A Meaningful Vote?

October proved to be the worst monthly performance in six years, as worries over US interest rate hikes, trade wars and European politics all combined to test investor nerves across the globe. The reporting season in the US was extremely positive with earnings up over 20% year on year, but broadly in line with expectations. Bonds were mixed with gilts firmer as Brexit issues seemingly reduced the chance of further interest rate hikes, whilst US-issues were weaker for the opposite reason. Elsewhere, the oil price continued its slide and at the time of writing is down nearly a third in six weeks. Gold has held up, but hardly offset weaker equities, whilst sterling edged back to its lowest level.

This month we had intended on quietly skipping a commentary, on the view that it would be made up in December by a much a larger, forward-looking edition. The only topic that seems to be of interest is Brexit and we've made our position clear in the last two pieces, here. There are countless things that we could comment on, or more to the point repeat, but sometimes it feels difficult to say anything useful given the incessant cacophony around us.

However, over the last few days we have received several calls and emails from clients asking pretty much the same question:

Given that it looks as though Theresa May will not get the majority that she needs to get the draft Brexit deal approved by parliament in the meaningful vote (expected to be at 7.00pm on Tuesday 11th December) shouldn't we be worried that the UK stock market will crash at the open on 12th December? Should we rethink our strategy?

In light of the remarks made by Bank of England Governor Mark Carney after the market close this evening (Wednesday 29th November) that a no-deal Brexit would:

- have worse consequences than the financial crisis of 2008
- cause a recession next year with GDP falling 8%
- lead to house prices falling by 30%
- lead to unemployment back over 7.5% (from 4.1%)
- lead to inflation of 6.5% (from 2.4%)

It seems likely that we will get a few more calls today.

Our position is as follows.

We believe that trying to second-guess the outcome and ramifications of the Brexit negotiations is ultimately of limited use when it comes to making investment decisions, assuming that you had a prudent strategy in place for the outset. There are several sources of concern that are far more important, which include:

- US interest rates and the risk of hiking too high, too quickly
- Full-blown global trade war
- Italian economic and political collapse and consequences for the EU
- Rising Chinese debt levels
- Rising value of the dollar and Asian indebtedness

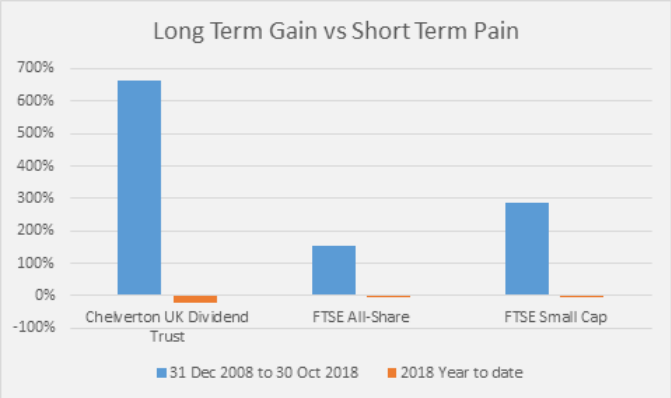
Any of these five issues could create a worldwide recession. Although recessions are generally not conducive for buoyant stock prices, it wouldn't necessarily lead to a material sell-off either. In other words, identifying cause and effect is hugely prone to error. To go as far as saying that Brexit is a red herring risks appears flippant – but we are tempted. But it is a distraction. In short, there are far more important factors that are likely to affect portfolio values. And at the time of writing the Dow Jones index is up a huge 600 points (+2.5%) after Jerome Powell, the US Fed Chairman, hinted that the widely anticipated rate increase in December may not materialise after all.

So will the stock market crash on 12th December? We strongly doubt it for the following reasons:

- Large one-day moves usually happen very unexpectedly. In this case although we appreciate the seriousness of the consequences, the market has had time to prepare. A worst-case scenario for the stock market is that whatever happens, the chances of a Corbyn government go up. But even then, how much will this move the price of AstraZeneca, Unilever or Diageo for example? Here is a prediction – by the close of play on December 12th, the FTSE-All Share index (a) will not be down by the most across the major developed markets (b) will not have been the most volatile.
- UK equities are already too cheap and reflect much, if not all of the bad news. The P/E ratio based on expected earnings at the end of 2019 for the FTSE All Share is 11.4x and compares to the US S&P-500 Index on 15.4x, Europe ex-UK on 12.7x, and the Japanese Nikkei 225 on 14.1x. (A higher ratio broadly indicates a market that is more expensive.)

This final point is ultimately the source of upside. We would argue that the UK should be at least at the same level as Europe, which has far bigger problems in the form of Italy, for example. The FTSE would need to rise over 10% for it to even out on a valuation basis. That could happen in a very short space of time.

Earlier this week we met up with David Horner, the Chelverton UK Dividend Trust lead manager. His strategy is built on the premise that superior returns can be achieved by smaller companies that successfully grow their dividends over time. There seems to be something in this because, as the chart below shows, the returns over the last 10 years have been extraordinarily good.



However, the less said about 2018 the better. At the time of writing the fund is down 23.8% compared to the FTSE All Share Index-5.6% and the FTSE Small Cap Index down 6.3%. The problem with the strategy is that at certain times, the investable universe can become deeply out of favour almost overnight. It is not so much the fact that it is smaller companies, which hasn't helped of late, more that they are UK-centric companies with relatively small exports. In an environment of higher import costs due to a weaker sterling, worries over a flight of cheap labour out of the country, the entire category can be tarred with the same brush. The largest holdings are Diversified Gas & Oil (DGOS), a producer and distributor of oil in North America, pub group Marstons, and Randall and Quilter (R&Q) a provider of specialist insurance services. Brexit doesn't exactly jump out as a reason to threaten the business model of any of these companies, but the valuations are beginning to suggest so. DGOS is now trading on a forward P/E ratio of just 7.2x and offers a prospective dividend yield of 6.5%. By comparison Marstons is on 7.7x and 7% and R&Q on 9x and 5%. According to Horner these companies are trading 'at the wrong price', i.e. they are far too cheap. The fact of the matter is that in the current environment with the Brexit doom-mongers at full volume it is difficult to hear the good news that is coming from any of these companies. But if they execute to plan, it becomes very clear why the returns could be huge over the next few years, but it does require patience, and that seems to be in short supply at the moment.

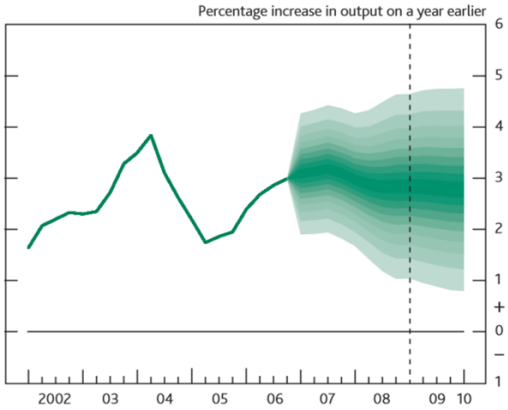
What seems remarkable is that the general public have not ran out of patience with the wild and inaccurate predictions of Mark Carney. If in any doubt of his team's ability to predict the future, we suggest a look at the four charts on page 3 of this article that show the track record of the Bank of England's forecasting team in the recent past. This lends weight to the great JK Galbraith's famous quote that the only function of economic forecasting is to make astrology look respectable.

Finally, one word on tolerance to risk. We generally rate this on a 1 to 10 basis with 10 representing the highest risk. The recent volatility has proven a good time to reassess this subject because actual recent events have served as a reminder that markets fall as well as rise. Many of the comments have been along the lines of "I think I'm a 3 out of 10 ahead of Brexit, but a 7 out of 10 afterwards". This is an understandable but major error. It implies that an ability to absorb capital losses is based upon European politics, which clearly doesn't make sense.

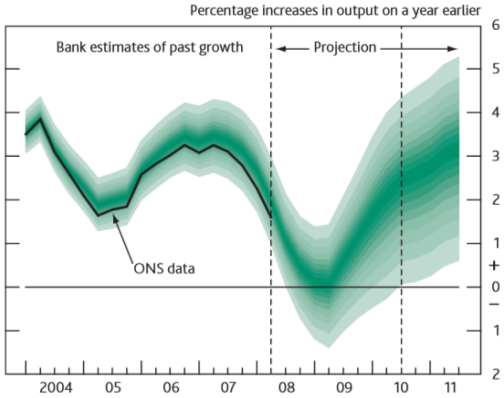
Our mantra is stay diversified, buy what appears to offer value and don't get drawn into buying and hoping. If holding cash makes you feel more comfortable, that is fine, but be aware that the opportunity cost could be high. And finally try not to let the media influence your thinking, we certainly don't.

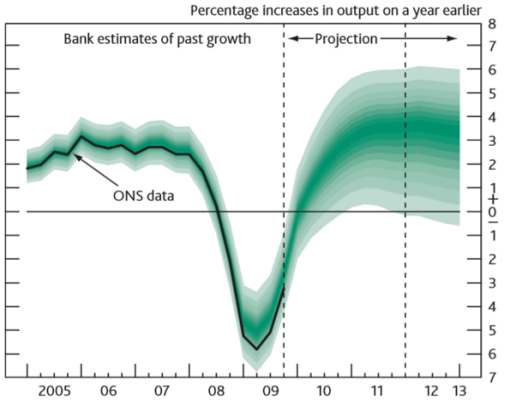
You're Going On A Long Journey ...

The four tables below tell the story of show the accuracy of the Bank of England's predictions before and after the financial crisis.

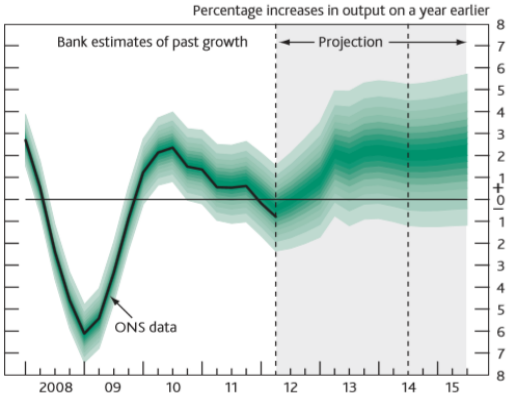


The chart on the left was drawn up by the Bank of England in February 2007, showing the actual and expected path of GDP growth. What it says is that the chances of hitting 1.0% in mid to late 2008 were very slim. By August 2008 a lot had changed and they were still waiting for lagging data to be confirmed.





By February 2010, the true picture emerged, and as it turned out GDP growth was-5%, a number deemed practically impossible before. Not daunted by being so spectacularly wrong, they continued unabashed, but this time almost doubled the range of potential outcomes. The result? They still missed the downturn in late 2011/early 2012.



Index	Region/Asset Class	31 Oct 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,128.1	-5.1%	-4.9%	+2.5%
UK Mid Cap	UK	521.6	-6.6%	-7.3%	+2.9%
UK Small Cap	UK	5,439.7	-6.6%	-6.8%	+9.4%
Dow Jones Ind Avg	USA	25,115.8	-5.1%	+7.4%	+38.4%
S&P 500 Index	USA	2,711.7	-6.9%	+5.3%	+27.5%
NASDAQ Comp.	USA	7,305.9	-9.2%	+8.6%	+40.8%
Nikkei 225	Japan	21,920.5	-9.1%	-0.4%	+25.8%
Euro Stoxx 50	Europe	3,197.5	-5.9%	-13.0%	+4.7%
CAC 40 Index	France	5,093.4	-7.3%	-7.4%	+13.0%
DAX Index	Germany	11,447.5	-6.5%	-13.5%	+7.3%
Milan Index	Italy	19,050.2	-8.0%	-16.4%	+11.2%
MSCI Emg Mkts (£)	Emg Mkts	513.8	-6.8%	-9.1%	+5.7%
IBOVESPA Index	Brazil	87,423.6	+10.2%	+17.6%	+34.7%
IMOEX Index	Russia	2,352.7	-5.0%	+14.0%	+18.2%
S&P BSE SENSEX	India	34,442.1	-4.9%	+3.7%	+23.3%
Shanghai SE Comp.	China	2,602.8	-7.7%	-23.3%	-16.1%
Hang Seng	Hong Kong	24,979.7	-10.1%	-11.6%	+8.9%
UK All Property	UK Property	134.9	-0.1%	+5.8%	+12.4%
UK Conv Gilts	UK Gilts	3,574.5	+0.9%	+1.3%	+1.9%
UK Index linked Gilts	UK IL Gilts	4,940.4	+2.8%	+3.3%	+0.8%
JPM Glob Agg. Bond ($)	Global Bonds	550.0	-1.2%	-2.2%	-0.9%
iBoxx Non-Gilt	UK Corp Bonds	336.5	+0.5%	+0.2%	+3.8%
WTI Crude ($/barrel)	Oil	65.3	-10.8%	+20.1%	+39.4%
LMEX	Base Metals	2,856.6	-4.6%	-12.4%	+14.2%
Gold Spot ($/oz)	Commodities	1,214.76	+1.9%	-4.4%	-4.9%
S&P Agri & Livestock	Agriculture	712.82	+1.3%	-7.8%	-11.7%
£1 = US$	Currencies	1.28	-2.0%	-3.9%	+4.3%
£1 = €	Currencies	1.13	+0.5%	-1.1%	+1.2%
£1 = Yen	Currencies	144.19	-2.7%	-4.5%	+12.4%