WE'RE OUT – **out cold** and now what!

While the effect of the UK referendum on forex markets appears to be lasting, equities have recovered strongly from the losses sustained in the first two days following the Brexit decision. The Top40 Index has rallied 4.2% over the past five sessions and is trading just 3% lower than the pre-Brexit vote.

I believe that uncertainties will remain high however, and would caution against buying equities at the current level unless we see Brexit "LIGHT". With the US yield curve flattening, I was cautious on equities even before the UK referendum as global equity markets were close to an all-time high against a backdrop of still-fragile economic growth and companies struggling to grow earnings. The Brexit vote only added a new layer of uncertainty to what was already a fully priced market facing a difficult environment.

In two weeks' time, the US will enter the second quarter earnings season. Importantly, the expected earnings will be uninspiring and companies' outlook statements are unlikely to be positive - in light of the referendum outcome and other pre-existing challenges (e.g. China slowdown, Greece, rates normalisation, etc.).

Both the S&P 500 and the 10-year Treasury yield are now close to the recent extreme high and low levels respectively. In each case, there is a flow story to be told – a chase for yield and security in the case of Treasuries and technical-driven buying and share repurchases by corporates in the case of the S&P. However, these two key assets tell very different stories about the outlook for the US and world economies. A 10-year Treasury below 1.5% is a pretty meagre forecast of future growth, but conversely, the S&P above 2100 represents a leap of faith or does it?

However, I fear that as the genie is truly out of the bottle, I remain wary and take the comments regarding a potential "Lehman" moment very seriously. We are unfortunately now more than ever being driven by policy decisions as opposed to economic fundamentals. Brexit signals that the centre in politics has moved away from the laissez-faire and globalisation consensus. This is generally very bad news for emerging markets. It is also bad news for the shares of global companies who have benefited tremendously from the steady dismantling of barriers to the free flow of goods, capital, and labour.

To those who posit that this is a financial meltdown (which I am not dismissing, as this scenario can easily be triggered by incorrect policy decisions, but believe it to be a tail risk), I will keep a wary eye on the numbers, looking for early signs that the worst-case scenario is unfolding. Especially by keeping an eye on the shape of the yield curve (see below-flattening is not a great sign); as indicated in prior correspondence, an important sign indicating slowing economic growth. This will also give an indication of changing equity risk premiums!

Personal Trust House Belmont Park Belmont Road Rondebosch 7700 · P O Box 476 Rondebosch Cape Town 7701 RSA
Tel: 021 689 8975 · Fax: 021 686 9093 · Fax to e-mail: 086 210 4931
Noordhoek Office Tel: 021 785 3298 · Somerset West Office Tel: 021 852 2265 · Knysna Office Tel: 044 382 2100 · Port Elizabeth Office Tel: 041 363 0300
International Office London Tel: 0044 7973 255 259
e-mail: personaltrust@ptrust.co.za · website: www.personaltrust.co.za

In my view, bank stocks will be the canaries in the coal mine, and especially so if the rerating spreads to non-UK banks (first signs = Italian banks are under pressure as Italy is potentially the most likely EU candidate to follow Brexit); I will continue to watch equity risk premiums for the S&P 500 and the FTSE100 and Germany to get a measure of how equity markets are repricing risk.

Investors are clearly worried that the Bank of England may cut its benchmark rate to zero, in order to meet the liquidity needs in the economy post-Brexit. A similar liquidity infusion approach is likely to be adopted by the ECB as well. These would pressurise the net interest margins "NIMs" of the banks compounding existing problems, which as a sector are taking the severest beating among all the sectors, post Brexit.

UK banks such as Lloyds Banking Group plc, The Royal Bank of Scotland Group plc, and Barclays plc are down 10-20 percent even today. For the two trading sessions, the losses are in 30-40 percent range. This cannot be just solely due to the fear of lower interest rates pressurising the NIMs. Big reputed global banks don't lose so much in market cap based on just rates or downgrades by rating agencies. Smart money is probably expecting huge write-downs in goodwill and multiple impairment charges in the coming quarters; even expecting recession in the UK to arrive earlier than 2017.

In the short term, my view that while Brexit etc. remains a risk, I am still of the view it should be regarded as a tail risk rather than a central scenario with regard to one's long term portfolio strategy. However:

- The global economy is heading into a period of major event driven risks such as the uncertainty about a possible next Fed rate hike and increased political risks.
- While we do not expect global equities to enter an outright bear market, anticipate global markets to move lower on a 3–6-month horizon given political uncertainty in particular, presenting better buying opportunities in the future.
- In terms of regions, we continue to slightly favour the Eurozone and Switzerland compared to the United States and Asia; Emerging Markets remain vulnerable.
- At the sector level, IT, healthcare and financials are our preferred sectors, while we expect consumer discretionary, utilities, energy and materials to underperform.

- Personal Trust's South African Equity model portfolio is well positioned to ride out any storms given the second point above.

On currencies:

- Remain neutral on USD/JPY and GBP/USD. Risks remain for further JPY strength if risk aversion persists, especially given Japan's rising external surplus.
- For GBP, the very large UK external deficit remains a risk, especially given political risks arising from Brexit, may be the BoE pricing is too cautious and that is more of concern than BREXIT. We therefore expect GBP/USD to remain volatile.
- Emerging Market currencies remain pressured, although appear to be bottoming.

However, given the current Personal Trust portfolio structure, with a sufficient portion in cash, I believe one should be focused on the long term strategy and ignore short term pulses. It is certain that corporate profits are increasingly shifting from asset-heavy sectors to idea-intensive ones such as pharmaceuticals, media, and information technology which have among the highest margins. Total returns given this low growth will assume ever greater import. Within these sectors too, firms are developing a winner-takes-all dynamic, with a wide gap between the most profitable firms and others.

In this light, given time, the positions taken on both sides of the "Channel" will fall more cleanly into place. Yet, the challenge inherent in the UK's EU referendum result is that it could trigger fears of a greater unravelling of the European Union which carries with it so many open-ended consequences and this troubles investors. We remain more than ever tied to policy decisions and not economic fundamentals.

Mark Huxter – July 2016