VERMEER NEWSLETTER

August 2019

THOUGHTS ON 2019

The Boris Bounce

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Since we established Vermeer Partners towards the end of 2018 this is the third occasion, we have attempted to succinctly corral our current thoughts on the world. It is somewhat disappointing that little has changed in the period and that the themes we discussed in February are still the main drivers today. The one key change from a UK perspective is obviously a change of Prime Minister and a substantial reshaping of his Cabinet. Unfortunately, we suspect that after the initial euphoria and bluster of the new regime has died down the stark reality is that none of the major challenges namely Brexit and the revival of a moribund economy will have gone away. Although it will be significantly more entertaining, we remain unconvinced the new government has either the mandate or will power to take the longer-term decisions required to get the UK back on a sustainable long-term growth trajectory.

We have tried to avoid adding our thoughts to the endless stream of rhetoric that surrounds the Brexit process. However, it is worth noting the reaction of the currency markets to the increased likelihood of a hard exit under Boris Johnson's control. Currency markets tend to be an accurate and real time measure of global investor sentiment and so the sharp selloff in the pound gives a clear indication that the consensus view is that it is particularly bad news for the UK. From a political viewpoint an anti-consensual view is always popular and the advantage here is that in the long term we will never know whether Brexit was good or bad since we cannot run a placebo. Expect the current government to continue its any Brexit is a good Brexit line and for the financial markets to disagree.

The flip side of the current sterling weakness is that it provides a fillip for the FTSE100. The index continues to be dominated by large global companies who earn the majority of their revenues overseas in other currencies and some who pay their dividends in US dollars or euros. When translated to sterling these make stocks look more attractive. An investor can capture the same effect by owning overseas companies directly in their portfolios, something that Vermeer actively encourages. It is worth noting that the year to date performance of the US market has been well ahead of the UK in both dollar and sterling terms.

What the UK cannot avoid is being caught up in the general malaise created by the constant fluctuations of the US vs China trade war. Having to rely on Twitter for US policy updates is frustrating enough, but the lack of consistency from the US in general is causing real headaches for all market participants. The latest escalations in tariffs and subsequent reaction in the currency markets is beginning to have structural impacts. The current inversion of the US rate curve, ie long-term interest rates are lower than short-term interest rates, is sometimes an indicator of forthcoming recession. Whilst we do not subscribe to this view it is a worrying development.

One of the peculiarities in most global equity markets in recent years is the huge differential between the performance of so-called growth and value stocks. Vermeer Partners is not particularly keen on the labelling of stocks, we prefer just to look for good companies, but the continuation of this trend even as economic growth has slowed has captured our attention. The intriguing point is that different factors have driven the performance of very different sets of stocks in geographical areas eg large tech stocks in the US compared to large consumer goods stocks in the UK, and the value stocks have performed poorly in all geographies. Whilst we will not specifically seek out value stocks, we are identifying several opportunities in this area.

This extreme dislocation between the valuations of growth and value stocks is one of the reasons that despite our gloomy outlook on the UK economy we do favour exposure to the UK small and mid-cap space. Small value stocks in the UK have been out of fashion for several years and now sit at very low valuations. Any improvement in the UK economy, no matter how small, will focus attention on this area and the relative lack of liquidity of these stocks will mean that any meaningful investment inflow will have a dramatic effect. We believe that one of the key catalysts for this process will be an increase in private equity purchases of quoted companies. We have already seen some evidence of this, and it is common knowledge that the private equity sector is awash with cash at present. Once there is clarity on Brexit, hard or soft or not at all, then more bids will emerge. A sub theme to this move will be a likely increase in shareholder activism with specialist investors taking stakes in quoted companies and seeking to exert influence on company strategy.

We will not trawl through our thoughts on other areas of the world given that they have not really changed since our Q2 thought piece. The factor which may change in the second half of the year is that the US may attempt a concerted push to get the dollar down against all other major currencies. The US certainly has the firepower to achieve this and although we long ago stopped trying to second guess the future moves of the current US President, the fact that it would be enacted as we move into a US election year gives it some credence. It would not be great news for global equity markets and would substantially increase uncertainty across all asset classes. In these circumstances we would expect to see gold continue its recent strong run.

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