The UK stock market has been volatile over the last 12 months but ended up travelling sideways overall. This period of consolidation follows strong gains and should prove healthy, provided that the adverse influences of political uncertainty, trade disputes and the gradual removal of central bank policy support do not tip the world into a period of disappointing growth or recession. As things stand, global GDP growth has slowed a little from its recent peak but still stands at a robust 4% year on year.

Below we update readers on three issues that have dominated recent news flow; US/China trade frictions, Emerging Market weakness, and Brexit. We then review how we are managing both the risks and opportunities of Brexit before re-affirming our overarching thoughts.

“global GDP growth still stands at a robust 4% year on year”

Trump’s Trade Wars
Having already exchanged tariffs on $50bn-worth of each other’s goods earlier this year, the United States and China have recently imposed new tit-for-tat tariffs. US tariffs on an extra $200bn-worth of Chinese goods and retaliatory tariffs by Beijing on $60bn-worth of US products took effect on 24 September. On the plus side, markets are relieved that the US will be applying a tariff of only 10% on these goods, rather than the 25% that had been mooted. On the downside, there seems a good chance that we have not seen the last shots in this battle. The US tariffs are set to rise to 25% at the start of 2019 if an agreement is not reached and Trump has threatened to respond to retaliation by imposing tariffs on all imports from China.

Commentators fear that an escalating trade war between the two largest economies in the world could meaningfully damage global growth prospects. Our hope and expectation remains that investors should expect common sense to prevail. Mr Trump’s tactic is to impose tariffs until he gets an offer of more favourable market access from the counterparty. Peace and a better trade agreement could break out at any moment and, in the meantime, the tariffs to date affect a very small proportion of world activity.

Emerging Market weakness
Having enjoyed a strong 2017, Emerging Market equities have been firmly out of favour on the back of persistently negative news flow. In particular, crises in Turkey and Argentina have captured headlines, prompting concerns of contagion risk. Both these countries have been forced into dramatic interest rate hikes (to 24% and 60% respectively) in an attempt to curb inflation following significant falls in the lira and peso.

More broadly, Emerging Markets have come under pressure from the rising trade tensions and a strengthening US dollar, which is being supported by the fact that the US Federal Reserve is raising interest rates relatively quickly compared to other major central banks. The reason US dollar strength has, to date, been seen as bad for Emerging Markets is that their economies typically borrow in dollars whilst paying the interest out of local currency profits, leading to a potential funding mismatch in the event of dollar strength. In the late 1990s, this situation led to defaults by Brazil and Russia, followed by a crash in the Asian “tiger” markets. Having said this, lessons have been learnt and central banks in these countries have since kept much better controls over borrowing in US dollars.

Intriguingly, this negative sentiment has left Emerging Market equities looking cheap both in absolute and relative terms. In aggregate, they now trade at a historically large discount to Developed Market equities, despite having a superior long-
term growth outlook. This looks attractive for investors with a long-term focus that will be able to ride out further short-term weakness in the event that US/China trade frictions escalate and/or the dollar strengthens further.

Brexit risk
Having triggered Article 50, the UK’s two year window for negotiating an exit from the EU ends on 29 March 2019. The recent informal EU summit in Salzbug failed to provide any sort of breakthrough in the negotiations. If anything, the two sides seem further apart.

The key sticking points are still the UK’s future trading relationship with the EU and how to avoid a hard border between Northern Ireland and Ireland or between Northern Ireland and Great Britain. Both sides seem to have hardened their stance. Donald Tusk said that the UK’s “proposed economic framework would not work” as it risked undermining the Single Market. For her part, Theresa May has rejected the EU’s modified plan for the Irish “backstop”, as it still implied a customs border in the Irish Sea.

Looking forward, negotiations are likely to ramp up again before the next European Council meeting in mid-October. Ultimately, our view is that a deal will be reached - but only at the eleventh hour. This leaves plenty of room for uncertainty in the meantime and one cannot rule out the possibility of a no-deal Brexit. It is therefore unsurprising that the most common question on clients’ lips at present is something along the lines of “how are you managing Brexit risk?” Our approach can broadly be summarised as follows:

1. Continue to manage well-diversified portfolios
Our policy has long been to manage equity portfolios that are well diversified by company, sector and geographic exposure. In this way we create robust portfolios that are well prepared for dealing with problems in any one company, sector or geography. In the example of Brexit, the largest threat remains the continuing weakness of sterling. If we leave without a deal then it is likely that sterling will weaken further. Whilst it is true to say that our equity portfolios have a strong weighting to the UK stock market, this is not equivalent to reliance on the UK economy. The UK stock market remains heavily skewed towards large multi-national companies that trade around the world and are simply listed here in the UK. In the event of further sterling weakness there is every chance that the UK stock market would perform well, thanks to the overseas earnings of the constituents translating into higher sterling earnings. Indeed, this is precisely what we saw happen in the aftermath of the Brexit vote on 23 June 2016. To this extent, the UK stock market provides a natural hedge against any woes that befall sterling and the UK economy.

2. Be alive to opportunity
Investing is about taking advantage of opportunities as well as managing risk. Thanks to the political uncertainties of Brexit and the possibility of a left-wing government coming into power, the UK stock market remains stubbornly out of favour with global investors. In particular, there is a marked divergence of performance within the UK stock market. Whilst the internationally focused stocks have typically performed relatively well, domestically focused stocks are singularly unloved, trading at valuations last seen post the 2008 financial crisis. Historically, such circumstances have proved a fertile hunting ground for stock-pickers. Within the constraints of sensible diversification, it is important that we do not neglect these opportunities.

Conclusion
We remain convinced that equities will deliver the best long term returns compared to the alternatives of cash and fixed return investments. However, we also retain the view that equity returns will moderate and that market volatility will increase from here. Stock markets have enjoyed strong returns since the Global Financial Crisis 10 years ago and there is, quite reasonably, some concern that the prevailing global uncertainties will combine to drive some form of stock market correction. We cannot refute this but we do find comfort in the fact that the valuation of the UK stock market does not feel too stretched – certainly compared to the US market, which has charged ahead and now looks very expensive (a cyclically adjusted earnings multiple in excess of 30x puts it in the 97th percentile of historic valuations). When the next market setback comes, the relative value offered by the UK stock market should lend our portfolios a robust quality. In contrast, the US equity market may be vulnerable given its uniquely high valuation and the possibility that the US economy may now come under pressure as tighter monetary policy bites and the positive effect of recent tax cuts fades.