Thesis Market Commentary

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Does 'political uncertainty' matter?

With the machinations of the last year, the phrase 'political uncertainty' has rapidly come back into vogue when discussing stockmarkets. Although the term is slightly vague, the prevalence of uncertainty in the market place can now be measured (in theory) and has more recently been categorised through the innovative 'Economic Policy Uncertainty' set of indices. In a rather clever way these trawl through newspapers and other sources for any key words or phrases that indicate unease about future policy direction. Unsurprisingly these indices have been surging in recent months, but should we be worried?

As grand overseers of the private sector, governments can affect companies in a variety of ways: through taxes, regulation, subsidies and through their international relationships. When changes occur, people worry more and the old adage that markets hate uncertainty is often heard. But what is ever certain?

Uncertainty reflects the unknown, an uncomfortable and unquantifiable environment where assigning probabilities to future events with any confidence becomes almost impossible. Uncertainty makes it difficult to balance risk and return appropriately and it has, on occasion, foreshadowed market downturns and volatility.

Intuitively this makes sense. Investors (typically) buy and sell based on how they see any particular company performing in the future. Unpredictable uncertainties make the future more difficult to forecast. Investors are less willing to pay for uncertain returns and, all else being equal, prices in risky assets normally fall.

In addition to causing jitters in the stockmarkets, uncertainty can also affect the 'real' economy. When businesses or individuals perceive uncertainty they become more reluctant to commit capital. Brexit provides a convenient example with its myriad of possible outcomes for a company. Unsure of Britain's future place within global trade, building an expensive plant, for example, could perhaps prove to be a costly mistake. A more sensible strategy might be to wait until negotiations are underway and the level of uncertainty has diminished. If every firm took this view it could clearly potentially cause a broad-based short term decline in economic activity.

Given the above, it seems counter intuitive that markets have continued their record breaking trend upwards! As with all things, however, it is worth looking at the bigger picture.

Take Donald Trump, who has undoubtedly created a maelstrom of uncertainty, not least in regard to the Koreans. However, not all uncertainty is equal in the eyes of the market. It is important to remember that Trump is potentially still seen as a business friendly president, with a populist agenda that should provide a short term boost in output, employment and real wages, even if he has trouble delivering anywhere near his full mandate. US business confidence appears unshaken by his eccentric judgement, with the CEO Economic Outlook Index (a gauge of CEOs' plans for investment, hiring and sales) only increasing since the election.

More importantly, economic data in the US has also continued to show resilience and corporate earnings have been buoyant, with 73% of the S&P 500 companies that have reported so far topping estimates. Although markets are supposed to hate uncertainty, a mix of uncertainty and good data is much more preferable to certainty and poor data. Simply put, unless political uncertainty translates into a significant impact on the real economy or corporate earnings, markets won't react too severely in the short term.

Closer to home, Brexit represents a slightly more complex scenario and will likely be seen as one of the most ambiguous events in recent history. Without writing an entire thesis on the matter, it is sensible to note that while political uncertainty has undoubtedly had some effect on the real economy, it is far from the apocalyptic scenario imagined by some.

How markets reacted in the aftermath is perhaps more significant for us as investors. As many would have noted, sterling devalued following the vote and therefore many UK companies, due to their international earnings, immediately saw an increase in revenues. As around 71% of revenues in the FTSE 100 are denominated in foreign currencies, this led the index broadly higher. Clearly, a significant number of UK listed companies are well and truly global in nature. Fortunately, this not only acts to diversify their cash flow, but also provides insulation against the influence of home grown political

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decisions. Conversely, some of the more domestically focused companies suffered, but anyone who invested at these attractive valuations would have been well rewarded now, which tells us that political uncertainty can also create opportunities.

Another relevant by-product over recent months is the number of companies announcing plans to move operations away from the United Kingdom if Brexit negotiations prove unfruitful. While the economy may suffer from such an exodus, this emphasises that in today's interconnected world, businesses can be increasingly nimble in how they deal with political uncertainty.

As investors, we must remember that we invest in companies and not countries. Businesses can move far faster than politicians often can and with new companies like Airbnb, Uber and others, globalisation's march forward is unlikely to be halted.

To summarise, news articles will continue to focus on political uncertainty. It's their job to sell bad news! While we should never ignore or become complacent about such uncertainty, we must continue to place it in the wider context; balancing it with any number of other dynamics that could affect future trends in stockmarkets. The actual valuations of assets (ie whether cheap or expensive) are by far a bigger driver of future long term investment returns, compared to either economic news or political uncertainty in the short term...

Source: Measuring Economic Policy Uncertainty (2015), Baker et al.

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News and views

With roughly two-thirds of corporates already having reported second quarter earnings, it is pleasing to see a trend of most sectors delivering positive growth and a majority of companies beating estimates. The market response to the good results however has been rather muted with stocks that beat estimates only outperforming marginally, while those that disappointed fell sharply. I presume this is reflective of where equity valuations find themselves, at above historical averages, and only those companies delivering superior earnings will maintain their strong share price.

Indices	Value as at 31/07/2017	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7372.00	0.81%	3.21%	9.63%
FTSE All Share	4046.20	1.10%	4.47%	10.74%
S&P 500	2470.30	1.93%	10.34%	13.65%
Dow Jones	21891.12	2.54%	10.77%	18.77%
Euro Stoxx 50 EUR	3449.36	0.22%	4.83%	15.33%
Nikkei 225	19925.18	-0.54%	4.24%	20.25%
MSCI Emerging Markets	1066.23	4.66%	23.65%	22.07%
UK Treasury 1.25% 07/22/26	103.25	0.56%	0.86%	-3.24%
Sterling/US$	1.32	1.40%	7.24%	-0.29%
Sterling/Euro	1.12	-2.01%	-4.55%	-5.81%

Source: Bloomberg

US

As expected, US growth accelerated from the soft 1.2% in the first quarter to an annualised rate of 2.6% in the second quarter. The Federal Reserve (Fed) held interest rates steady although it said plans to reduce its balance sheet would begin shortly. It appears at this stage that the Fed is not going to be side tracked by softer inflationary pressures in the short term, and with the number of jobs being generated by the US economy beating expectations with 220,000 jobs being added, it is likely the Fed will stick to its path of lifting interest rates gradually. Political events resurfaced with the Trump administration facing yet another setback when President Trump's healthcare reform bill ended in failure. The market took the news in its stride although the healthcare sector was among the weaker performers over the month.

UK

Governor of the Bank of England Mark Carney continues to sound alarm bells over the growth in consumer credit and car loans, fearing banks are becoming complacent and assuming the relatively good economic times will continue indefinitely. On the back of this, the Prudential Regulation Authority will bring in a new 'stress test' and ordered lenders to provide details by September of how they are protected against customer debt risks. On the macro front the latest treasury update shows consensus GDP forecasts for 2017 at +1.6% YoY, followed by +1.4% YoY for 2018. UK equities bounced back over July following their poor performance in June, albeit the recovery was driven by a narrow band of stocks and

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sectors, with resources companies being top contributors as supportive Chinese economic data drove a sharp recovery in industrial metal prices.

Europe
European equity markets continued to tread water in July as expectations of less expansionary policy from the European Central Bank pushed the euro higher and effectively put the brakes on the equity market rally. The euro-area economy maintained its steady and broad-based expansion but with inflation still elusive and unemployment still lofty, albeit falling, it is difficult to determine the future path of monetary policy in Europe.

Japan
The latest update to the official economic projections acknowledged the struggles the Bank of Japan has had in achieving a sustainable pick-up in inflation. It is pushing back the year in which it expects inflation to reach its 2% target level from 2018 to 2019. Japanese equities were left behind in the broader global market advance as the yen appreciated against the dollar in the second half of the month. Headwinds were also felt from Prime Minister Abe's ruling Liberal Democratic Party's heavy defeat in the Tokyo Metropolitan Assembly election. This has raised a red flag that Shinzo Abe is facing an uphill struggle amid plummeting ratings and a growing lack of confidence in his leadership.

Emerging
Emerging markets recorded another robust return, with dollar weakness providing a tailwind. Equity markets in Asia advanced as China recorded an above consensus estimate of second quarter GDP increasing 6.9% year-on-year, seemingly showing little impact from the authorities' moves to selectively tighten liquidity. In Latin America, Brazil was the best performing market as the central bank cut interest rates by 100 basis points to 9.25% and signalled that further reductions were on the agenda for their next meeting scheduled for September. In addition to this the Senate passed a government-sponsored labour reform measure, aimed at loosening decades-old employment laws, that provided a boost for stocks.

Bonds
A softening in inflation data and tempering of central bank rhetoric helped corporate bond markets to outperform government bonds. The premium over government bonds that corporates pay to borrow is extremely tight at the moment and is potentially another sign of investor complacency.

An update on some of our favoured stocks

Segro
We think Segro delivered a strong set of first half results and operating metrics, reflecting a portfolio which is well-positioned to take advantage of favourable occupational and investment market conditions. Its successful £557 million rights issue during the period created significant capacity for growth. Three quarters of the proceeds have already been deployed or allocated to specific investment opportunities, including taking full ownership of the APP portfolio of industrial property at and around London's airports. Furthermore, business confidence in Continental Europe has picked up in recent months, which is promising given its aggressive land banking focus in Germany, Italy and Spain as the 'hot' logistics markets. Importantly there is no sign at the moment of any slowdown in the growth of internet retailing which is an essential driver of demand for modern warehouse space across its markets, both in big boxes used for logistics and smaller, urban warehouses used for last mile delivery. Segro shares trade at a premium rating versus the other large REITs and rightly so, we think, since the outlook for the company remains positive given strong occupier demand for industrial/logistics property and a largely de-risked development pipeline.

Smurfit Kappa
Smurfit Kappa is one of the leading providers of European and Latin American paper-based packaging, and key to its success has been its collaboration with forward thinking customers by sharing superior product knowledge, market understanding and insights in packaging trends to ensure business success in their markets. This strategy has been further reinforced by the expansion of its Global Experience Centre network with the opening of its first Experience Centre in the Americas, located in Dallas, and its latest European venture in Madrid. The focus on helping customers succeed in their marketplace whether it is increasing sales through using ShelfSmart, or reducing costs by using SupplySmart is a growing success. Smurfit reported revenue growth of 5% for the first six months with strong demand in most markets, with containerboard price increases feeding through to corrugated price recovery. We think Smurfit is well placed to continue to capitalise on a positive pricing environment and expect it to deliver sequential margin improvement through the remainder of 2017 and into 2018. In addition to this, we believe industry fundamentals continue to look attractive with inventories remaining low and new capacity increases in Europe being absorbed well by the market. The valuation discount to peers looks unjustified to us and we think a period of outperformance is warranted.

BAE Systems
BAE Systems is one of the world's leading suppliers of defence equipment and systems. It delivered strong results for the first half of 2017 and has reiterated its full year guidance, supported by a number of new contract wins. A slight negative stemming from this update was that Typhoon deliveries (not production activity) would fall from 20 in 2017 to 11 in 2018. In addition to this we think the pending outcome of the triennial pension funding review is holding the shares back at the moment. Clarity from the deficit funding arrangements will be eagerly looked for towards the end of this year. Aside from these headwinds

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BAE benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia which provides a good degree of earnings visibility. Governments in its major markets continue to prioritise defence and security, with strong demand for its capabilities. The US Department of Defense 2018 budget proposal is likely to be the next catalyst for the stock, if passed in a timely manner. The proposal contains some promising funding for areas where BAE operates and would support the medium-term planning assumptions. We believe BAE is a strong, well run business offering leading technologies that give it a competitive advantage and make it well placed to continue to generate good returns for shareholders.

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