fallen from 1.38% to 0.86%) to maintain aggregate demand.

US

Similar to Europe, the United States stock market did well during the month when translated into sterling with a rise of over 9%. However in dollar terms the rise was much more modest at 0.24%. The impact of BREXIT for the US is much more on the politics rather than economics. Does this give a fillip to the Trump presidential bid?

One outcome has been the attraction of the US dollar for its "safe haven" status. This makes it harder for the US to export but will lower their inflation. A recovering economy has pushed up US wages, house prices, mortgage lending and retail sales. This may have tempted the Federal Reserve to raise interest rates. However given the current uncertainties this appears less likely, as a rate rise would make the dollar even more attractive and further push up its value, thereby exacerbating the problem.

Europe

Unsurprisingly the UK vote spilled over into European markets which fell by approximately 4% in euros. However when translated into Sterling the FTSE Developed Europe ex UK index was actually up on the month with a rise of 3.8%. The most striking outcome for Europe so far has been in the European bond markets. The difference in yields, referred to as the "spread", has widened between those of Germany, which are now negative across much of the maturity, and those of the peripheral countries, such as Greece, Spain and Portugal which have increased.

Will the outcome of the UK vote encourage other countries to demand a vote of their own? At the moment it is simply not known, however Europe faces 6 elections in the next 18 months and their results should indicate how secure the European project is.

Japan

The yen also attracted those fleeing sterling's weakness: BREXIT has done no favours for Japan and its hoped-for recovery. Although the Japanese economy has been sluggish for many years, it is still the world's third largest economy. A weak yen to boost the country's exports and hence growth has been one of the key planks of their Premier's plan, known as "Abenomics". However the yen has been strengthening for the whole of 2016 and last week's referendum result prompted a flight to safety and that included the Yen. However interest rates in Japan are now negative causing consumers not to spend (they earn no interest) and companies hold back investment in response to a lack of demand and an ageing population.

It is little surprise that the stock market has fallen by over 10% in yen terms over the past month, albeit it has risen by 6% in sterling.

Emerging markets

Although the majority of Emerging Market (EM) trade is with each other and the United States, there are still risks if the US dollar continues to strengthen. Many EM companies and governments borrowed "cheaply" in dollars but the more the dollar rises, the more expensive it becomes to repay those debts in local currencies. And should interest rates rise in the US, there will be a flow of monies leaving EM markets in search of the higher yield in the US, not unimportant when so much of the world offers so little yield, if at all.

However sentiment may improve. If the US delays rate rises and the gyrations of the dollar and other countries settle down, then EM stock markets may offer good value. Emerging Markets were up by just over 3% in the past month, much better in sterling terms with a rise of 11%, adding to a good year-to-date figure of close to 16%. And finally for once, political instability has not come from the developing world, but in this instance a developed one, the UK.

* All performance data quoted in this article is derived from FE Analytics

First published on 6th July by Simon Brett of Parmenion Investment Management.

One of the key themes over the past few years has been that, because trend growth rates in Western economies are currently appreciably below those recorded during the 10 to 15 years prior to the recession, we feel more vulnerable to potentially negative shocks.

And there is no doubt that we have just experienced a very significant shock, with the result of the Brexit referendum being that the UK is now on a course that will take it out of the European Union. The risk is, however, that our greater feeling of vulnerability leads us to overstate the immediate negative consequences of Brexit for the economy.

Looking at the currently published UK GDP data for the 15-year period between 1993 and 2007, there were only three quarters in which the year-on-year growth rate was below 2%: 1.9% in both Q4 2004 and Q1 2005, and 1.4% in Q4 2006. We now know of course, that the average growth rate of 3.0% over the period was unsustainable, if not reckless, and that the authorities should have paid more attention to the escalating debt levels and the deterioration in the trade accounts that accompanied this growth. However, to the extent that the Bank of England and Treasury were happy to parade the UK's resplendent growth, it is unsurprising that there developed during this time a sense of invulnerability. How foolish we were.

With a trend growth rate now of 2%, it is inevitable that bumps in the road seem more disturbing. Losing momentum from this rate could take us quickly into territory that has recessionary characteristics – although not necessarily defined 'technically' as a recession (two consecutive quarters of negative quarter-on-quarter growth). And that is the fear now, with the suggested logic being that reduced capital investment and heightened uncertainty lead to an overall decline in aggregate demand.

Another theme that I have written about on a number of occasions relates to monetary policy. Specifically, I have written that the Monetary Policy Committee

(MPC) should have used the emergence of above-trend growth between mid-2014 and end-2015 as an opportunity to begin the process of normalising interest rates. One of my arguments was that in doing so, the MPC would create room for policy manoeuvre should the economy be subject to a shock. So, it would have been helpful had the MPC been able to initiate an easing in monetary policy, albeit temporary, in order to reassure nervous households and companies. Of course, the MPC is not precluded from cutting rates from their current level of 0.5%, but this would be of much lesser benefit. It could also embark on additional quantitative easing, although this could easily prove counter-productive.

Inevitably, in the immediate aftermath of the referendum, economists and commentators have concentrated on the potentially negative near and medium-term consequences of the UK leaving the EU. Indeed, it is almost as if the UK were not just leaving the EU but being physically cut off from continental Europe, with our islands being dragged into the mid-Atlantic (gone are the days, it seems, when creating a mid-Atlantic economy was seen as a panacea). Some of us, with longer memories, can remember similar forecasts of an approaching economic cataclysm following our unseemly exit in 1992 from the Exchange Rate Mechanism. In fact, that apparent monetary disaster kick-started a period of strong recovery from recession.

The downside risks now are greater than they were in 1992 and the political consequences of Brexit for both the UK and the EU could turn out to be profound. However, it is wrong to ignore the positive impact that the fall in the pound could have on exporters and companies competing with imports. While the initial impact

on the trade accounts will be negative, due to the higher cost of imports, volume effects resulting from improved competitiveness could be meaningfully beneficial to growth. Equally, while the prevailing mood at the moment is one of uncertainty and concern, it is not too difficult to see this becoming more positive, as companies begin to talk about improving export opportunities. Indeed, the shake-up that approaching Brexit gives to the economy could prove invigorating, in that it will force companies to look for new arenas in which to do business.

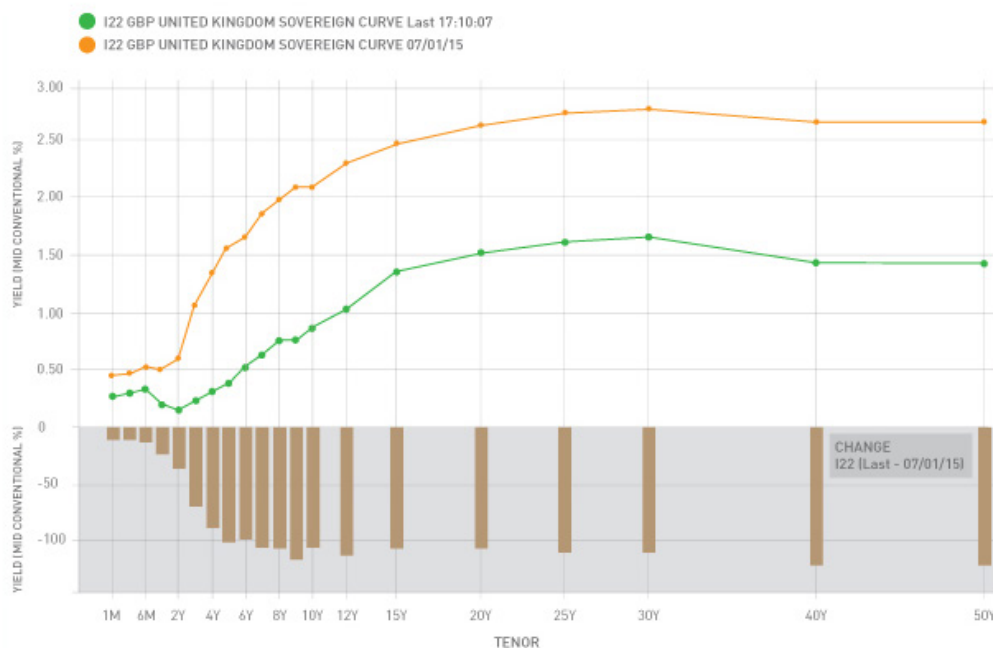
As a barometer of how investors regard the likely consequences of Brexit, the financial markets initially seemed to confirm people's worst fears. Fairly quickly however, markets stabilised. While the currency has – helpfully – remained at lower levels, equity markets have been recovering from their initial falls. This does not mean there will not be further reverberations, possibly triggered by political developments. However, it cannot be taken as anything but a positive sign that at the time of writing, the FTSE 100 is showing a positive total return over the year-to-date.

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In the world of fixed income the shape of the yield curve is supposed to reflect the market view of future GDP growth, interest rates and inflation.

Longer dated debt tends to command greater yields to compensate investors for the extra uncertainty of lending money further into the future. Typically post an economic shock, like that experienced in 2008/9 with the Global Financial Crisis (GFC), the yield curve steepens as the short end falls to reflect lower base rates whilst the long end stays up in anticipation of economic recovery. This time, however, due to the significant structural issues facing the developed world of excess debt, ageing demographics, surplus manufacturing and poor productivity, yield curves have actually moved lower and flatter (see chart below).

UK Government Yield Curve



Source: Bloomberg

On the one hand this appeared to be the aim of many central banks pursuing Quantitative Easing (QE), but on the other is it actually compounding the delay in the recovery process and what is the meaning for investors?

Post the GFC in order to stimulate growth policy makers not only lowered interest rates to historical lows but also announced asset purchase programmes including buying longer dated sovereign debt (and increasingly corporate debt by the ECB). The aim was to keep yields lower than they might otherwise have been and therefore reduce the cost of debt for businesses enabling them to continue functioning, despite the lower growth environment, and even possibly maintain their capital expenditure programmes. However, what this strategy has meant is that whilst employment has held up better than expected, with global capacity (supply) being greater than demand, we have actually ended with persistent disinflationary/deflationary pressures, which appear hard to break free of.

Unfortunately central banks find themselves between a rock and hard place, as the alternative stimulus tool of fiscal policy lies in the hands of politicians, who almost without exception are in disarray and unable or unwilling to take decisive action. Given this backdrop, uncompetitive companies continue to survive creating benign pricing power and a somewhat stalemate status quo.

There is however a glimmer of light, but one which demands careful consideration amongst investors. Over the next 2/3 years a significant amount of corporate debt will need to be refinanced as existing debt matures. Unless issuers have robust prospects investors are likely to demand higher yields and if default rates tick up, as is increasingly anticipated, this additional risk premium may well help to stop the

downward shift being observed in the yield curve over the last few years.

But for the moment this remains some way off. In the meantime the shallow and increasingly flat yield curve is creating multiple challenges right here and now. The banking sector is facing a squeeze on profitability as a flatter yield curve compresses their margins; life insurance companies find it hard to match assets and liabilities; and pension funds' assumed rate of return of 7%+ are facing widening deficits as actual returns come in less than expected; and this is made all the worse by ageing societies and increased life expectancy.

Ultimately until central banks step back from buying longer dated debt (including reinvesting maturing debt already held) the position and shape of sovereign yield curves is likely to remain biased to the downside and with a flattish profile. In this situation investors are likely to remain 'forced' to seek positive real yields wherever they can in an attempt to generate an income. In such a scenario the risk profile of some portfolios may get stretched as new asset classes are added or asset class concentration increases, both being something Parmenion deliberately avoids. Instead, Parmenion continues to adopt asset class diversification for all Risk Grades via the use of our standard 20 year historic dataset providing risk framework consistency and delivery of outcomes in line with expectations.

In conclusion, unadulterated yield curves are extremely useful guides of the future for multiple market participants, but heavily manipulated ones due to the comings and goings of QE are dangerous and potentially misleading, possibly to the detriment of investors and businesses alike, especially those failing to maintain financial discipline. As ever adopting a long term, diversified and balanced approach is the methodology Parmenion believes in and which will be delivered upon across all of our investment solutions.

First published on 7th July 2016 by Peter Dalgliesh of Parmenion Investment

Management.

Brexit: What next for those who are about to retire?

The decision made by the British public to leave the European Union last month has triggered financial uncertainty in the British economy, and this in turn has rippled through to global markets.

Those who are investing for the long-term need not feel overly worried about current market volatility. But for those who need to make large financial decisions now, such as whether or not to retire, they will feel that they have a very difficult set of cards in their hand which they need to play.

Those who are about to retire may have very good reason to feel concerned about their financial situation, and will need to think carefully about the decisions they are about to take. The vote to leave Europe has thrown up new concerns and very real problems. For instance, annuity rates have fallen further, which means those looking to exchange their saved pension fund for a secure income for life will currently be offered a lower income than would have previously been available. The value of Sterling has fallen, so the cost of living could rise in the coming years. Mark Carney, the Governor of the Bank of England, has suggested that interest rates will also fall which is bad news for cash savers.

Market volatility, whilst an expected consequence of stock market investing, is particularly concerning at a time when the investor wants to withdraw their money - post Brexit we saw an immediate slump in the value of the FTSE 100, which has now rallied to an 11 month high, and who knows what will happen next. In summary, the vote to leave Europe has created a perfect storm scenario for those who are about to, or considering retirement.

If you are about to retire, how do you start to prepare?

The first step for those considering retirement is to understand the make-up of your current pension savings. Most people's pension funds will contain a mix of different asset classes; these will behave differently in different market conditions, and some

will be low risk, some high or higher risk, so it is important to know what your pension contains. Some pension funds have an automatic life styling option. This means that as you approach your chosen retirement age, your pension fund is gradually de-risked by drip feeding money out of riskier investments and moving money into more cautious funds or assets and cash. If your money is in this type of pension arrangement and you are close to your chosen retirement age then your money may be reasonably protected at this point from market losses, but you are likely to benefit less from market gains. Not all pension plans have this arrangement, so if yours does not, then it may be a good time to review your fund and see whether, or how, it has been affected by recent events. A financial adviser can help you determine your current financial position.

What decision do you take next?

The next step is to establish how much income your pension savings can generate for you in retirement and how you would like to structure that financial arrangement. You have the choice of whether to take a fixed guaranteed income which can pay you an agreed sum for the rest of your life called an annuity, or to invest your money, withdrawing an income on a regular basis, or on an ad hoc basis as required. Some investment products offer income guarantees, which can help provide more security in your retirement income. You don't have to choose just one of these routes to drawing your pension income; if you want some security and some flexibility you can use a combination of these options.

What happens if the figures don't add up?

It is often at the point of retirement that many people realise that they don't have enough saved and that their income for retirement is not going to be the sum they

had expected to receive. There are ways to try to rectify this; some people choose to defer taking retirement, thus enabling them to continue to contribute to their fund, and by pushing back their retirement age, when they do take a pension income it will be calculated to provide for fewer years. Others may take a phased approach, taking a proportion of their pension income and then working part time to supplement their income. If you are faced with insufficient savings then a financial adviser can help you to develop and plan your financial goals for the short time frame you have available. They will also make sure you take advantage of all the available tax incentives linked to pension plans to help you achieve this.

What is clear is that there has never been a more important time to take financial advice. Taking financial advice at this point will ensure that all the retirement options have been considered and any personal circumstances, such as your health are considered. Simple factors, such as an existing medical problem which will reduce a person's statistical life expectancy can in some cases secure a person a higher annuity income, should this be the income route they wish to take. In the uncertain post-Brexit period, those approaching retirement will need to be open-minded about their retirement plans.

If you are approaching retirement then it is important you speak to your financial adviser to discuss all the options available to you.

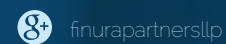
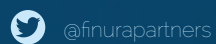
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