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Brexit Update – December 2018

Brexit has dominated British politics for the last two years, but with less than four months to go to the date of the UK's departure from the European Union on 29 March, it continues to be a source of great uncertainty.

The referendum result showed the UK electorate was split down the middle on the issue and any "solution" is likely to be unacceptable to a significant minority. The ill-judged and inconclusive election in June 2017 left the Tory government without a clear majority or mandate to negotiate with and the EU has shown little inclination to make the UK's exit anything other than painful.

Whilst it is still very unclear what form Brexit will take we have attempted to assess the implications of a number of possible outcomes. The most likely include

1. Theresa May's compromise agreement passes through Parliament
2. There is no agreement and the UK suffers a hard, or unmanaged, Brexit.
3. A re-negotiated agreement, or new referendum, or no Brexit at all.

The first of these would probably be the most positive option for investment markets. Businesses could continue to trade and shares in the EU and UK, which have been significantly down-rated by global investors, could perform well. Events of the last few weeks have made this highly unlikely as an opportunistic coalition of opposition and rebellious Tory MPs appear determined to object to the proposal despite failing to offer a plausible alternative.

If the UK leaves the EU without an agreement, we would expect reduced economic growth or a recession. Sterling would probably fall, and stock markets would be volatile until new trading arrangements were agreed. In this instance we would expect your global and UK equity funds to offer some protection against currency movements. If Sterling falls the value of your global equities are likely to rise to take account of the "increased" value of their foreign assets. FTSE 100 companies should therefore offer some protection as a large proportion of their revenues are derived outside the UK.

The third option is the hardest to assess. The EU is unlikely to have much appetite to offer further concessions to the UK. Some pro-European MPs have suggested that Article50 is withdrawn and that the UK remains within the EU, but this would fly in the face of the referendum result. Similarly the constitutional basis for another referendum appears weak and there is no guarantee that it would produce a definitive answer.

From an investment perspective the most damaging aspect of continuing Tory party infighting is that it increases the possibility of an early general election, with the risk of a Labour/SNP government with an anti-capitalist agenda. Whilst we believe this would be a very negative outcome for investment markets and the UK economy we do not believe we are at a point where this should form the basis of our investment decisions. If circumstances change we will reassess this risk.

Currency movements

The chart below shows the movement in a number of major currencies from early 2016 and illustrates the sharp devaluation of Sterling (and corresponding rise in other currencies) following the unexpected referendum result.

Immediately following the referendum result the British Pound fell by 10-20% against the other major currencies. Since then the Pound has lost further ground against the Euro and US Dollar, although it has strengthened marginally against the Japanese Yen.

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UK equities

Given the UK's decision to move away from its largest trading partner and the uncertain political position it is not surprising that global investors have reduced their exposure to UK assets. One report suggested that global investors have sold $1 trillion of UK shares since the referendum.

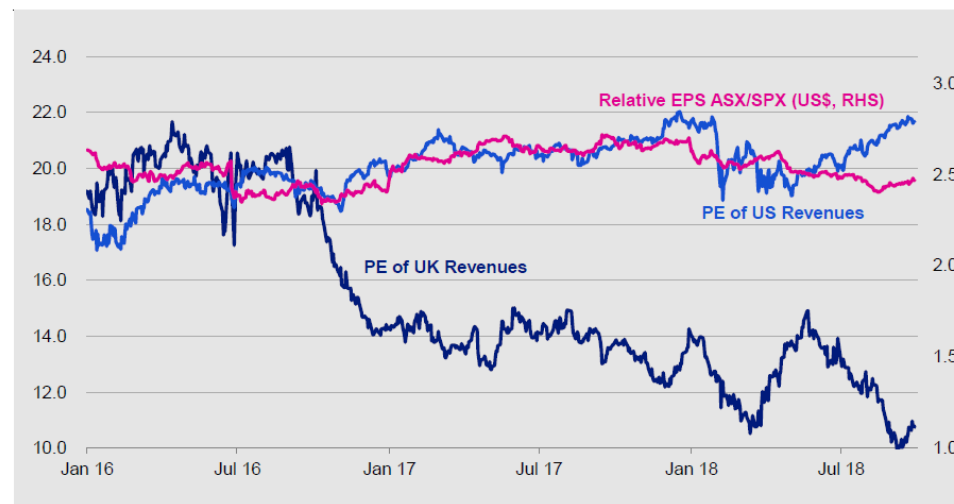
The most recent Bank of America Merrill Lynch survey of fund managers found that the UK "continues to be the most disliked region by the participants" with the allocation to UK shares falling to a net underweight position of 27%. The net underweight exposure to the UK is not a particularly new phenomenon as the survey has found that investors have been underweight UK shares for the majority of the last 15 years (apart from a short period in 2013/14).

UK domestic facing businesses

Shares of UK companies with exposure to the UK economy have been particularly unfashionable since the referendum result. A study of global businesses for Invesco calculated price to earnings (p/e) ratios for UK and US generated revenues. As the chart below shows, the price that investors will pay for UK based revenues has fallen significantly since the referendum, from a p/e ratio of around 20 in the first half of 2016, to a current figure of around 11. In contrast the p/e ratio for US revenues has stayed broadly level at around 20.

This fall has not been accompanied by a reduction in UK earnings. The third (pink) line on the chart suggests that the ratio of earnings per share for UK and US listed companies has not changed significantly over the same period.

An untidy Brexit which damages the UK economy will undoubtedly have an impact on UK domestically facing shares, but the study suggests that a great deal of this pessimism is already reflected in current share prices. Conversely, if Brexit is less than dreadful, there is scope for UK shares to recover.



UK multinational companies

In practice most listed companies generate their revenues in a wide number of countries. The UK stockmarket is generally regarded as the most international of the major global stockmarkets and by some estimates around 70% of the earnings of the large FTSE 100 companies are derived outside the UK.

This geographical diversification provides some protection against short term currency movements and over the last few years it has been noticeable that a fall in Sterling normally leads to a rise in the FTSE 100 index as their global assets and revenues are revalued. Following the initial shock of the referendum result the FTSE 100 index quickly recovered as the sharp fall in Sterling more than offset concerns about the economic impact of the decision.

A disorderly Brexit might lead to fears that multinational companies would relocate, but as Unilever demonstrated earlier this year, this process is not straightforward.

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Current fund positioning

Different fund managers have taken different approaches to their portfolios in the lead up to next March.

A number of highly experienced UK fund managers including Mark Barnett at Invesco, Neil Woodford at WIM and Nigel Thomas at Axa Framlington believe that the de-rating of UK domestic shares has been overdone, and that, once the uncertainty of Brexit is removed, the shares will recover quickly. In the short term this stance has hurt performance as UK shares have continued to prove unpopular.

Other UK fund managers have taken a less extreme view. The most recent figures we have received from the managers of the Artemis Income, Trojan Income and Threadneedle UK Equity Income funds suggest that their exposure to UK revenues is between 32% - 38% of the total. Interestingly figures provided for the Liontrust Special Situations fund, which we might have expected to show a higher UK exposure given its focus on mid-sized businesses, also showed UK revenues in the same range. In contrast, the Invesco High Income fund has an exposure of around 53% to UK revenues.

Global equity funds include exposure to UK companies but again the overall exposure to the UK economy is limited. We believe that a portfolio of good quality global equities will provide a useful hedge against currency movements and uncertainty in the lead up to next March.

Multi-asset funds typically have much smaller exposures to equities in general. To put this into context figures provided by the Trojan fund indicate that only 5% of the fund's equity holdings (less than 2% of the overall fund) had exposure to UK based revenues.

We continue to regard fixed income investments as unsustainably expensive at current levels. Government bonds continue to be seen as a relatively "safe" asset during times of uncertainty and it was perhaps not surprising that government bond prices have risen (and yields have fallen) during the stock market falls of the last quarter. In the event of an untidy Brexit we might see bond prices rise again in the short term, but in the medium term we see UK government bonds to be exposed to a weakened economy.

Overall we believe that a portfolio of well managed UK and global equity funds, supported by adequate cash reserves to enable investors to see through periods of short term equity market volatility without being required to access their investments at short notice, remains a sensible approach to the uncertainties of Brexit.

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Summary of investment outlook

The following table summarises our thoughts on the portfolio implications of a variety of Brexit scenarios. UK shares have fallen in absolute and relative terms over the last couple of years but have the potential to recover if the Brexit solution is less than awful. Global equities will also provide some protection to any weakness in Sterling or the UK economy.

We continue to see cash as a more attractive alternative to bonds at current price levels. With uncertainty likely to continue for several months it is important that sufficient cash is held to provide a source of funds should markets fall further in the short term.

	Soft Brexit *Minimal trade disruption, some reduction in GDP but no recession*	**Hard Brexit** *Major disruption, possible recession and devaluation of Sterling*	**No Brexit** *Political uncertainty but minimal economic impact*
UK domestic facing shares	Have potential to perform well	Bad outcome already priced in to some extent	Removal of uncertainty should help shares recover
UK multinational shares	Could benefit from removal of uncertainty. Any rise in Sterling would reduce value of global revenues	Non-UK assets and revenues would benefit from the devaluation of Sterling	Could benefit from removal of uncertainty
Global equities	Unaffected	Would provide some protection against a Sterling devaluation	Unaffected
UK government bonds	No impact	Could rise if seen as potential safe haven, but would be vulnerable to long term effects eg inflation and increased interest rates	No impact
Global bonds	No major impact	Could benefit as a perceived safe haven and would offer protection from a fall in Sterling, but global bonds remain unattractive in the medium term	No major impact