Quarterly Newsletter
Winter 2016/2017

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

As regular readers of our Quarterly Newsletters know, at the beginning of a new year we always look back over the preceding twelve months, and what a year 2016 has turned out to be!

The year was full of the unexpected: if at the beginning of the year you had placed a £10 accumulator bet on a Brexit outcome of the referendum, a Trump victory in the US presidential election and Leicester City winning the Premiership, you would have netted £45million! Both the referendum and the presidential election provided catalysts for market movements, Leicester City happily less so.

Using football parlance, 2016 was a year of two halves. The pattern of movements in major market indices showed a clear contrast between negative sentiment and downward pressures in the first half of the year and a strong rebound since then. If you analyse the actual numbers of the first and the second halves of the year, they are inevitably distorted by relative currency strengths over the period, but the pattern is clear. Early in the year we saw Chinese growth angst and concerns for various electoral outcomes, but those worries have largely evaporated as the year progressed, with both the FTSE 100 and the Dow Jones approaching record highs towards the end of the year.

In local currency terms – a fairer measure as Brexit has depressed sterling – the MSCI World index has increased by 6.9% for the year. Other indices are up, the Dow Jones 10.4%, the FTSE 100 8.8%, the Euro Stoxx 50 4.3%, the Nikkei 225 9.5%, NASDAQ 7.5% and Emerging Markets 8.5% (with the exception of BRIC countries that fell by 7.7%).

The gold price went up by 7.4% and oil, after dipping to an incredible $27 per barrel in January, has more than doubled to over $56 by the end of the year.

As you will know, our actions in the run-up to and after the EU referendum stood our clients in good stead. When it came to the US presidential election, we agreed with the consensus and expected Wall Street to take a negative view of a Trump victory. Well, we all were wrong, and the market continued on its upward path. Donald Trump is being inaugurated today, and although it is far too early to make any predictions, we are feeling less than panicky over what lies in store. We hope the outrageous rhetoric of Trump the campaigner will be replaced by calmer policies of Trump the president. We do worry that his economic plans could lead to protectionism and potential trade wars, but we take some comfort from the fact that the American political system has a lot of checks and balances in place that were designed to keep any maverick in the White House under some form of control.

This week was rather momentous for the UK, too. On Tuesday, we heard our Prime Minister Theresa May's long-awaited clarification of her position vis-à-vis the EU and her Brexit negotiation intentions. Before her Lancaster House speech, Mrs. May was accused of dilly-dallying, her cabinet and her backbenchers about being split about which approach to take. Mrs. May undoubtedly was in a tricky position, knowing full well that only a small majority had voted to leave the EU.

So, what were the options before her speech? 1) Ignore the referendum result altogether and stay in the EU. 2) Go for a form of 'soft' Brexit by reaching agreement with the EU on some levels (be that through retaining only partial control of the UK's borders, continuing to pay contribution to the EU's, coffers, accepting the superiority of the European Court of Justice and quite possibly some other measures) in order to enjoy continued access to the single market. Part of a 'soft' Brexit would also mean continued membership of the Customs Union which, whilst offering some clear trading advantages, would stop the UK from entering into a free trade agreement on its own with any other country as it is only Brussels that can negotiate such agreements with 'outsiders'. 3) Opt for a 'hard' Brexit, by making it a clean break.

Most "Remainers" keep telling us that having access to the single market is of paramount importance, but is that really true? First of all, anyone has *access* to the single market, but usually not on a tariff-free basis. At worst, and in the absence of any sort of agreement between the EU and the UK, the UK would have to trade with the EU countries under World Trade Organisation (WTO) rules, as do America, Australia, India, large parts of South America, Africa, the Middle East and South East Asia.

Having said that, it now gets interesting. Under WTO rules, the EU is not allowed to discriminate against the UK specifically, but the WTO itself recognises that Regional Trade Agreements (RTAs), and the EU is the biggest of those RTAs, by their very nature <u>are</u> discriminatory. There is a clear dichotomy between WTO rules and the reality, and it is mostly to do with the fact that WTO rules relate to tariffs and tariff-cutting, whereas RTAs often add several layers of requirements relating, for example, to labour, investment, competition and environment. These additional requirements act like a form of poison pill which renders WTO rules less than fully effective. Bearing in mind the feeling of antipathy expressed by leading eurocrats towards the UK following the latter's decision to leave the EU, it is to be expected that negotiations will be anything but easy.

We now have heard her speech, and a pretty bold one it was. She says that we will leave the single market but would like to renegotiate and arrive at a new customs agreement. In view of what we have just said above, that makes perfect sense – if it is achievable… Initial reactions from across the Channel to that proposal were less than enamoured. Some called her plan illusionary or even delusionary.

Possibly anticipating such negative feedback, there was a veiled threat to her EU opponents when she reiterated what Philip Hammond had hinted at in an interview with a German newspaper a few days ago, when he said that an EU rebuff could force the UK to adopt a different economic model. That really is a euphemism for saying that the UK could become a low-tax economy right on the doorstep of the EU.

Mrs. May stated that she wants EU citizens living and working in Britain to have a permanent right to do so, but she expects the EU to be equally accommodating to our citizens living there. To offer EU citizens living here a unilateral guarantee of that sort would have been a very magnanimous gesture and seen her taking the moral high ground, but she did not quite go that far, keeping the potential for a quid pro quo as a bargaining chip.

She did, however, yield to pressure from some parliamentarians of all parties by putting the final deal – in other words, a deal that has already been approved in principle by her and the EU countries' governments – to a vote in both Houses of Parliament before it would be enacted.

Whatever is being said right now, we are in for a prolonged period of debate and arguments. It will be akin to a repetition of all we have gone through in the run-up to the referendum last June.

The one thing we can take some comfort from is the fact that the UK, despite all its woes (NHS, a growing debt mountain, low productivity et al), is a relatively strong economy when compared with the rest of the world. This alone will ensure that the UK will be taken seriously when negotiations begin.

You may remember that, back in October, the International Monetary Fund (IMF) was forced into an about-turn when it conceded that they had been proven wrong when forecasting trouble for the UK economy. In fact, the UK is reckoned to be the fastest growing economy of the G7 nations in 2016. You will also recall that, prior to the EU referendum, the IMF predicted that a vote to leave the EU would trigger a stock market crash and push the country into recession.

The IMF is an international organisation formed some 70 years ago, initially to help construct an international payment system after the Great Depression and World War II. Its brief has been widened a great deal since then and now includes, among other things, ensuring financial stability, promoting global economic growth and reducing poverty, the latter particularly in developing nations. Initially there were just 29 member states, but that number has grown to nearly 200. The IMF nowadays also has some financial clout through its so-called Special Drawing Rights (we have written about that in a previous Newsletter) which essentially is a pool made up of members' quotas that are roughly in line with their relative positions within the world economy. The IMF thus can supplement a member country's official reserves, as it did in recent times to help Greece.

Greece is a good example for what has been going wrong with not just the EU and the euro, but also the IMF. By standing alongside the European Central Bank in helping to bail out Greece, it went against its own cardinal rule that austerity measures should be offset or at least mitigated by devaluation and debt relief. Neither were options offered to Greece, and it highlights the fact that the IMF has become too political. Could it be the fact that the IMF did not see the design faults of the European single currency? Even Professor Otmar Issing, the ECB's first chief economist and often called the founding architect of the monetary union, recently stated that the euro project had been betrayed by politics and had gone wrong from the very outset. He was quoted as slamming the first Greek rescue (by the ECB *and* the IMF) as little more than a bailout for German and French banks, insisting that it would have been far better to eject Greece from the euro as a salutary lesson for all. The Greeks should have been offered generous support, but only after it had restored exchange rate viability by returning to the drachma.

He was saying, in essence, that the IMF should have stuck to its cardinal rule.

Ever since the Maastricht Treaty was signed, we at Lacomp have argued that the euro project would ultimately fail unless there was full economic integration, both in political and fiscal terms. Clearly, the IMF did not see it that way. It also failed to see the financial crisis of 2007-09 coming, and it furthermore failed to anticipate the multi-year Eurozone debt crisis which started in 2009. Little wonder, therefore, that the British electorate was not all that impressed by George Osborne using the IMF's dire prognostications as a cornerstone of his "Project Fear".

If we are faced with a period of uncertainty in Europe, the same can be said of America and, to some degree, the rest of the world. The election of Donald Trump must be amongst, if not the biggest, political upsets in history. We are getting quite used to seeing upsets at the ballot box. The pollsters got the 2015 UK general election completely wrong, and nobody gave Jeremy Corbyn a chance. But Trump trumps it all.

Talking of political upsets, we must not forget the upcoming general elections in the Netherlands in March, followed by France in April/May and Germany in September. With the ascent of populism and nationalism, in some cases extreme, it would be foolish to predict the electoral outcomes with any real certainty. When we write our next Quarterly Newsletter, we will know the Dutch result, and it could provide us with a pointer of what to expect elsewhere. These three elections at this point are hardly conducive to their political leaders concentrating on the Brexit negotiations, quite apart from the fact that M. Hollande will no longer be in his job by June.

It would be very welcome to have a period of calm and reflection before the real fun starts.

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