IMPERIUM CAPITAL

momentum

Global Matters Weekly

Realpolitik

14 September 2020

– Richard Stutley, CFA

Realpolitik is the art of designing policy based on practical rather than ideological considerations: what works, not what we think *should* work. Pragmatism is an important part of investing and tells us that positioning too aggressively around political events like Brexit and the US election is risky, because both the result and the market outcomes are difficult to predict. Given a low probability of correctly predicting either, we need to see evidence of significant mispricing in order to introduce large positions in our portfolios.

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Two big events are looming, the US election on November 3rd and Brexit, with a practical deadline of 15 October and an actual deadline of the end of this calendar year. We need to be realistic about our ability to forecast the outcomes of these events. The track record of both professional forecasters and betting markets is poor and has only been getting worse: Trump's election in 2016 and the Brexit referendum were both highly unexpected outcomes and, in the case of the former, so was the market's positive reaction.

The odds of a trade deal between the UK and EU have fallen in recent weeks, with the latest round of trade talks yielding little progress and with the UK government seeking to pass new legislation that goes against aspects of the Withdrawal Agreement. Under the terms of the agreement, signed in January, Northern Ireland is part of the UK customs territory but remains more closely aligned with EU regulations in order to avoid the need for customs checks along its border with the Republic of Ireland: in short, a soft border has been drawn down the Irish Sea. Ensuring that border is not too strong is a concern for the UK government as well as Unionists in Northern Ireland and this is what the new legislation aims to qualify. Whether or not the legislation is approved by Parliament at the first time of asking, it demonstrates what the UK government is prepared to do to ensure the free passage of goods between the UK mainland and Northern Ireland; it thus serves as a reminder that reducing the most restrictive barriers to trade is in both side's interests, otherwise the Irish problem will not go away.

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In terms of the market moves, a no deal Brexit with the sudden raising of barriers to trade would be unambiguously bad in the short run for both the EU and the UK, given the large amount of trade that goes on unencumbered between the two currently. However, one needs to consider the extent to which this is already priced in, given the weak performance of UK assets in the years following the referendum. UK assets have a meaningful risk premium built in and sterling and mid cap stocks adjusted lower in response to the news last week. Today's entry point is attractive, plus there is still time for a deal as long as both sides can be pragmatic about what is needed: at this stage a 'skinny deal' would suffice, with phased introductions of customs checks on areas not covered by the deal and hence time for further agreements to be introduced in key areas, rather than one comprehensive deal by the end of this year. For these reasons we are comfortable to stay invested in the UK in our portfolios.

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In the US, a win for the Democrats would seem to be the less market-friendly outcome given Biden's pledge to fund his "Build Back Better" programme by raising taxes, but it will remain to be seen which campaign pledges ultimately become policy and markets may react positively to the prospect of more predictable policymaking. There are more signs of mispricing in the US, with US assets having significantly outperformed post Trump's tax reforms and deregulation, some of which is likely to be rolled back under a Biden presidency. Further, the US stock market has become concentrated in a few mega cap tech stocks, which are in the crosshairs whichever party eventually wins in November. With markets priced richly despite these risks, we have index put options in place beyond the election in our eligible portfolios.

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Politics matters but, as investors, how we approach binary events like elections is more important. In the absence of clear mispricing, we will not take an extreme position in either direction, given the low probability of us correctly predicting the outcome. Overall, today we still think it is right to stay invested in portfolios while building a diversified defensive bucket. We will let our partners know should that change.

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The Marketplace

- A mixed week for global equity markets which returned -1.3%
- Vaccine trials resume after last week's pause
- Brent crude fell -6.6% ending the week at $39.8 a barrel
- Gold rose 0.3% to end the week at $1940.5 an ounce

Market Focus

US

- A volatile week in US equity markets with the benchmark technology index pulling back over 10% from its all-time high on 2nd September. The major index declined by 2.5% following a slump in energy and technology names
- Pfizer CEO says they could know if coronavirus vaccine works by the end of October and distribute it to Americans before the new year. AstraZeneca also resumed trials after a test subject became ill last week
- Inflation data for both core and headline beat expectations rising 0.4% between July and August. Initial jobless claims were higher than expected at 884K for the week ended 5th of September
- The dollar rose for the second week, gaining 0.66% last week as investors sought safe havens
- US treasuries returned 0.4% last week

Europe

- The European Union is studying the possibility of legal action against the UK over PM Boris Johnson's plans to breach the Brexit deal, amidst a ratcheting up of tensions
- ECB President Christine Lagarde says the recent appreciation of the euro has partly offset the positive impact that the ECB's stimulus had in boosting inflation and reiterated that policy makers stand ready to adjust their stimulus instruments if needed
- European carmakers face bigger emission cuts than they've been counting on this decade, according to an update of the European Union's climate plan
- The main continental European equity index returned +2.10%

UK

- U.S. House Speaker Nancy Pelosi says if Brexit undermines the Good Friday agreement "there will be absolutely no chance of a U.S.-U.K. trade agreement passing the Congress."
- Nvidia says it agreed to buy SoftBank Group's chip division Arm for $40bn, taking control of some of the most widely used electronics technology in the semiconductor industry's largest-ever deal
- New U.K. coronavirus cases surpassed 3,000 for a third day, prompting the government to tighten restrictions on gatherings of more than six people.
- UK equities rose 4.00%, helped by a weaker pound

Asia/Rest of The World

- Yoshihide Suga is widely tipped to succeed Japan's Prime Minister Shinzo Abe with the backing of around 80% of MPs.
- Japan's GDP growth came it an annualised pace of -28.1% in Q2 due to weakness in consumer demand
- Chinese equities fell by 3.0% on the back of the US tech downturn and on the US adding SMIC (China's top chipmaker) to its list of sanctioned companies
- China's exports rose by 9.5% in August

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

Asset Class/Region	Currency	Currency returns			
		Week ending 11 Sept. 2020	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	-2.5%	-4.5%	4.7%	12.8%
United Kingdom	GBP	4.0%	1.3%	-19.7%	-16.6%
Continental Europe	EUR	2.1%	1.3%	-5.9%	-0.1%
Japan	JPY	1.2%	1.1%	-3.6%	6.0%
Asia Pacific (ex Japan)	USD	-0.7%	-1.7%	2.8%	12.4%
Australia	AUD	-1.0%	-3.0%	-11.8%	-8.8%
Global	USD	-1.3%	-3.5%	1.9%	9.7%
Emerging markets equities					
Emerging Europe	USD	0.4%	-2.9%	-25.2%	-15.9%
Emerging Asia	USD	-0.9%	-1.2%	7.5%	19.8%
Emerging Latin America	USD	-1.9%	1.8%	-31.5%	-25.0%
BRICs	USD	-1.9%	-2.3%	2.3%	13.6%
China	USD	-2.6%	-3.6%	14.9%	27.0%
MENA countries	USD	0.2%	1.0%	-8.8%	-4.6%
South Africa	USD	4.2%	2.4%	-19.2%	-14.4%
India	USD	0.9%	0.6%	-8.4%	2.2%
Global emerging markets	USD	-0.7%	-0.8%	-0.7%	9.8%
Bonds					
US Treasuries	USD	0.4%	0.3%	9.4%	9.1%
US Treasuries (inflation protected)	USD	0.3%	-0.5%	9.5%	10.4%
US Corporate (investment grade)	USD	0.3%	0.3%	7.1%	9.4%
US High Yield	USD	-0.2%	-0.3%	1.3%	3.8%
UK Gilts	GBP	1.0%	2.0%	9.3%	6.4%
UK Corporate (investment grade)	GBP	0.4%	1.0%	5.7%	6.2%
Euro Government Bonds	EUR	0.1%	0.7%	3.1%	0.6%
Euro Corporate (investment grade)	EUR	0.0%	0.3%	0.8%	0.4%
Euro High Yield	EUR	0.1%	0.4%	-1.8%	-0.2%
Japanese Government	JPY	0.3%	0.3%	-0.9%	-2.4%
Australian Government	AUD	-0.1%	0.5%	3.8%	3.0%
Global Government Bonds	USD	0.2%	-0.2%	7.4%	6.8%
Global Bonds	USD	0.1%	-0.2%	6.7%	7.1%
Global Convertible Bonds	USD	-0.5%	-1.7%	11.4%	16.1%
Emerging Market Bonds	USD	-0.2%	0.4%	3.8%	7.2%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 11 Sept. 2020	Month to date	YTD 2020	12 months
Property					
US Property Securities	USD	-2.6%	-2.0%	-16.0%	-16.0%
Australian Property Securities	AUD	-1.0%	-2.6%	-20.0%	-19.5%
Asia Property Securities	USD	-0.3%	-1.2%	-16.6%	-11.9%
Global Property Securities	USD	-1.2%	-1.7%	-16.0%	-12.3%
Currencies					
Euro	USD	0.0%	-0.9%	5.6%	7.5%
UK Pound Sterling	USD	-3.4%	-4.4%	-2.5%	3.8%
Japanese Yen	USD	0.1%	-0.3%	2.6%	1.5%
Australian Dollar	USD	-0.1%	-1.6%	3.9%	6.1%
South African Rand	USD	-0.8%	1.1%	-16.0%	-12.0%
Swiss Franc	USD	0.5%	-0.7%	6.5%	9.2%
Chinese Yuan	USD	0.1%	0.2%	2.2%	4.1%
Commodities & Alternatives					
Commodities	USD	-2.2%	-4.7%	-20.6%	-15.4%
Agricultural Commodities	USD	0.8%	0.4%	-2.3%	8.2%
Oil	USD	-6.6%	-12.0%	-41.8%	-34.5%
Gold	USD	0.3%	-1.6%	28.1%	29.9%
Hedge funds	USD	-0.5%	-0.5%	1.3%	4.3%

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