Quarterly Newsletter / Spring 2018

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

Wow! What a start to 2018!

In our January Newsletter, we commented on the general tone of complacency that had accompanied 'bad news days' which seemed to indicate that the pressure on investors to find an income stream in the face of persistently low interest rates outweighed considerations of potential negatives. Everyone was hoping that the global 'Goldilocks' economy – not too hot, not too cold – would continue on an even keel. The most widely used proxy for investor sentiment is the VIX index which records the price of options on America's S&P 500 – in effect, the VIX rises when investors become nervous, giving it the nickname 'Fear Index'.

We noted in January that the VIX had been flatlining for most of the year and had closed on 31 December at just over 10, having begun 2017 at the dizzying level of 14 – this against a long-term average of 18.5 – despite the usual range of potentially de-stabilising events around the globe. To put this into perspective, the Wall Street crash of 1987 saw the VIX shoot up to 180 (!) and the financial crisis of 2008 merited 80 points.

This was all to change in early February when the US reported *better than expected* jobs data which was interpreted as a forerunner of higher inflation, rising interest rate rises and impending disaster.

On the day that the new Chairman of the Federal Reserve, Jerome Powell, took office, the VIX closed above 37 and the Dow Jones Industrial Average experienced its biggest ever daily points fall (in percentage terms it was the worst day for six years). Ironically, having taken credit for the higher market valuations since taking office, President Trump was less inclined to 'own the downside'. For once, there was a subject on which his Twitter account remained silent. In fact, roughly a third of the market gains made under his tenure evaporated in a few days.

You will recall that we also highlighted investor sentiment as a key factor driving markets in the short term. Nothing had fundamentally changed and the market turmoil was, in this instance, triggered by positive economic news! As is the case in the modern world, the contagion was felt globally and there was much speculation as to whether this was the beginning of a long-expected market correction. In the end, reason seems to have reasserted itself and calmer, albeit more volatile, conditions prevailed.

Volatility is not, of itself, unusual. On average, there will be fifty-two daily moves of plus or minus 1% in the MSCI World index each year. In the first quarter of 2018 there have been nine such days whilst there were only three in the entire previous year! Arguably the real surprise has been the *lack* of daily volatility over a prolonged period and the events of February marked a return to 'normality'.

There is, in our view, a sound argument for remaining in equity markets, not least because global growth overall remains strong and inflation is still subdued. China's growth rate remains steady, and the Chinese economy is now increasingly driven by consumer activity rather than capital intensive infrastructure projects. Europe has been largely positive (even, to a lesser extent, at the periphery) although data released at the end of March point to a loss of momentum: a slump in loans to firms and a falling Purchasing Managers Index (PMI) call into question the European Central Bank's plans to halt its bond-buying programme (Quantitative Easing). In America, President Trump's tax reforms look set to continue driving S&P 500 earnings for some time to come.

Technological change is driving productivity improvements and keeping prices down, offsetting the potential inflationary impact of the robust growth figures. The chief beneficiaries of technological change appear to be the economies of South East Asia: not only do they have a young and upwardly mobile (and increasingly wealthy) population, they have rapidly adopted new technologies, leap-frogging older systems and achieving a productivity boost in the process. The growth of online banking and retail sales continues at a remarkable pace, particularly in China, which is predicted to surpass the US as the major global economy in the coming years.

Nearer to home, the UK has not been in quite such a fortunate position. Inflation of imported goods (especially foodstuffs) has been driven by the weaker pound, whilst poor productivity has kept real wage levels subdued. Arguably it is the very impact of the global growth story which has allowed the UK to achieve the growth levels that it has since the Referendum but, as sterling recovers and the devaluation premium evaporates, the economy is coming under greater pressure. The pound has gained in strength against the US dollar and is only a few cents weaker than it was before the Brexit Referendum, but we believe that this apparent resurgence is down to dollar weakness rather than sterling strength. The UK has fallen from leader to laggard in terms of G7 growth rates and both consumer and investor sentiment are weak.

UK consumer sentiment appears particularly bearish. The pre-Christmas trading period saw early discounting as retailers sought to fend off the attractions of lower cost online offerings. Those with an efficient e-commerce facility fared better but generally speaking, retailers had a tough holiday trading period at the end of a tough year.

Sentiment has apparently not lifted as the year progressed – car sales dropped 5.5% year-on-year (in contrast with growth of 4% and 4.7% in Germany and Spain respectively) whilst analysts Moody’s predict that UK car sales will fall by more than 10% over two years. Of course, Britain recently has adopted an anti-diesel approach which depressed car sales in general.

To add to the consumer anxiety, there has been a rash of profit warnings and closures across the retail sector – Mothercare, Maplin, Toys ‘R’ Us, Carpetright and Prezzo – as well as job cuts at John Lewis. Over 21,000 retail jobs have been lost in the first three months of this year, and analysts have warned that there is a worry that the UK is heading for a consumer-led downturn. A recent British Retail Consortium survey has provided further circumstantial backing for this – the survey showed an average fall in footfall in the High Street and highlighted poor March weather, internet shopping and Brexit nervousness as the likely causes. This would be very serious as consumer spending accounts for roughly two thirds of the UK economy.

On the investment side, the FTSE index fell some 6.35% in the first quarter validating our decision to reduce UK exposure in the portfolios in December. This contrasts with most other markets (save Japan) which have remained flat or mildly positive despite the turmoil in February.

Since we mention Brexit nervousness, we cannot avoid looking at what is happening across the Channel. After some serious horse trading, Mrs. Merkel at long last managed to cobble together a coalition with the Social Democrats. It took her more than four months to achieve this, and her own position is much weakened.

The Social Democrats are very much in favour of further EU integration, much further than Mrs. Merkel wanted to go. It will not help her when she has to convince her electorate that a European style IMF, suggested by both France and Germany, is a good idea. Such a “European Monetary Fund” would replace the “Troika” (European Commission, ECB and IMF) when dealing with bailouts of EU member states and would undoubtedly simplify the process, but the fly in the ointment, as far as Mrs. Merkel is concerned, might be the fact that, ultimately, it would be the German taxpayer who would underwrite such bailouts. Of course, you could argue that since Germany is the politically dominant force in the EU and its main economic beneficiary – by a large margin! – that is fair enough…

Another outcome of this new "Grand Coalition" is that Germany looks like forming an ever-closer bond with Monsieur Macron's France, and it is becoming increasingly unlikely that the EU's stance in the Brexit negotiations will become more accommodating. It almost seems as if the EU are determined to punish the UK for the temerity of wanting to leave and discourage others from following suit.

The EU now appears to care a great deal about the border between the UK and Ireland post-Brexit and how the UK's staying outside the Customs Union could threaten the Good Friday Agreement, returning the region to disharmony and the paramilitary outrages of yesteryear. The major players in reaching the Good Friday Agreement are well known: UK and Ireland, yes; all local political parties, yes; even Americans like Bill Clinton and George Mitchell, yes. But I am struggling to think of any obvious or high-profile involvement by the EU or its leaders in the peace process.

The EU tell us that anything other than a hard border cannot work. Or could it?

Take the border between Sweden, a EU member state, and Norway which is not a member. The border is over 1000 miles long, and in some sparsely populated areas the border crossings are completely unattended: more than 25,000 people cross the border on a *daily* basis to work on the other side. Of course, the relationship between Norway and the EU is governed by the EEA (European Economic Area) Treaty, which does connect Norway to the EU common market, and Norway has even signed up to the Schengen Agreement. In order words, such a system could not be replicated in the UK/Ireland/EU situation, but it shows that willingness and cooperation on both sides goes a long way to solving border problems. However, Norway is *not* part of the European Customs Union, and there are customs controls for the movement of goods. These controls are administered by the customs authorities of both countries and whilst there are sporadic physical checks, the system largely relies on CCTV and automatic number plate recognition technology.

Another good example is Switzerland, totally surrounded by EU member states (except for its 15-mile border with Liechtenstein, which belongs to the EEA). Switzerland is neither in the EU, nor is it part of the EEA or in the Customs Union. However, every day more than *23,000* goods lorries and *over 2 million* people cross the border (about 300,000 to go to their place of work) between Switzerland and the EU, and this happens without lorry parks or long queues and delays. Although Switzerland signed up to Schengen (concerning people, not goods), in a recent referendum the Swiss population decided they wanted to put a stop to that. As in the case of Sweden and Norway, many rural border points are completely unmanned, and they have been that way for decades. Lorry traffic from known operators largely pass unhindered, but occasionally there are checks, usually based on information and risk analysis, followed by electronic scanning.

In last weekend's Sunday Times, Dominic Lawson wrote about meeting a Swiss academic who for three years was chief negotiator in Switzerland's negotiations with the EU. This man was highly regarded by both sides, and he now says that it is absurd to claim it is impossible to have a "frictionless" border between the north and south of Ireland, and that the UK could easily remain outside the Customs Union.

We don't know where the Brexit negotiations will take us, but Treasury figures give us the "likely impact" on GDP under different scenarios: if we stay in the EU, there is no negative impact. If we opted for an EEA deal, the negative impact would be 2%, which would increase to 5% if we opted for a Canada style Free Trade Agreement, and sticking to World Trade Organisation tariffs would result in a negative 8%. Serious stuff, one would think!

However, please remember that it was the same Treasury that "cautiously" predicted, *before* the EU Referendum, that a Leave vote would have horrendous consequences. By publicising the Treasury figures, the then Chancellor George Osborne told us that a Leave vote would cause an "immediate and profound" economic shock, with GDP growth down by between 3 and 6%. He said that we would suffer a year-long recession, house prices would fall by 10% and that there would be up to 820,000 job losses over a two-year period. In the event, job numbers increased to a record high, house prices rose and GDP did not decline.

So, Treasury figures need to be taken with more than just a pinch of salt: out of their last 35 predictions, only one has been correct!

If the UK stays in the Customs Union, it would not only have to abide by the EU's tariffs on goods coming from anywhere (without having any meaningful input on how they are set), but it would also be impossible for the UK to have any individual free trade agreements with the rest of the world.

However, a group of cross-party parliamentarians, led by Yvette Cooper and Nicky Morgan (the former staunchly Labour, the latter with a more personal loathing of her own party's leader) have just tabled a motion demanding a vote on the UK staying within the Customs Union.

It would appear that the Westminster bubble and London-centric power base are still firmly in the 'Remainer' camp, and both continue to largely ignore the prevailing views of the rest of the country.

Coming out of the EU whilst staying in the Customs Union is not just about trade. It would have serious consequences for the ability of the UK to govern itself as an independent nation, and we would continue to be subject to the jurisdiction of the European Court of Justice. In fact, it would be worse than fully staying in the EU, as we would have zero input on the future rules and regulations coming out of Brussels. It would simply leave the UK in a totally subservient position.

If we feel strongly about Brussels' rules and regulations that frequently feel more akin to a diktat, we have good reasons for that view. Lacomp operates as an investment adviser, and we are forever faced with new, often ill-thought-out and questionable rule changes.

Recently introduced rule changes include MiFID II (MiFID stands for Markets in Financial Instruments Directive), and they have placed a considerably more onerous administrative burden on firms such as Lacomp. Quite a few duties that used to be carried out by management groups have been passed down the food chain to us.

Another new and rather odd aspect is the need for us to write to you within 24 hours (!) should the overall value of your portfolio fall by more than 10% since the last valuation point.

The Black Monday Crash in October 1987 and the Financial Crisis of 2008 would have triggered such a letter, so we appreciate it must come as a huge comfort to our clients to know that a) not only are we aware of the problems but b) we will be writing to you about it, even though every media channel would have been screaming the same thing during the time it took the postman to find his way to your front door!

An ill-thought-out rule? Well, let's assume that following your third quarter valuation at the end of September, the markets start to fall, and by the end of December, your portfolio value has dropped by 9%. That would not trigger such a letter. Assume further that the portfolio again falls by another 9% *after* the end of December valuation. Still no need to write the letter, even though the portfolio has fallen by over 17% since the end of September valuation…

New rules relating to Capital Adequacy Requirements for SIPP (self-invested personal pension) providers prompted them to ask us to report on the portfolio constituents of a SIPP on a daily (!) basis. Having rebuffed that ludicrous demand, they at least agreed to let us report on a monthly basis, which does make some sense.

New and much tighter anti-money laundering rules have been introduced, particularly when they relate to beneficial ownership, source of funds and wealth, politically exposed persons and the reliance on third-party information.

Conditions governing "Know Your Client" have changed, requiring us to send you the annual Financial Information Updates with an additional questionnaire about your risk profile and the beautifully-termed 'capacity for loss'. It is understandable that some long-established clients are scratching their heads – some bemused, others slightly annoyed - when completing these forms.

Alas, it is a new world we are living in, and please remember that our regulator takes the view that all this is done to protect you, the client.

You may well say that since all these new requirements have been thought up in Brussels, it will not be so bad as we are soon to leave the EU. Sadly, think again! The FCA and its predecessors have always embraced what came out of Europe, and we remember one particular case when our UK regulator saw fit to gold-plate an EU edict to such an extent that it was told to abandon that approach.

Whilst talking about recent changes in financial services, let us not forget that in a month's time the new GDPR ("General Data Protection Regulation") regime will come into effect across Europe. Of course, data protection has been around for a long time, but the EU felt that it needed improving. Any "improvement" of this type, as we have learned from experience, is never straightforward, takes a lot of management time to implement and, also as usual, is costly. You will not notice too many differences, other than the fact that most emails between you and ourselves will have to be encrypted, even though we may have been emailing each other for ages. This new requirement cannot be avoided, and penalties for some GDPR failures can be truly draconian.

We will be writing to you separately about GDPR and encryption before long.

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