Brexit: Preparing for uncertainty

November 2018

Brexit developments may be front and centre of UK investors’ minds, but our global portfolios allow us to step back and look at the bigger picture.

Economic conditions are still positive and while the uncertainty of Brexit has presented a challenge for businesses, a UK PMI score of above 50 is still in growth territory.

Unemployment is extremely low compared to historic norms and there are far fewer people out of work in the UK compared to Europe. This is a key indicator of economic stability.

Strong global growth helped by positive economic data in developed markets, including low unemployment and high consumer confidence.

Corporate earnings have remained consistently positive throughout the year, a fact not necessarily reflected in share prices.

Market volatility, driven by idiosyncratic issues, is creating a wealth of opportunities that play to the strengths of stockpickers.
With just months to go until the UK is set to leave the EU, negotiations continue to stall around certain sticking points, such as the Irish border. With Prime Minister Theresa May facing battles on multiple fronts, the uncertainty over the final position of the UK in March next year is understandably causing concerns for investors, but while increased market volatility can cause disappointments, it can also create opportunities. Overall, should the UK agree some kind of deal, it should be positive for investors.

That said, as global investors, we focus on the bigger economic picture and the wide array of asset classes that we can invest in, not just the UK market. In 2018 there has been a clear divergence of performance between different geographies and asset classes, with very few related to Brexit. The US has been the standout performer among equities, driven primarily by technology stocks against a background of strong corporate earnings and economic data, with business and consumer confidence at all-time highs. Equally, Japan has become a bright spot within equity markets in the past few months, helped by low unemployment, a clear path on monetary policy and a weaker yen against the dollar.

So while Brexit may be dominating the headlines in the UK, it does not distract us from objectively assessing global markets and creating portfolios that can adapt to a changing environment, whether that is the sharp market sell-off in mid-October, or the threat of a no-deal Brexit. Our investment philosophy of focusing on client outcomes, diversification and downside defence will not change, and the tools we have at our disposal to invest across equities, bonds and alternatives, means we can be nimble to both protect against sharp downside moves and take advantage of unexpected investment opportunities.

For example, in September the FTSE 100 index made gains driven by energy and a rise in the oil price that had no relation to Brexit dramas, meanwhile UK housebuilders have suffered because of the government’s plan to impose additional layers of tax on foreign buyers of UK property, not as a result of Brexit. Likewise, while many FTSE 100-listed companies do have big operations in the UK, according to FTSE Russell approximately 76% of their earnings are derived from overseas. Activity in global markets is just as important, maybe more so, when assessing the outlook for UK listed business.

There will of course be plenty of companies based in the UK and elsewhere that will look to blame Brexit for their performance, and uncertainty has held back investment in some sectors. But we’re not managing money solely in anticipation of what’s going on in Brussels or Westminster. For us the focus is on the fundamentals and what is happening in the business cycle in the UK and around the world, and the divergence across geographies has further demonstrated the need for a fully diversified portfolio.

No matter what the outcome, the UK is not going to disappear and will remain one of the world’s largest business centres. That means it is a question not of ‘if’ we invest but of when, how and with what level of conviction. But this will not be at the expense of the positions that are working for us. While no-one has a crystal ball to predict the future, as managers we are confidently positioned in the knowledge that our well-resourced multi-asset team, and the underlying managers we invest in, are constantly analysing the markets, monitoring risks and searching for opportunities to take advantage of any market events.

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## Brexit outcome analysis: No/Bad deal vs deal

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<th>No/Bad deal</th>
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| **Sterling** | Likely impact: Although the currency is stable at around 1.30 against the dollar, if the UK crashes out of the EU or agrees a 'bad' deal then the pound is likely to experience weakness as there will be enormous uncertainty over what it means for the UK. This will have an inflationary impact and could provide a dilemma for the Bank of England as the natural inclination to raise rates would need to be balanced against the risk of a stagflation scenario if growth and confidence are low.  

What it means for the portfolio: In an inflationary/stagflation environment our portfolios would benefit from our balanced approach and exposure to real assets and fixed income, for example infrastructure, alternative income strategies and commodities. |
| Likely impact: The pound is likely to rally, which would push inflation lower. This would benefit companies importing into the UK, and we are a large importing economy, but could hinder exporters. There would likely be more upside risk to sterling in the event of a deal that ticks all the boxes on trade and access to the single market.  

What it means for the portfolio: Increased certainty in the wake of a deal could see increased inward investment and would be unambiguously good for the UK economy and our exposure to the region. |

| **Equities** | Likely impact: UK large cap equities could have mixed results, despite many of them benefiting from overseas earnings as the general wisdom is if sterling falls, large cap equities should outperform. There may be some initial currency translation effects from a weaker sterling but they are likely to wash through quite quickly. Small and mid-sized companies are likely to be harder hit, particularly in a no-deal scenario, as these companies have already been languishing for the best part of 12 months on the uncertainty over negotiations.  

What it means for the portfolio: This could hit certain sectors harder, such as UK retail and autos, which we have little exposure to, so it would have a transitory effect on the portfolios. However, if the details suggest some sectors could be more affected, this could cause a de-rating that may throw up opportunities in areas with sound fundamentals. As global investors, we recognise that while the UK is important to our clients, it is a small part of the overall universe, and there will be plenty of opportunities to exploit. |
| Likely impact: Any certainty could provide a relief rally among UK equities and a violent snap higher, particularly among small and mid-caps. For technical reasons some large caps might see a more muted reaction if sterling rallies strongly because of currency translation effects.  

What it means for the portfolio: The direction of travel for equities is likely to be more predicated by that of global equities. Small and mid-caps would be expected to do particularly well, however a lot of underlying businesses have already been marked down regardless of whether they'll be affected by Brexit. Uncertainty has exposed weaker business models, however, there are also structural changes such as a change in consumer habits that are affecting high street retailers. This will be a good environment for stockpickers to identify the right opportunities. |

| **Fixed Income** | Likely impact: The short-term there is likely to be a flight to quality such as UK gilts, the question is whether this will continue post-Brexit. That said, should sterling significantly weaken this will provide an inflationary force that could be bad for government bonds.  

What it means for the portfolio: We would likely continue to favour shorter duration credit as a means of getting fixed income exposure rather than UK sovereign debt. The problem with UK government bonds is that with yields so low already there is not much room for error. |
| Likely impact: In the short-term a deal would likely be deflationary. However, in the longer-term, sentiment will likely be more positive with sterling rallying, the economy picking up and interest rates rising.  

What it means for the portfolio: More positive sentiment, rising interest rates and an improving economy would likely see a move towards higher risk assets. |

| **Alternatives** | Likely impact: With such a broad spread of asset classes it is unlikely that the outcome of the negotiations will fundamentally change the outlook for alternatives.  

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Important information

Past performance is not a guide to future performance and may not be repeated. Investment involves risk. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested. Because of this, an investor is not certain to make a profit on an investment and may lose money. Exchange rates may cause the value of overseas investments to rise or fall.

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