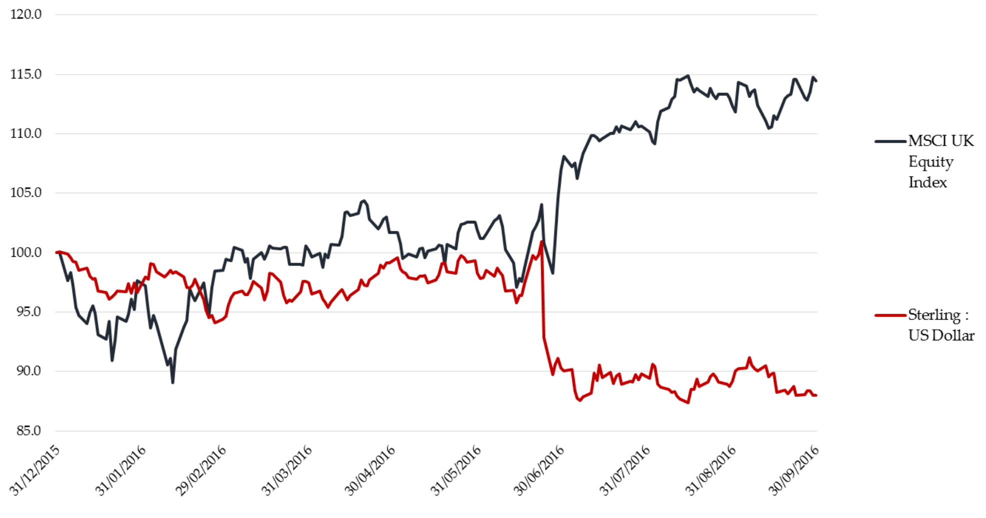
Market Commentary
Third Quarter 2016

"An election is a moral horror, as bad as a battle except for the blood; a mud bath for every soul concerned in it."
(George Bernard Shaw, playwright and critic, 1856-1950).

With investment markets still digesting the as-yet unknown consequences of the UK's EU Referendum vote to leave the European Union, there are plenty of incipient opportunities for voters to unsettle nerves in the remainder of this year and into 2017. Throughout the mud-slinging battle of the US Presidential campaign, Hillary Clinton has remained the front-runner ahead of Donald Trump, although the latter has somehow kept in the November election race. A Clinton win is by no means certain however. Trump's anti-globalisation policy of protecting American interests through trade controls would almost certainly hurt US corporates' sales abroad and lower global economic growth, while increased government expenditures and tax cuts, allied to stricter immigration rules could lead to higher US inflation and interest rates. The result could be a sell-off in both US government bonds and equities although, conversely, the dollar is likely to benefit from increased interest rates and heightened geo-political uncertainty. Shortly after the US elections, voters face an Italian referendum on constitutional reform and next year there are elections in Germany, France, the Netherlands, Hungary, Sweden, Norway and the Czech Republic. Each 'mud bath' provides a potential outlet for a populist anti-establishment protest, with politicians and investors possibly wrong-footed. Against this backdrop, the UK will embark upon potentially protracted 'Brexit' negotiations.

We remind ourselves, however, that markets can discount bad news and uncertainty, such that the performance of investments can appear completely at odds with the current pre-conceived wisdom and disconnected from the underlying economic reality. Take, for example, Figure 1, below. Most market observers expected UK equities to slump from any vote to leave the European Union, and yet the market, represented by the blue line in the chart, has accelerated upwards over the third quarter of 2016. Sterling, shown below in red and against the dollar, in suffering a precipitous fall and weakened by a rate cut, has provided a fillip for larger UK listed companies that earn a disproportionate percentage of their profits in overseas currencies. Exporters, tourism and UK assets sought by international investors should also benefit, but weaker currency advantages do not accrue for many domestic economy orientated companies and indeed most of these smaller companies may not be listed on the stock exchange.

Figure 1. UK equities rise while sterling slumps



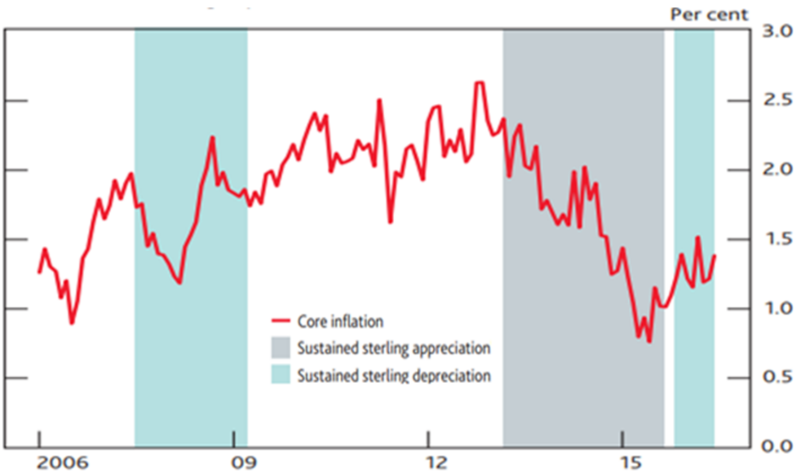
Source: Bloomberg October 2016

Past performance is not a reliable indicator of future performance

Neither is the impact of a substantially reduced currency necessarily beneficial nor benign: higher inflation is one negative outcome for many. Previous Bank of England reports suggest that as much as 2.7% could be added onto UK inflation, due to increased non-energy import prices, resulting from sterling's recent 15% currency devaluation. Any additional oil price costs could push UK inflation even higher, albeit from very subdued levels. Figure 2, below, shows that UK core inflation, indicated by the red line, typically rises during sustained periods of sterling depreciation (light blue shading) and falls when the pound rises (darker blue shading). Higher inflation has negative consequences for companies that rely on imported materials or finished goods, who may then attempt to pass on higher prices to consumers. Wages either increase to keep pace with inflation or consumers' real disposal incomes decline, potentially lowering demand for goods and services and slowing the economy. Additionally, any inflationary pick-up may well precipitate the end of prevalent accommodative monetary policies and cause a sharper turn in the interest rate cycle. On the plus side, debt-laden governments would no doubt welcome the outcome that higher inflation has of lowering the burden of future loan repayments, especially if they are resolved to stimulate economies by increased fiscal public expenditure.

We have waited expectantly for evidence of higher inflationary pressures, given our central view of a slowly improving global economy. Over the long term, investing in equities has proven to be a sound method of achieving an objective of real, after inflation, capital preservation. Therefore, we believe that higher quality UK equities with a bias towards overseas earnings and international stocks should form the core of an investment portfolio. These should be supported by diversifying assets, in varying proportions, as the investment outlook alters. We have been incrementally reducing our underweight equity stance, given their current relative attractiveness against other assets and potential for both capital and income growth. We also have good exposure to UK and US index-linked government bonds that should outperform conventional fixed income, if interest rates and inflation rise. Other assets, such as infrastructure and property, may benefit from higher government spending towards areas such as transport, housing, hospitals and schools. Finally, given the potential for any market upset from 'Brexit' and heightened global political tensions, not least due to the large number of impending elections, it seems prudent to maintain a higher than normal proportion of a portfolio in cash.

Figure 2. Sterling and UK Core Inflation



Source: Bank of England Inflation Report August 2016 Past performance is not a reliable indicator or future performance