

Global Insight

Focus Article

Brexit: U.K., are you O.K.?

As the U.K. plunges into the unknown, investors need to be nimble as the reality of Brexit evolves.

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All values in U.S. dollars and priced as of August 31, 2019, market close, unless otherwise noted.
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**Wealth
Management**

Brexit: U.K., are you OK?



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Markets have come to grips with the idea that U.K. Prime Minister Boris Johnson's threat to pull the U.K. out of the EU deal or no deal is more than just a negotiating tactic. As the country plunges into the unknown, investors need to be nimble as the reality of Brexit evolves.

The new game plan

After taking power, U.K. Prime Minister Boris Johnson took little time making his Brexit intentions clear with a sweeping purge of the cabinet and filling it with many prominent Brexiters. His government has been laser-focused on delivering Brexit by October 31.

Johnson's stated preferred option is to negotiate the terms of a Withdrawal Agreement by which the U.K. would leave the EU. But should he fail in this endeavor, he would countenance a "no-deal" Brexit, i.e., let the U.K. walk out of the EU on October 31 with no transition period and shift trade to World Trade Organization terms. To convince the EU and U.K. voters that he was serious about pursuing this option, he not only ratcheted up the no-deal rhetoric, but also had the Treasury earmark £8.3B to prepare for exiting the EU.

Gloves off

But his plan soon faced difficulties. Parliamentary arithmetic has worsened. Following a recent by-election, the defection of a Conservative Member of Parliament (MP) to the Liberal Democrats, and the expulsion of 21 rebel Conservative MPs, Johnson now heads an inherently unstable minority government. Moreover, a majority of the House of Commons opposes a no-deal Brexit, as does a majority of the public, according to opinion polls.

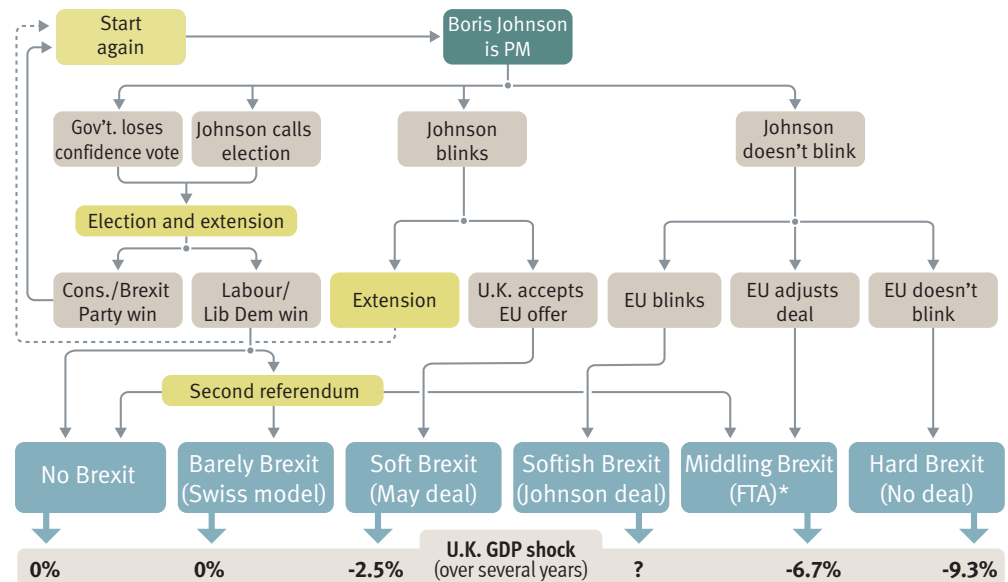
The House of Commons recently wrestled control of parliamentary business from the government by voting to force Johnson to request an extension from the EU to delay Brexit until January 31, 2020, unless a deal on the terms of the exit is approved by Parliament. This, in effect, would avoid a no-deal Brexit in the autumn.

Given the unfavorable parliamentary arithmetic, the likelihood of a general election has now increased. Its result, given how divided the country is and the "first-past-the-post" (or winner-take-all) system, remains as opaque as ever. At one end of the spectrum, a Conservative government could return and implement a no-deal Brexit. At the other end, a Labour/Liberal Democrat coalition could pursue a second referendum.

Brexit: U.K., are you OK?

No clarity on how Brexit will unfold

How various scenarios would impact the U.K. economy over several years



*Free trade agreement; Source - RBC Global Asset Management

Fiscal stimulus anyone?

In a gambit which suggests positioning for an upcoming election, over the past few weeks Johnson announced a flurry of spending commitments and proposed tax changes at an unprecedented rate for a Conservative prime minister. He clearly intends to support the economy, which contracted by 0.2% q/q in Q2.

Fiscal measures helpful but unlikely to offset Brexit impact completely

Estimated cost of announced spending and tax initiatives

Fiscal spending	Cost
Employing an additional 20,000 police officers	£1.1B/year
Raising spending per school pupil	£4.6B/year
Towns' fund for disadvantaged areas	£3.6B/year
National Health Service	£1.8B/year
New prison beds	£2.5B
New railways	£39.0B
Taxation	Cost
Raising higher tax threshold to £80,000 from £50,000	£9.0B/year
Increasing starting point for National Insurance contributions to £12,500	£11.0B/year
Exempting houses under £500,000 from stamp duty	£4.0B/year
Cuts to corporate income tax*	TBD

*This measure was discussed during the Conservative leadership debates

Source - Bloomberg, Reuters, IFS, ukonwards.com, RBC Capital Markets, RBC Wealth Management

But some perspective is needed. Some of this spending had already been promised by the previous administration, such as the funds earmarked for the National Health Service and the poorest cities and towns. Other proposals, such as infrastructure spending, would take years to plan and would require legislative approval, which could be problematic given the parliamentary arithmetic.

As for tax changes, their impact doesn't tend to be immediate. For one, they would mostly take effect in a new tax year, or not until April 2020 in this case. The value added tax (VAT), a sales tax, is an exception. The government lowered the VAT during the financial crisis, as it judged that this was the quickest and most direct way to put money in the pockets of households. Moreover, RBC Capital Markets points out that it has been common for major tax changes in the U.K. to be phased in over a number of fiscal tax years, rather than in one go—for example, the cut in the main corporate income tax rate from 28% to 17% occurred over a 10-year period.

For now, the prime minister expects this fiscal largesse will be paid by the country's fiscal headroom, the equivalent of spending one's overdraft limit. With the economy slowing, this headroom is expected to decline, so more borrowing is likely, eventually.

What of the BoE?

As the government's stated policy has been to continue to work towards a smooth Brexit, and as the fiscal plan has not yet made it into the budget officially, the Bank of England (BoE) has maintained its guidance for "increases in interest rates at a gradual pace and to a limited extent." But if the economy slows further, the BoE is likely to adopt a dovish stance. Indeed, RBC Capital Markets expects a 25 basis point (bps) cut at the BoE's November meeting.

Should the Conservatives win a majority enabling them to pursue a no-deal Brexit, we believe the economy would need immediate support. This would be more readily effected by monetary policy rather than fiscal policy. In this situation, RBC Capital Markets projects there would be as much as a 50 bps cut and a resumption of quantitative easing.

Sterling: Pounded

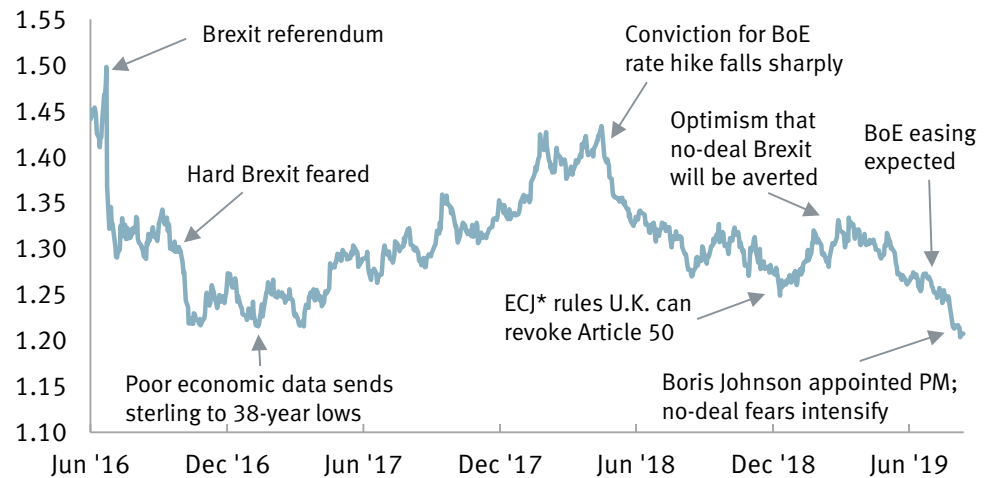
The pound was one of the worst-performing G10 currencies this summer, piercing through its post-Brexit referendum low against the U.S. dollar, as Johnson ratcheted up the no-deal Brexit rhetoric. But should a change of government (Labour/Liberal Democrat coalition) herald the possibility of an exit with a deal in place or a second referendum, a substantial relief rally in the currency cannot be ruled out, given how deeply undervalued it has become. Conversely, a Conservative victory could lead to further underperformance.

Fixed income: Safety first

We anticipate continuing demand for the perceived safety of government bonds given heightened political uncertainty and therefore maintain our Market Weight view on government bonds with short-duration positioning. Our base case is that the BoE will become more accommodative.

Timeline of key Brexit events driving the pound

GBP/USD through its post-referendum low



*ECJ = European Court of Justice. Source - FactSet, RBC Wealth Management; closing prices through 8/13/19

Fiscal stimulus is not presently being priced into the market and this is likely to remain the case as it is unclear that the current minority government has the power to deliver it.

For now, we would not expect U.K. 10-year government bond yields, which have currently fallen to 0.48%, to follow the upward move of U.S. Treasuries that occurred in the aftermath of President Trump's election in November 2016. The effect of Brexit dampening growth prospects and heightening demand for safe-haven assets currently outweighs the risk yields may rise due to fiscal stimulus.

Sterling-denominated corporate credit provides relatively attractive valuations, though we would be prudent and avoid issues from companies exposed to the domestic economy.

Equities: A bargain bin?

We reiterate our Market Weight stance on U.K. equities given the low valuations, with the MSCI United Kingdom Index trading at a price-to-earnings multiple of below 12x 2020 consensus earnings estimates, and having an overall dividend yield of 5%. Moreover, at some 22%, the discount of the MSCI United Kingdom Index to the MSCI World Index is as deep as it has been in close to 10 years.

In the current uncertain environment, we believe it makes sense to continue to focus on companies which generate revenues abroad despite their recent run of outperformance and often fuller valuations. Their repatriated earnings benefit from a weaker currency and feel less impact from the U.K.'s weak domestic outlook. In a no-deal scenario, we would expect the shares of these companies to continue to outperform, but we would be alert to opportunities in domestic-centric companies, which may become even more deeply discounted in any further selloff.

However, should a change of government increase the possibility of a second referendum or an exit from the EU with a deal, we would expect the pound to strengthen, which would crimp the upside potential of companies that generate a substantial percentage of revenues from international sources. And with better visibility on the economic outlook, we would expect some rotation into attractively valued domestic stocks.

Necessary to be nimble

It is not an overstatement to say that the uncertainty in the U.K., given what is at stake, is unprecedented. September has already been a momentous month for headlines as Parliament has returned and the Brexit debate restarted in earnest. Investors should be alert and flexible as the reality of Brexit evolves.

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