Psigma
Investment Management

8th October 2018

View from Psigma
POLITICS AND BREXIT

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We have regularly been asked for our comments on the ongoing UK political situation and how our view on the UK departure from the European Union is shaping our investment strategy. We therefore thought it would be useful to detail clearly our latest thinking on this tricky subject and how our views are influencing the way we are currently managing our client portfolios.

The view that we have held since the morning after the Referendum on 23rd June 2016 remains the same; agreeing a smooth exit from the European Union will be very challenging and an eventual deal is unlikely to please either side, nor the vested interests on both "sides" of the divorce. Indeed the recent lack of cohesion in Brussels and amongst the Conservative Party, as well as the absence of any form of sensible alternative suggested by the Labour Party in the UK, show clearly how perilous the discussions have become. Admittedly there have been a few hurdles apparently cleared, even if the runners have then on occasion stumbled backwards and knocked them over, but the major points of argument over the terms of post-Brexit trade, the free passage of European citizens and the requirements for the border in Northern Ireland remain unresolved to varying degrees. Until we see some resolution in each of these three matters it is impossible to see a satisfactory end to the situation. At this time we continue to view the chance of "no deal" as being very real, but much can change in the coming months, and surely politicians both here and in Europe must realise that some sort of trade agreement is vital for both the UK and the export-dominated markets in Europe. Another Referendum could also open up another range of possibilities, were the Labour party to join certain Conservative "rebels" in calling for one of the eventual deal that is reached with Europe.

The issues of course are not just in the UK, but also in Europe, where both the leaders of France and Germany are in unfavourable domestic situations and where a great division exists between pro-Europeans and nations like Hungary and Italy. We must wait to see what final approach the Europeans take to the negotiations.

The UK political situation has been unsustainable ever since June 2016 and became much more so after the snap UK general election that was held in May 2017. The failure of Mrs May and the Conservatives to achieve the convincing win that they were forecast and they themselves fully expected, (our own view was that a landslide was unlikely), has crippled the power that the government holds and materially weakened their negotiating hand in Brussels, as we feared it would. To date, the Conservatives have proved that that their ability to hold on to power is one of their undoubted strengths and the potential for a second election started to diminish when an agreement was made with the Democratic Unionist Party in Northern Ireland, a relationship that has ensured a fragile grip on power ever since. It perhaps speaks to the credibility of the current UK parliamentary opposition that despite the increasingly levels of acrimony within the Conservative party, there has been no further election or a complete collapse of the current government.

The Corbyn-led Labour party continues to call itself a "government in waiting" but the chances are that such a possibility has become less likely since the post-election months of 2017. Our view is that we have probably passed the point of "Peak Corbyn". Indeed the reaction to the recently ended Labour party annual conference was far from impressive, with seemingly many moderate labour voters put off by the "hard left" economic suggestions and the continuing undercurrent of anti-Semitic feeling. One cannot rule out a Corbyn-led administration, even if the chances appear to have receded, particularly as many sections of society have become increasingly bitter over the divergent fortunes of the rich and everybody else from the "recovery" that has taken place after the Great Financial Crisis. This is of course not just a UK phenomenon and my recent trip to the US showed that the societal scars there also run very deep. Those who forecast that "populism" was on the wane should think again after recent elections in Italy, Germany and Sweden, and the deep divisions in society and widespread dissatisfaction with the political elites remains. This is likely to continue as the grave economic situations brought about by heavy debt loads and poor demographics weigh upon the developed world. Our chief view is that politics in both the UK and other parts of the world is as high now as it has been for a long time and these domestic and international fears influence our investment thinking.

Our Investment Strategy

We created our investment process fifteen years ago around a "global, go anywhere" approach and we continue to stress that events in Washington and, increasingly, Beijing are more important to our portfolios than what happens in 10 Downing Street. That being said, "Brexit" and the potential of a Prime Minister Corbyn are arguably two of the greatest political threats that our country has faced in decades, so we have taken a number of steps over the last few years to completely understand the risks we are taking in the UK and ensure we are adequately compensated for them. A key example of where we are being suitably rewarded is our positions in high quality UK corporate bonds, where UK investors can glean an additional 1% in annual yield from investing in investment grade UK corporate bonds over their global peers. This "Brexit premium" is sufficient compensation, not least as we view Brexit as a risk to corporate profitability of high quality companies, rather than a solvency risk. On the other hand we are almost totally eschewing the dubious virtues of UK gilts, where we feel that 1.5% per annum is too low a reward for lending money to the cash-strapped UK government. We are also being selective about those investments that we will make in the UK, whether in bond or equity markets.

Our approach has also always been to view UK equities as "just another asset class" and to invest in UK-listed international companies as a "window on the world". We have held an "underweight" stance on UK equities for much of the last few years and the allocation we have to domestic UK equities is relatively small. We continue to believe that better opportunities exist elsewhere in global markets, most notably in Japan and certain emerging market economies, and valuations of such assets are lower than those in the UK. This underweight UK stance is certainly up for debate and as part of our "open minded" approach and given our contrarian philosophy this might change in the future, but for now the economic outlook and asset valuations in the UK are insufficiently attractive for us to increase our allocations.

As part of our overall risk analysis we can say with precision what the UK economic influence on our portfolios is. Including the aforementioned UK corporate bonds and UK domestic-facing equities, our portfolios are about 25% invested in UK-sensitive investments, some of which might actually benefit from a flight to quality in a dangerous political situation in the UK. The rest of our portfolios are invested in global markets and we continue to hold about 30% of a Balanced portfolio in international currencies, which should benefit from any political uncertainty in the UK. We feel that the current balance is sensible, but will increase and decrease exposure proactively to reflect any change in our views.

Conclusion

It is almost impossible to predict whether a deal will be struck between the UK and Europe, whether there might be a second referendum (where the result is practically impossible to predict given the emotion invested by every voter) and whether the Conservative party can hold their factions and their alliance with the DUP together to last until the next election in 2022. That being said, there is no certainty that Corbyn's Labour would be elected at a "snap" election, given their extreme policies, and trying to guess whether they would genuinely implement a "hard left" economic programme and "capital controls" is very hard at this juncture. Of course, the risks to the UK economy and UK asset markets are real and we continue to make totally certain that we hold a great deal of diversification across portfolios and that those UK investments we hold are worth the risk that we are taking.

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