Creative Benefits Solutions

Investment Commentary

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INTRODUCTION

The first three months of 2017 have brought us plenty to write about: Britain's formal triggering of Article 50; the inauguration of President Trump; good news for Europe, both politically and economically, and an acceptance in China that their economy will grow at its slowest rate for more than a quarter of a century. On the world's stock markets, two of the markets we cover were up by more than 10% in the first quarter of the year: one is down by that amount. The rest have, in the main, moved more sedately in the right direction. Let's make a start...

UNITED KINGDOM

Theresa May famously swept into Downing Street declaring that "Brexit means Brexit" and went on to commit herself to triggering Article 50 of the Lisbon Treaty by March 31st. In the event she beat her self-imposed deadline by two days, formally delivering a six-page letter on March 29th. There will now be two years of negotiations before the UK – in theory - could leave the EU on March 29th 2019.

Those negotiations will be long, tortuous and difficult. Much has been made in the press of what the UK wants and – inevitably – focus has been on how much we should pay to leave (or how much we should be paid, depending on your political view). But it is far more complex than that and in the special sections of this report, we look at what the remaining EU27 countries will want from the negotiations. Their contrasting – and sometimes conflicting – demands will undoubtedly impact on the final terms of our leaving the EU.

Prior to the EU Referendum, there were plenty of gloomy predictions about the state of the UK economy should 'Leave' win. In the main, these predictions haven't been borne out, and the news for the UK economy has largely been good in the early part of 2017.

The year got off to a good start with positive figures for the manufacturing and service sectors, with manufacturing undoubtedly having been helped by the post-Brexit fall in the pound. The Society of Motor Manufacturers and Traders also reported that 2016 had seen UK car sales (traditionally a good barometer of economic confidence) hit an all-time high, with 2.69m vehicles sold, thanks to "very strong" consumer demand.

The Bank of England weighed in, lifting its forecast for economic growth in 2017 from 1.4% to 2%, a figure confirmed by Chancellor Philip Hammond in his first Budget speech. Unfortunately, the good news in Hammond's speech was swiftly overshadowed by his forced U-turn on Class 4 National Insurance contributions.

It's been a perennial feature of this Report, but the first quarter of 2017 brought yet more gloom for the UK high street with even John Lewis threatening 'hundreds' of job losses. Philip Hammond announced action on business rates in his Budget but it is becoming ever more difficult for retailers in highly rated high street shops to compete with online competitors in out of town locations. As one commentator put it, referring to both the NIC climb-down and the business rates furore, "We have a 20th Century tax system trying to cope with a 21st Century economy."

What did our 21st Century stock market make of the first quarter of the year? The FTSE 100 index of leading shares started 2017 at 7,143: it closed March up 3% at 7,323, having touched an all-time high of 7,424.96 in the middle of the month.

EUROPE

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EUROPE

But what about the other 27 countries?

As above, Brexit has now been officially triggered and between now and the theoretical end of the negotiating in March 2019 there'll be plenty of good news and bad news, irrespective of your viewpoint. The newspapers will be full of argument and counter-argument about the UK's negotiating position and what it wants from our – for now – EU partners.

But what about the other 27 countries? What do they want from the negotiations? All countries want different things – or different combinations of things – be it trade, security, tourism or the protection of their citizens' rights. We have used these special sections in the Report to look at what the EU27 might seek in the negotiations.

Above all things, Germany will seek to protect the integrity of the single market – what's been described as 'Keine Rosinenpickerei,' translated as 'no cherry picking.'

This was a doctrine first introduced by Angela Merkel in a speech shortly after the referendum and Germany's view is simple: if the UK can cherry pick then the single market will quickly fall apart as other countries seek to do the same. Germany fear other EU countries doing this much more than it fears any potential damage a hard Brexit could do to the German economy.

France will take a similar view: it wants to stop the 'contagion' of Brexit spreading to other countries. They may also want to make sure the UK sticks to the same rules as apply now: France doesn't want what it will see as unfair competition from the UK. France will also seek to protect European manufacturing projects – such as Airbus – and the fishing industry could also be a potential area of conflict.

Italy will seek to protect the rights of its citizens, and will also want reassurances over financial services. They'll probably favour agreeing the terms of the divorce first, before talks begin on trade – so they'll oppose the 'parallel negotiations' that the UK would prefer. But Italy may be one of the more conciliatory countries: Prime Minister Paolo Gentiloni has suggested that their approach will be based on encouraging the other members of the EU27 to stay, rather than making them too scared to leave.

And what of Spain? It's not simply a question of Gibraltar: Spain is a firmly pro-Europe country and will not break the negotiating position of the European block. What Spain essentially wants is a clean, amicable break: British tourism is integral to the Spanish economy – but Prime Minister Mariano Rajoy also wants to make it clear that you cannot do better "outside than inside" the EU.

Madrid also favours a quick, reciprocal deal on citizens' rights – there are more British citizens in Spain than Spaniards in the UK, a unique case in the EU.

...And now we come to Gibraltar. Spain would like Gibraltar not to be addressed at all in the negotiations, and left to a bi-lateral deal between Spain and the UK. Spain will also want to make sure that Scotland leaves the EU on exactly the same terms as the rest of the UK: any preferential treatment for Scotland will only encourage separatism in Catalonia.

In these negotiations, all countries – big and small – can make the negotiations difficult: there will undoubtedly be late night negotiations and last minute deals at some point – perhaps more than once. In the next section, we look at what some of the smaller EU27 countries might want.

What do Europe's smaller countries want from the Brexit negotiations?

Make no mistake, they have the power to disrupt the negotiations every bit as much as the larger countries – look at the way the EU-Canada trade deal was under threat until a last minute deal satisfied – or bought off – the Belgian province of Wallonia.

A good example is Austria, which will have a pivotal part to play in the negotiations as it takes over the rotating presidency of the Council of the EU in the second half of 2018. Yes, Austria will want to safeguard the rights of its 25,000 citizens living in the UK, but it also wants to make sure it is not one of the countries that fills the hole left by Britain no longer contributing to the EU. According to Sebastian Kurz, Austria's Europe Minister, it wants to make the EU "leaner and fitter" – which is unlikely to chime with the sentiments of the Brussels bureaucrats.

For many of the smaller countries – particularly those in Eastern Europe – the protection of the rights of their citizens in the UK will be paramount. The Nordic countries – Sweden, Denmark and Finland – appear to have a particular interest in preserving the integrity of the single market and the 'unity' of the EU, very much mirroring the position of Germany. Bulgaria is another country which at this stage seems to have not much interest in Brexit and a lot of interest in staying on the right side of Angela Merkel.

Security will be a big factor for many countries, such as Belgium, Croatia, Cyprus and Portugal. Cyprus will also want to protect its tourist industry. And of course, continuing trade with the UK will be a major factor for a lot of the EU27, none more so than Ireland, given that its economy is so interconnected with that of the UK.

Dublin will also want to make sure that peace in Northern Ireland is protected, and that a solution is found to the border between Ireland and the province. Make no mistake, though, Ireland has declared its position, and it is very firmly on the side of the EU. "We are completely on the side of the EU," said European Affairs minister Dara Murphy, "Every aspect of Brexit is unwelcome."

Let's leave the last word to the Dutch: with the exception of Ireland, the Netherlands has the highest rate of exports to Britain of any EU country – but again, they are very firmly in the EU camp. Europe spokesman Ann Mulder dismissed Britain's expectations as, "Alice in Wonderland," and added, "Britain doesn't need extra punishment in the negotiations. They are shooting their own foot."

The needs and ambitions of the EU27 are many and diverse. It's important to note that there are at least two agendas in play for the smaller countries in the EU: what they want from the Brexit negotiations – and how they can use the Brexit negotiations to get what they want from the EU.

UNITED STATES

January 20th brought us the inauguration of Donald Trump as the 45th President of the United States.

Trump was quick to promote his 'America first' maxim and threaten any company re-locating to Mexico with dire consequences. Clearly Ford executives were listening as they cancelled plans to move to Mexico and instead announced a $700m expansion of their plant at Flat Rock in Michigan. This was followed in March by a commitment to invest a total of $1.2bn in the plant, while Toyota ended January by announcing plans to invest $10bn in the US over the next five years.

These were all hailed as successes by the new administration, and it was initially thought that they would take some time to feed through into the jobs figures. Jobs growth had slowed to 156,000 in December 2016, against 204,000 in November and general estimates of 175,000. However, the economy added 227,000 jobs in January and another 235,000 in February (smashing expectations of 190,000 jobs) and making the long heralded rise in interest rates inevitable.

It duly arrived at the monthly meeting of the Federal Reserve policy making committee, as the rate moved up by 0.25% to a range of 0.75% to 1% - only the third rate rise in a decade.

In company news, Apple returned to growth thanks to the success of the iPhone 7 and posted its highest ever quarterly revenues - $78.4bn – in the final quarter of 2016. Intel made a $15bn bet on driverless cars as it bought Israeli company Mobileye: working with BMW they are planning to have 40 test vehicleson the road by the second half of this year.

A round of funding saw the ride-hailing app Uber valued at $68bn, which made the $24bn stock marketdebut of loss-making Snapchat (it lost $516m in 2016) look positively pitiful.

Wall Street looked on all this and liked what it saw. The Dow Jones index rose 5% in the first three months of the year to end March at 20,663.

FAR EAST

As we noted in the introduction, the Chinese Government has accepted that growth in the economy is slowing down. Chinese Premier Li Keqiang announced that the country's growth target for this year would be 6.5%, down from last year's 6.7% - when the country's economy grew at its slowest pace for 26 years.

February was a turbulent month in the Far East, largely for political reasons, as North Korea conducted another missile test, with the missile flying 300 miles towards the Sea of Japan. President Trump assured Japanese Prime Minister Shinzo Abe that the US "stands behind Japan, its great ally, 100%."

Toshiba had even greater problems than missiles flying towards them, as the company continued to struggle with cost overruns at Westinghouse, the US nuclear firm it bought in 2006. Toshiba's Chairman was forced to resign after the Japanese conglomerate revealed details of a $3.4bn loss for the year.

Problems too in South Korea, where Lee Jae-yong, Samsung's heir apparent, has been arrested in South Korea on bribery charges and former leader, Park Guen-hye, saw her impeachment over the scandal upheld by the courts: three people died in the ensuing protests.

What of the region's stock markets? Hong Kong led the way in the first quarter, with a rise of 10% to 24,112. China's Shanghai Composite index was also up, albeit by a more modest 4% to 3,223. The South Korean index was up 7% to close March at 2,160 with Japan being the only market to fall – it was down 1% to 18,909.

EMERGING MARKETS

Brazil was our star stock market performer last year, with a rise of 39%. Despite this, the country has more than its fair share of problems and a huge amount is riding on new President Michel Temer's ability to sort them out.

State oil producer Petrobras is at the centre of a massive corruption probe, with dozens of politicians having been arrested for taking bribes to grant lucrative contracts to private companies who then massively overcharged Petrobras. In January, Teori Zavascki, the judge overseeing the corruption probe, was killed in a light aircraft crash – and the inevitable conspiracy theories were quick to surface.

By March, it had been confirmed that the country has been in recession for two years, with the economy shrinking by 3.6% in 2016: it is now 8% smaller than it was in December 2014. The main reason has been the fall in commodity prices and the recession has seen unemployment rise by 76% to 12.9m – equal to a rate of 12.6%.

India remains the world's fastest growing major economy, but it had a slight problem last month when the country's banks ran out of money. Back in November, Indian Prime Minister Narendra Modi announced that 500 and 1,000 rupee notes (worth around £6 and £12) would no longer be legal tender, in a move designed to reduce corruption. March saw the deadline for handing in the old notes and there was predictable chaos in the banking system, with 40% of cash dispensers being empty. Having handed in their old notes, customers couldn't then get new ones.

Despite the news of the recession, Brazil rose for two of the three months, closing up 8% at 64,984 – but the winner of this term's 'Progress Award' was India. Having opened at 26,626, the stock market closed March 31st at 29,620 for a rise of 11%.

CONCLUSION

We mentioned in the introduction that one market had fallen significantly in the first quarter of the year: that was Russia, with the stock market tumbling 11% to end at 1,996. There must be real worries in Moscow about the prospect of Marine le Pen winning the French presidency: 40% of Russia's foreign currency reserves are held in euros, and a win for le Pen cannot do anything other than threaten the future of the euro.

We hope you've enjoyed this first Quarterly Report of 2017. Clearly, we're living through turbulent times and we appreciate that clients are going to have plenty of questions. Rest assured that we are always here to answer: simply pick up the phone or send us an email and we will get straight back to you.

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Chair of the Investment Committee