MARKET BULLETIN

ST. JAMES'S PLACE WEALTH MANAGEMENT

Monday 20 June 2016

This precious stone

Perhaps it is appropriate that Britain's referendum on EU membership takes place 400 years after the death of a man who may have done more than anyone to shape this nation's view of itself. William Shakespeare put his best-known lines about his island home into the mouth of the Flemish John of Gaunt, among them: "This other Eden, demi-paradise,/ This fortress built by Nature for herself/... This precious stone set in the silver sea".

But if the UK referendum is about a great deal more than money, that didn't stop markets, central bankers, and trade and business leaders last week from saying plenty about what an exit might mean financially. Rightly or otherwise, the prognoses were not positive. With the prospect of the referendum dominating markets, the world's leading indices fell: the FTSE 100 (-1.6%), the S&P 500 (-1.4%), the FTSEurofirst 300 (-2.2%), and the Nikkei 225 (-6%). Sterling volatility struck a record high – above even the level it reached in 2008. The investor havens of gold and gilts both saw significant inflows.

Senior figures delivered their warnings too. George Osborne's warning of a £30 billion black hole in UK finances failed to strike a chord – his claim that his post-exit Budget would need to include tax rises and spending cuts was met with accusations of blackmail. A survey published by Bank of America Merrill Lynch said a UK exit from the EU was the top risk currently faced by the global economy and the chairman of Deutsche Bank said an EU exit would be an economic "disaster" for the UK. The head of the IMF warned that leaving the EU would mean a "negative and substantial" economic blow and "permanently lower incomes". Business lobby groups in Switzerland, Albania, Canada and Norway each warned that their own trade deals with the EU were less advantageous than the UK's current arrangements, in a series of statements coordinated by the pro-Remain Confederation of British Industry.

Results were published last week of a survey of leading UK-based economists conducted by the Centre for Macroeconomics; all those surveyed agreed an exit would create negative short-term disruption to financial markets and more than 70% said there would be substantial negative long-term consequences for the UK's financial sector. There was also confirmation last week that the UK's share of global mergers and acquisitions has fallen to a record low this year – down 70% from the same period in 2015.

The prospect of the referendum also captured the attention of the world's central bankers. In their respective rate-setting meetings last week, central banks in the US, UK, Switzerland and Japan all chose to take no action. Each pointed to the risk of a British exit from the EU. Mark Carney, governor of the Bank of England, warned that "the outcome continues to be the largest immediate risk facing UK financial markets, and possibly also global financial markets", while Haruhiko Kuroda, his counterpart in Japan, reported that "Britain's EU referendum is shaking markets".

Financial markets have grown increasingly sensitive to referendum news and events as the date draws closer, but often markets have simply responded to the primary indicator: the polls. Last week, six polls in a row showed the Leave camp ahead, with a lead of between three and seven percentage points. But the brutal murder of a Labour MP on Friday (the first such incident since 1990) put campaigning on hold – and appeared to check the progress of the Leave camp. Indeed, sterling surged overnight to its strongest one-day performance since 2009 as polls swung in favour of the Remain camp.

What would happen to markets in the immediate aftermath of an exit vote is impossible to predict. Nevertheless, markets have already delivered their own responses to polls showing a boost for the Leave camp – many analysts believe these responses offer a sign of things to come, should Britain vote to leave. If so, then a vote to leave would presage a fall in the value of the pound, a fall in gilt yields, a rise in the price of gold, and a fall in stock prices. A sell-off lasting four working days ended last week with losses on the FTSE 100 amounting to £98 billion.

Inevitably, the two sides disagree over what such signals really communicate – whether they point to long-term economic pain or simply to the short-term uncertainty on markets that a vote to leave would create. Either way, the UK might take a long time to actually leave the EU (despite apparent EU wrangling last week to force a quick resolution in the event of an exit vote). Again, the actual impact of protracted deal-making is hard to predict – markets might dislike the uncertainty of Britain existing in a kind of limbo, its future status unclear; or they might appreciate gradualism, as many of the uncertainties are sensibly ironed out (and all the more so if trade continues unchanged throughout the negotiations).

But it is worth remembering that, even in 2016, UK stocks have not always taken much note of politics. Indeed, UK sectors have behaved very differently so far this year and often for much more global reasons. Oil and gas companies have risen by almost 15% on average, and basic materials companies by more than 20%; while telecoms companies have fallen more than 8% and financials by more than 13%. For investors, whether the causes of such swings are domestic politics or global trends, such variations underline the importance of both active management and diversification.

Tech ambitions

Investors have given a great deal of attention to some of the tech giants in recent weeks, not least because some analysts fear that Apple may be reaching a plateau, while Facebook recently announced its plans for a range of new focuses, among them artificial intelligence. Last week it was the turn of Microsoft, which acquired the job networking site LinkedIn for $26.2 billion.

Given that Microsoft's chief customer base is office workers, LinkedIn's 100 million active monthly users could add to its dominance. Moreover, although it added a 50% premium to LinkedIn's share price, the latter had already fallen 40% in 2016. The purchase sets Microsoft in more direct competition with Facebook – the social networking site hopes that traffic to work websites will be driven primarily from social media. Microsoft is hoping its acquisition will prove better-timed than its purchase of Nokia three years ago.

Rating trouble

China and Japan both received negative press last week. China's mainland-listed shares were not granted accession to the dominant MSCI emerging markets category – the US index provider argued that China was yet to offer sufficiently free access to foreign investors. While China does not need the MSCI badge – it is already home to the dominant emerging markets stock market – it would have been a welcome reputational boost. Meanwhile, Japan received a downward revision to its outlook from Fitch Ratings, as the agency pointed to the country's failure to address its debt problems with sufficient speed.

Yet the most remarkable debt news of the week came from Germany, where Bund yields struck negative territory for the first time in their history. Inevitably, worries about a British exit from the EU, and its impact on other European countries, were to the fore. Investors will need to hold their nerve for the week ahead, and perhaps longer, as markets deliver their verdict on Britain's historic vote.