QUARTERLY MARKET COMMENTARY

BREXIT: It seems that this is the only word we have heard in the last three years and if you are anything like us, you just want a final resolution to this process, whatever that may be.

However, it seems we are even further away from a resolution than we were just a few months ago with Theresa May stepping down as Tory leader on 7 June, the subsequent Tory leadership battle, Labour's push for a second referendum and the UK's European election result for Nigel Farage and his BREXIT party.

Whatever the outcome on 31 October, clearly there will be some form of economic impact on both the UK and the European region. Of course, the economic impact will be dependent on what the outcome is and could be very different for both sides.

Michel Barnier, chief negotiator for the European Union (EU), and Emmanuel Macron, French President, have both been very vocal over the last year in their steadfast refusal to adapt or be flexible to Theresa May's withdrawal agreement, citing the 'European region's right to defend its position against the red lines that the British have chosen themselves'.

To a large extent, this cannot be argued, given that it was the UK's decision to seek a withdrawal from the EU. However, the constant and critical message of apparent betrayal levelled at the UK by the EU and the potential negative impact on our domestic economy is never far from the headlines.

A number of leading investment companies and commentators have tried to set out an economic path or trajectory for the UK depending on the various factors involved. The results, as you would expect, have been very mixed, from the UK entering recession 12 months after the UK leaves the EU to the UK being one of the best performing economies in the region.

As with all of this, it is purely conjecture, given the number of various factors involved. However, it would be interesting to see how the two economic regions are performing now and consider which is perhaps best placed to withstand the uncertainties surrounding BREXIT. Let us take a look.

The UK economy, as measured by the Gross Domestic Product (GDP) grew by 0.5% in the first three months of 2019, following a 0.2% rise for the last three months of 2018. Indeed, the International Monetary Fund (IMF), in its latest 'World Economic Outlook', has forecast GDP growth in the UK at 1.2% for 2019, compared to 1.3% for the Euro area as a whole, but has stated that it retains the right to increase its forecast for the UK Economy this year.

This does seem somewhat stating the obvious, given that the UK economy achieved almost 50% of the IMF forecast in the first quarter alone! Looking at the key drivers of the economy, consumer and government spending were robust and net trade, which had been a detractor in Q4 2018, strengthened following previous measures to stock build by companies ahead of BREXIT.

Inflation in the UK, as measured by the Consumer Price Index, is at a comfortable level of 2.1% (as at 22 May 2019), slightly above the Bank of England's inflation target but not high enough for the UK Monetary Policy Committee to start worrying about interest rate rises.

UK Labour and unemployment data remains incredibly strong with the unemployment rate in the UK at 4%, the lowest level since records began in 1975. As a result, UK wage growth grew at its fastest rate since 2008 amid labour shortages and as companies struggle to fill vacancies.

Retail sales were strong in the first three months of the year, whilst Manufacturing PMI (Purchasing Managers Index) stood at 55.1%, one of the highest in the developed world.

There has been a noticeable detraction in the UK housing market over the last year with the latest forecast from the Royal Institution of Chartered Surveyors (RICS) suggesting that overall sales volumes are set to weaken by around 5% in 2019. This reflects a lack of homes on estate agents' books, affordability issues, uncertainty surrounding BREXIT and prospective interest rate rises.

However, the Central Bank support of Quantitative Easing (QE) and ultra-loose Monetary Policy in the UK since 2008 has had the desired effect of increasing money supply in the economy and allowing the UK banking sector to improve their balance sheets. As a result, the UK consumer looks in reasonable shape, the banking sector has strengthened and share prices in the UK look comparatively cheap.

In Europe, the picture looks less rosy. Growth, as measured by GDP, came in at 0.3% for the first 3 months of 2019. This followed the IMF slashing their growth forecast from 1.7% to 1.1% for 2019. The Eurozone unemployment rate currently stands at 7.8%, which although an improvement on the 10% rate in 2016, still remains at elevated levels compared to the UK and US.

Eurozone activity has declined with business and manufacturing PMIs falling sharply since the turn of the year. Indeed, the latest reading in Germany is the lowest in 6 years.

Italy is already in recession with suggestions that Germany and France are not far behind. The German 10-year bund yield has also turned negative, on fears of a deflationary environment.

The European Central Bank have taken a number of measures to stimulate the economy since 2008 with their own QE programme and monetary policy. However, recent economic data would suggest that further stimulus may be required. Accordingly, future expectations of interest rate rises have been pushed further out and the ECB recently launched a further round of TLTROs (Targeted Longer Term Refinancing Operations). This allows European banks to borrow from the ECB to loan to companies. The ECB rate is -0.4%, so banks are getting paid to borrow the money. A number of questions remain over the solvency and future credit worthiness of certain European banks.

Italy's debt has also been in the news again. The European Commission recently published an analysis of Italy's debt levels, which showed the country is in serious breach of Eurozone budget criteria. This perhaps should be no surprise, given the Italian coalition government's previous hard-line stance with their EU counterparts. In essence, Italy's dispute with the EU is about sovereignty. Who gets to make the decisions about how the national economy is run – even if that means running it into the ground.

As we have said before, all of this is happening at or near the time when Mario Draghi, head of the ECB and considered one of the most accomplished central bankers, is set to step down. His term finishes in November. The debate should not really be who will win and who will lose from the BREXIT process. But in this world of protectionism and self-survival, it will inevitably boil down to this point. If that is the case, then the UK appears better placed than the EU to weather the next storm clouds approaching!

As always, it is impossible to predict the future - especially whether stocks and shares will fall or rise. Therefore, it is important that medium to long term investors maintain a diversified portfolio to benefit from stockmarket rises when they happen and to dilute volatility when there is a fall. Our strong belief is that a sensible investment strategy involves riding out stockmarket volatility.

June 2019