IMPERIUM CAPITAL momentum NEWPORT

Weekly Digest

Week ending **11 June 2017**

Hung, Drawn and Quartered: The Demise of Strength and Stability

When PM Theresa May called the general election 7 weeks ago, ostensibly to deliver strong and stable leadership through the impending Brexit negotiations, the Conservative party enjoyed a commanding lead in the opinion polls which would have delivered a landslide victory. Despite a wholly inept campaign by May and a surprisingly good one by opposition leader Jeremy Corbyn, all expectations the day before the poll still called for a Tory win by a margin of 40-80 seats. So the result, a hung parliament with no single party having an overall majority, was a shock and is undoubtedly bad for the country, disastrous for the Conservative party and catastrophic for Mrs May. Here are some of the manager's thoughts on what it means both shorter and longer term.

What does it mean for government policy?

The government will struggle to stick to its austerity programme and tight spending policy. One message from the electorate appears to be that more spending on health, education, policing, security, infrastructure and social care is vital and if the Tories are to win in 2022 they will have to loosen the purse strings. More spending, tax rises and higher debt seem inevitable.

What about Brexit?

Brexit negotiations are due to start in seven days. It is possible that the government will not be in a position to do so; negotiations to form a government with the DUP could take some time, as would a leadership election (which could be hard to avoid). A mortally wounded PM is arguably not best placed to lead these critical negotiations, and some delay seems possible. This plays into the hands of the EU and weakens the UK's position as the two year exit period is ticking down. Furthermore, the election result is likely to be interpreted as a rejection of May's negotiating position, which is widely seen as a hard Brexit with the UK exiting the single market and customs union in order to regain control of immigration from the EU and independence from the European Court of Justice.

How does this affect the UK in the longer term?

Hung parliaments and coalition governments with a very slim majority are fraught with risk and given the multitude of evident divisions in the UK, between the haves and have-nots, young and old, Brexiteers and Remainers, those who have benefitted from the forces of globalisation and those who have suffered, all point to huge challenges for the government to survive. However, the DUP are likely to be reliable partners, albeit at some cost, so the prospects of surviving a full 5 year term are reasonable. The bigger problems come from the Brexit negotiations and the ultimate exit arrangements, and the growing prospect of a hard left government in five years. The Labour party under Corbyn, with his entrenched extreme left, anti-business, pro big government and state intervention, high tax and spend philosophy (and manifesto), has now been given the golden opportunity to build a significant base in parliament and will be more than ready in five years to take advantage of policy mis-steps by the government, and any post Brexit economic malaise, to form a government. This is hardly likely to be an investor-friendly environment and could well end in stagflation, high debt and weak capital markets.

What should investors do?

The result was a shock for markets but so far they have reacted predictably and calmly: sterling and gilts have weakened somewhat, internationally focused UK equities have strengthened while domestic oriented equities have weakened modestly. This seems appropriate. Markets dislike uncertainty but it should be remembered that although the result was a shock the government has not changed and is unlikely to do so, quite possibly for the full five year term. The socialist Labour party did not win and cannot form a government, so the worst outcome for markets has been avoided. We face a period of uncertainty, greater than we had hoped and expected prior to the election, and government policy both domestically and in terms of Brexit has to be revisited; very significant changes are inevitable but the broad thrust of Tory philosophy is intact. The end result could even be a more pro-growth policy mix, with an increase in government spending, and a softer Brexit, which would resonate well with investors.

Under these circumstances the managers of the core portfolios believe that the best course of action is to sit out the immediate heightened uncertainty and take stock as the new government and its policies become clearer. It is important to stress that this is purely a UK domestic issue and has no bearing on global markets. The UK market has performed well since the sharp falls immediately after last year's referendum and the managers have been anticipating a period of consolidation and drift in equities in the shorter term. The portfolios are already positioned for this. Should there be unexpected shocks and weakness in markets in the UK, current thinking is to use these as buying opportunities, but the moves so far are insufficient. Sterling is an undervalued currency but as with Brexit, the uncertainty created by the election is most likely to fall on the currency, so further weakness cannot be ruled out in the shorter term. Patience and calm seem the best approach in this environment.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

The **Marketplace**

- Conservatives fall short of majority in UK election
- ECB revises core inflation and growth forecasts
- Limited market response to Comey testimony
- Strong US economic data reaffirms rate hike expectations
- US responds to Qatar and Gulf diplomatic crisis

Market **Focus**

UK

- Sterling immediately fell 2.0% versus the US dollar following UK election exit polls suggesting the Tories would fail to achieve a majority. The pound has since remained flat, currently trading at USD 1.27. This short term move reflects both the surprise of the poll and the potential implications of political instability on Brexit negotiations.
- The recent agreement between the Tories and the Democratic Unionist Party has somewhat aided certainty, reflected by the floor created under Sterling and the relative flat movements.
- The fall in Sterling provided a boost to UK equities, which ended a four day losing streak by rising 1.0% on Friday, resulting in a weekly return of -0.1%.
- Data releases included figures showing the UK trade deficit decreasing to GBP -2.1 billion, exceeding expectations of a GBP -3.5 billion deficit. Although industrial production figures for May were weaker than expected, with +0.2% growth month-on-month.

US

- The markets had a limited response to James Comey's hotly anticipated testimony on Thursday with the S&P 500 closing up 0.2%, although over the week the index retreated 0.3%.
- Brent crude oil prices fell 3.6% over the week, including a 4.1% fall on Wednesday following US EIA data showing crude and gasoline supplies unexpectedly rising the week prior.
- US weekly initial jobless claims remained low at 245,000.
- President Trump announced his commitment to holding talks with all parties involved in the Gulf diplomatic crisis in an attempt to stabilise the situation. The Qatar Stock Exchange fell 7.3% on Monday, after four Gulf state nations cut all diplomatic ties with the state over its alleged sponsoring of terrorist activity in the region.
- With unemployment at a low 4.3% and economic growth forecasts for Q2 of 3.4% the US Federal Reserve is expected to raise the Federal Funds rate by 25 basis points following the Federal Open Market Committee meetings on Tuesday and Wednesday this week.

Europe

- Following the European Central Bank (ECB) meetings on Thursday, governor Mario Draghi announced revisions to core Euro Area inflation, with forecasts for 2018 and 2019 lowered by 0.1 percentage points to 1.4% and 1.7% respectively. Q1 GDP was unexpectedly revised up by 0.1% to 0.6% quarter-on-quarter. During the meeting the ECB made no indication of any preparation plans for tapering their quantitative easing programme, pushing back expected timings of the exit. The Euro initially fell 0.4% versus the US dollar following the meeting, and depreciated 0.7% over the week to USD 1.1.
- Germany reported better than expected rises in industrial production with a 0.8% increase month-on-month versus expectations of +0.5%.

Glyn Owen & Oliver Cooper

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Asset Class/Region	Currency	Currency returns			
		Week ending 10 June 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	-0.3%	0.9%	9.3%	16.6%
United Kingdom	GBP	-0.2%	0.2%	7.6%	25.5%
Continental Europe	EUR	-0.4%	0.6%	11.7%	20.4%
Japan	JPY	-1.2%	1.6%	5.9%	21.7%
Asia Pacific (ex Japan)	USD	0.5%	1.6%	19.5%	23.8%
Australia	AUD	-1.9%	-0.8%	2.2%	10.5%
Global	USD	-0.6%	0.6%	10.9%	16.1%
Emerging Market Equities					
Emerging Europe	USD	-0.7%	-0.1%	4.2%	14.4%
Emerging Asia	USD	0.9%	1.9%	23.4%	27.9%
Emerging Latin America	USD	-0.4%	0.1%	9.6%	18.9%
BRICs	USD	0.7%	1.4%	17.7%	27.2%
MENA countries	USD	-0.8%	-0.5%	0.5%	8.5%
South Africa	USD	-2.4%	-0.2%	12.1%	15.6%
India	USD	0.1%	0.9%	25.4%	23.7%
Global Emerging Markets	USD	0.4%	1.4%	18.9%	24.4%
Bonds					
US Treasuries	USD	-0.2%	0.0%	2.1%	-1.0%
US Treasuries (inflation protected)	USD	-0.5%	-0.2%	1.7%	0.9%
US Corporate (investment grade)	USD	-0.2%	0.1%	3.6%	3.1%
US High Yield	USD	-0.1%	0.1%	4.9%	12.4%
UK Gilts	GBP	0.2%	0.0%	2.4%	5.1%
UK Corporate (investment grade)	GBP	0.3%	0.1%	3.6%	7.9%
Euro Government Bonds	EUR	0.4%	0.3%	-0.1%	-1.1%
Euro Corporate (investment grade)	EUR	0.0%	0.1%	1.3%	2.2%
Euro High Yield	EUR	0.0%	0.1%	4.0%	8.1%
Japanese Government	JPY	0.0%	-0.1%	-0.2%	-2.8%
Australian Government	AUD	0.1%	-0.1%	3.5%	0.8%
Global Government Bonds	USD	-0.3%	-0.1%	4.2%	-3.1%
Global Bonds	USD	0.1%	-0.1%	4.2%	-1.3%
Global Convertible Bonds	USD	-0.6%	0.4%	7.7%	6.6%
Emerging Market Bonds	USD	0.0%	0.5%	7.2%	7.2%

Source: Bloomberg

Asset Class/Region	Currency	Currency returns			
		Week ending 10 June 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	0.3%	1.8%	1.9%	1.6%
Australian Property Securities	AUD	-3.1%	-1.6%	-1.2%	-5.8%
Asia Property Securities	USD	0.1%	2.1%	18.7%	17.7%
Global Property Securities	USD	0.0%	1.5%	8.5%	5.9%
Currencies					
Euro	USD	-0.6%	-0.3%	6.4%	-1.0%
UK Pound Sterling	USD	-1.1%	-1.2%	3.1%	-11.9%
Japanese Yen	USD	0.0%	0.2%	5.9%	-3.1%
Australian Dollar	USD	1.3%	1.3%	4.7%	1.4%
South African Rand	USD	-0.4%	2.4%	6.5%	15.2%
Swiss Franc	USD	-0.5%	-0.1%	5.1%	-0.5%
Chinese Yuan	USD	0.2%	0.4%	2.3%	-3.4%
Commodities & Alternatives					
Commodities	USD	-0.7%	-1.4%	-6.8%	-6.8%
Agricultural Commodities	USD	1.8%	1.6%	-0.3%	-8.8%
Oil	USD	-3.6%	-4.3%	-15.3%	-7.3%
Gold	USD	-0.6%	-0.2%	10.0%	-0.1%
Hedge funds	USD	-0.2%	0.3%	2.6%	5.5%

Source: Bloomberg

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