THE FUTURE IS YOU KLEINWORT HAMBROS

CIO BLOG

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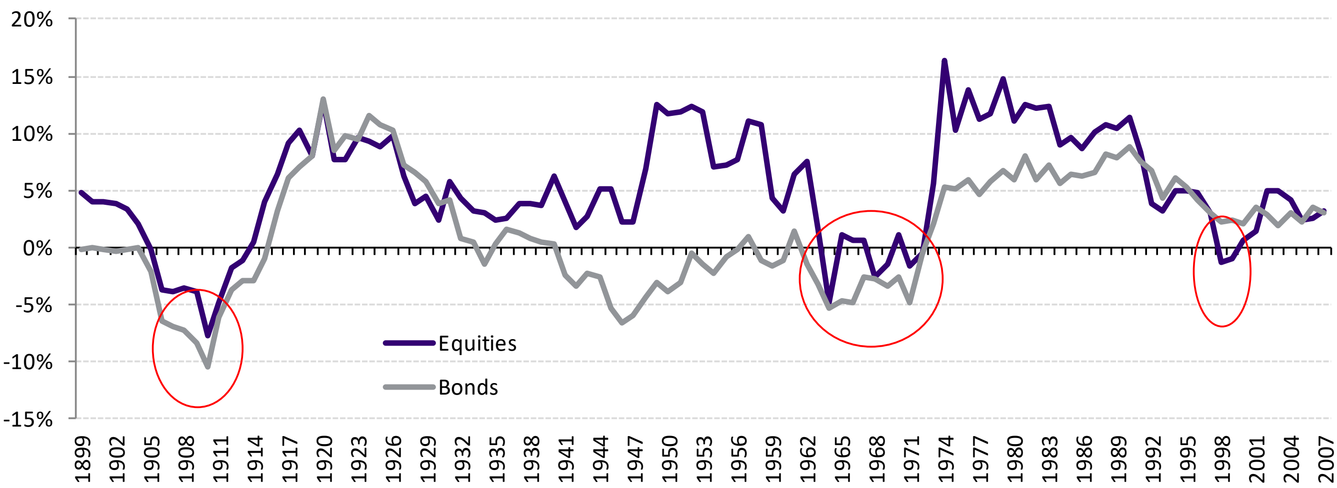
BREXHAUSTED

Figure 1

UK Equities & Gilts Rolling 10-Year Forward Total Real Return, Annualised

1899 to 2018



Past performance should not be seen as an indicator of future performance
Source: Kleinwort Hambros, Barclays Equity Gilt Study 2018. Data as at 31/12/2018

Deal or No Deal still remains the question. While fatigue has set in from almost three years of Parliamentary debate at Westminster – and at dinner tables and water coolers – we still have no idea what will happen at the end of March 2019, less than a month away from the legal obligation to exit the European Union. Angst, shock, opprobrium and ridicule fill the air.

Nonetheless, the FTSE 100 is up 26% since 22 June 2016, the day before the Brexit vote, to the end of February 2019 in total return terms (i.e. including dividends). Many will argue this is due to large multi-nationals hardly being “British” companies; the plummeting pound helps their repatriated profits. Inconveniently for that line of argument, the FTSE 250 – more suitably “domestic” – is up 19% in that time.

Geopolitics tend not to matter in the short-term

Indeed, it is easy to draw the conclusion that one's asset positioning should be defensive during times of heightened conflict or stress. However, financial history teaches a different lesson: geopolitics rarely impact equity markets over the next year or so. The data just does not support the "geopolitical tensions are bad for markets" hypothesis (see figure 2).

For example, the world was brought to within an inch of nuclear Armageddon during the Cuban missile crisis in October 1962 (markets were reasonably flat in the months leading up to the crisis). An investor in the S&P 500 – a US and global equity bellwether – would have been up 7% in the following month, up 16% over the next quarter and up 34% a year later. Khrushchev may have blinked, but investors were on a roll.

Though investors at the time were indeed relieved that the world did not end, it hardly meant an end to tensions. The Cold War was still very much in full swing, and less than two years later, in August 1964, the US Congress passed the Gulf of Tonkin resolution officially "authorising" the Vietnam War. With the US waging a tremendously costly war across the globe, one would imagine equities performed poorly. Once again, investors were rewarded by staying the course: the S&P 500 returned nearly 9% over the following year.

The experiences above are not isolated. Investing in the S&P at the advent of the Six-Day War in 1967 between Israel and its neighbours would have returned 13% over the next year. Investing when the Soviets invaded Afghanistan in December 1979 would have returned nearly 10% in the next six months, a return that shot up to 30% in the next 12 months. More recently, the Russian annexations of the Ukraine, the Brexit vote and the election of Donald Trump were followed by strong returns for investors: the S&P rocketed up by 17.3%, 15.0% and 14.8%, respectively, over the following 12 months.

For all the horror images, real-time press coverage and social angst, geopolitical crises simply do not appear to affect markets often. While some events can be linked to losses – the Arab-Israeli war of 1973 or the September 11th attacks in the US in 2001 – the real causes are often more nuanced (Bretton Woods in the early 1970s, and the bust of the nascent tech sector at the turn of the century).

Figure 2

Event	Date	S&P 500 TR Index	
		Months after	
		1	12
Korean War	Jun-1950	-7.5%	24.6%
Soviets into Hungary	Nov-1956	1.4%	-6.7%
Cuban Missle Crisis	Oct-1962	7.2%	33.6%
Gulf of Tonkin Resolution (Congress "authorises" Vietnam War)	Aug-1964	1.3%	6.0%
Six-Day War	Jun-1967	2.0%	10.2%
Soviets into Czechoslovakia	Aug-1968	3.5%	-1.0%
Arab-Israeli War	Oct-1973	-6.7%	-36.0%
Soviets into Afghanistan	Dec-1979	2.9%	32.2%
Martial law in Poland	Dec-1981	-4.8%	18.2%
Falklands War	Apr-1982	0.0%	37.9%
US invades Grenada	Oct-1983	-1.0%	3.0%
US invades Kuwait	Feb-1991	3.1%	18.3%
Serbians into Kosovo	Feb-1998	5.3%	23.5%
September 11 Attacks	Sep-2001	4.0%	-11.4%
US invades Iraq	Mar-2003	6.2%	37.2%
North Korea sinks a South Korean naval vessel	Mar-2010	4.3%	16.6%
Russian invasion of the Ukraine	Feb-2014	2.4%	17.3%
Brexit	Jun-2016	4.0%	15.0%
Election of Donald Trump	Nov-2016	3.7%	14.8%
	Average	**1.3%**	**12.9%**
	% of time negative	**21.1%**	**21.1%**

Past performance should not be seen as an indicator of future performance
Source: Kleinwort Hambros, Bloomberg. Data as at 31/01/2019

Long-term geopolitical transformations are also poor guides for investing

If investors should look through the knee-jerk reactions to geopolitics, the question of long- term, transformational geopolitical change still remains. Here again, context is critical. It is true that Brexit – the cause célèbre du jour – does pose new and unexplored questions for the UK. However, so did World War II, the loss of the British Empire, the subsequent downgrade of the UK's status as a pre-eminent global military and cultural power and dizzying social, demographic and technological changes over the last 100 years. None of them caused UK equities to lose their long-run return potential – and there is little historical evidence of these tectonic political transitions being useful markers for investment decision making (see figure 1).

Since the turn of the last century, UK equities have averaged 6.7% per year after inflation. And while equities tend to be volatile and can lose value dramatically – UK equites were down 57% in 1974, its worst one-year performance – over the long-run, let's call it 10 years for the purpose of illustration, the asset class tends to deliver returns far outpacing all directly competing investments (i.e. cash, bonds).

Ten-year forward returns from equities have been negative in only three periods. The first was in between 1905 to 1913, in the lead up to WWI (i.e. 1914 to 1918). While the war was a factor of course, most the investment losses can be traced to huge inflation between 1915 and 1920, where the cost of living index increased at an annual average of 17%[1], followed by the post-war economic collapse that decimated the British economy between 1919 and 1921 (the economy actually did relatively well during the WW1).

The second period where long-run equity returns were hit hard was in the late 1960s and early 1970s, once again a period of huge price increases, where annual inflation averaged above 13% (1970 to 1981). The cause this time was not war, though the geopolitical ramifications of the Arab oil embargo did cause skyrocketing oil prices. Arguably, however, a much more significant driver of the inflation was the collapse of the Bretton Woods gold-backed system of exchange rates and poor monetary policy that coincided with that exogenous shock.

The third period was brief, with 10-year equity returns being negative from market peaks in just two years, 1998 and 1999. The "dot-com" era, as it is known, is most remembered for the hundreds of companies promising to change the world by harnessing the power of the newly created internet. It led some investors to pay mind-bending valuations for promise and potential that remained largely unrequited.

Investment implications

One could (and should) surmise that excessive, double-digit inflation or overvaluation are much more salient sources of worry for equity investors – who must be long-term in their outlook – than geopolitics. And neither are significant worries for now. Inflation in the UK is at its lowest point in two years (~1.8%). Moreover, with demographics feeble and productivity frail – and with monetary policymakers armed with both powerful tools and a strong public mandate – this worry is minimal. Similarly, valuations for equities in the UK are arguably cheap, with the FTSE 100 currently offering a dividend yield near 5%.

This time is not different.

Source: Kleinwort Hambros, Bloomberg. Data as at 25/02/2019

[1] Kleinwort Hambros, Barclays Equity Gilt Study 2018. Data as at 31/12/2018

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