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Independent Investment Strategy

U.K.

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Next
Weekly Macro Strategy Report
Friday, February 26

U.K.: Limited Room To Maneuver

MRB U.K. Recommendations*

Relative Performance	-		N		+	
Government Bonds**	□	■	□	□	□	*p.14*
Currency (vs US$)	□	■	□	□	□	*p.14*
Equities***	□	■	□	□	□	*p.16*

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* 6-12 month horizon
** Relative to hedged global fixed income benchmark
*** Relative to common currency global equity benchmark
Note: + = maximum overweight, N = neutral, - = maximum underweight

The U.K. economy is littered with structural imbalances. Aggressive monetary reflation limited the fallout during the Great Recession, but has encouraged a further buildup in excesses over the past few years. Indeed, U.K. residential real estate has been in a mania and households are heavily indebted. It will be difficult for this economy to avoid a deflationary adjustment at some point down the road, especially given the limited policy arsenal that remains unused.

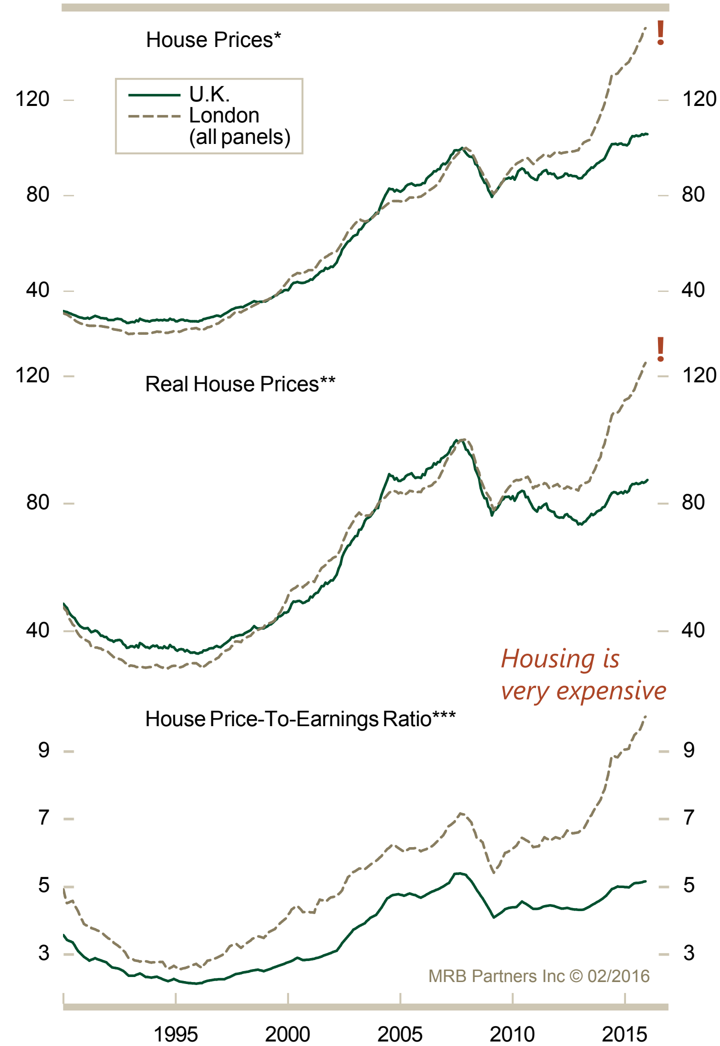
That said, structural vulnerabilities will not impede a further cyclical economic expansion. Indeed, the U.K. is currently enjoying self-reinforcing economic growth that should persist over the next year on the back of extremely easy monetary conditions. An ongoing cyclical expansion in the midst of structural challenges makes the U.K. a particularly difficult economy to evaluate and for investors to position their portfolios. Indeed, we recommend closely monitoring the risks that could bring the longer-term vulnerabilities to the forefront. At the moment these include the threat of Brexit, commodity-related financial contagion, and the end of the global luxury mania.

- The U.K. has substantial imbalances that threaten the longer-term outlook for its economy and asset markets. Most worrying are the housing and credit bubbles.
- However, extremely easy monetary conditions should make the cyclical economic expansion more durable than investors currently anticipate over the next year. The primary risks in 2016 are Brexit and whether commodity contagion leaks into the global financial system and the U.K. housing market.
- Policymakers have limited room to maneuver in the current backdrop, but conditions will need to be gradually tightened in order to deter further housing and credit excesses.
- Investors are too complacent on the timing of eventual BoE rate hikes. Stay underweight U.K. Gilts within a global hedged fixed-income portfolio.
- We are still underweight the pound versus the U.S. dollar, but recent depreciation is overdone and a near-term bounce is probable.
- Finally, we remain underweight U.K. stocks versus global equity benchmarks, albeit expect that much of the underperformance trend has now been realized.

This report updates MRB's structural and cyclical views on the U.K. economy, policy backdrop and financial markets. It includes our recommendations for domestic assets and overall asset allocation strategy. While we are more bearish than most investors on the long-term outlook for the U.K. economy and assets, we are more constructive on the cyclical outlook. The market is too dovish in its expectation for the BoE, although the Carney-led perennially dovish central bank is likely to err on the side of caution until the referendum result is known.

We are underweight Gilts within a global hedged fixed income portfolio and remain underweight U.K. stocks versus global equity benchmarks, largely due to their energy exposure and defensive characteristics. Finally, we are underweight the pound versus the U.S. dollar, even though the recent depreciation is a bit overdone relative to the betting odds which are against a Brexit.

Chart 1 U.K. House Prices Are In A Bubble, Particularly London



* Rebased to pre-crisis peak; source: Nationwide
** Rebased to pre-crisis peak; deflated by headline cpi; source: Nationwide
*** Source: Nationwide

Structural Backdrop: Alarming Imbalances

Over the past several years, we have regularly highlighted the substantial structural imbalances present within the U.K. economy. These do not prevent a sustained cyclical expansion, partially because the ongoing escalation of excesses provides near-term support to the economy (see below). Nonetheless, structural imbalances pose a material longer-term threat that needs to be monitored as they will eventually come home to roost, likely during the next global recession. These include:

- **Housing Bubble:** The U.K. already had a full-fledged housing bubble heading into the Great Recession. Unlike the U.S., policymakers were able to prevent it from bursting by slashing interest rates and refinancing the large percentage of homeowners with floating rate mortgages. Also, currency depreciation attracted foreigners. Since then, U.K. home prices have risen to fresh all-time highs (about 6% above their pre-crisis peak). London has led, with prices surging to levels 50% above their 2007 peak (**chart 1**). Homes in the U.K. now sell for about five times the level of household incomes, while those in London trade at ten times (double the long-run average). Home prices are also stretched relative to rental yields. The lack of supply has often been cited as a major underlying support for elevated London home prices. However, the city is starting to expand vertically and there is a tremendous amount of building as well as conversions currently underway.

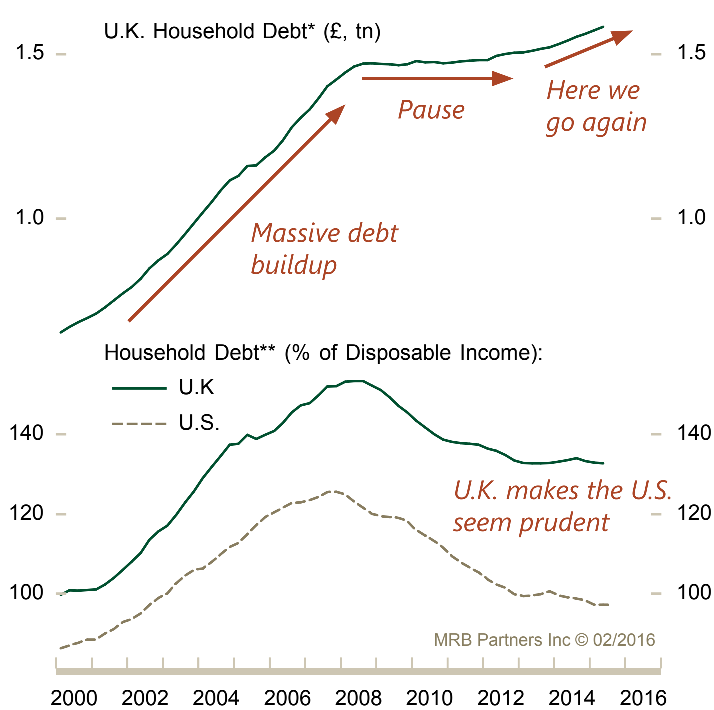
The housing and credit bubbles are a major longer-term threat

❍ **Credit Excesses:** Not surprisingly, private sector leverage is also elevated, which exposes the U.K. to debt deflation risks in the event of a housing fallout. The run-up in household credit was dramatic prior to the Great Recession, even compared with the U.S. (**chart 2**). In the years since, credit has only increased modestly and has eroded as a percentage of disposable income, which is encouraging. Nonetheless, debt ratios remain more stretched than the U.S. was at its peak. There is also significant ownership of secondary homes and buy-to-let properties, which investors are typically more willing to dump during a housing downturn.

❍ **Policy Limitations:** The BoE will not be able cut policy rates materially from current levels and refinance homeowners to offset any wobbles in the property market, as it did in 2008 (see below). Reflationary support will need to come from fiscal policy and/or the currency. Unfortunately, the U.K. government's balance sheet has deteriorated substantially since the Great Recession. Net public sector debt as a percentage of GDP has increased 43 percentage points since 2007 to just over 80% and the government continues to run a structural budget deficit (**chart 3**). Although public sector debt levels are not yet alarming, there is limited fiscal latitude to support the economy in the event of future housing or financial sector strains. This is especially true given that the U.K. has a global banking center with total assets of nearly six times the size of the economy. The need for even a minor bailout could cause government debt to mushroom and trigger sovereign debt strains.

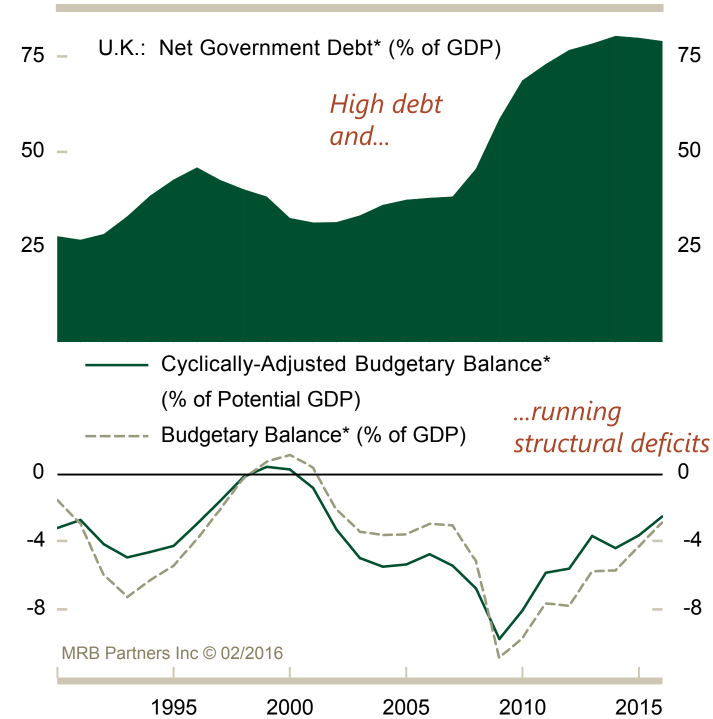
❍ **Lack Of Competitiveness:** It would be beneficial if the U.K. economy received support from abroad to help offset any future domestic stresses. Unfortunately, the U.K. economy has a limited manufacturing export sector and is not particularly competitive. The IFO Institute's survey indicates that the U.K. economy is chronically less competitive than the U.S. or Germany. Indeed, unit labor costs have risen much more rapidly and

Chart 2 **U.K. Household Leverage Is Excessive**



* Source: Bank of International Settlements
** Sources: Bank for International Settlements and national sources

Chart 3 **U.K. Has Weak Public Finances**



* Source: IMF

productivity growth has been considerably weaker than in the U.S. or Germany (**chart 4**). As a result, the U.K. runs a persistent current account and trade deficit. Thus, the pound would have to depreciate substantially further in order to boost competitiveness and provide material reflationary support in the event that deleveraging forces were to develop.

Final Word: *The U.K. economy is sitting on top of housing and credit bubbles, which will eventually deflate and result in significant deleveraging pressures. This is not an imminent threat, nor does it prevent a further cyclical expansion (see below). However, it is a risk that needs to be regularly monitored, especially given the lack of a sufficient monetary or fiscal reflationary arsenal to combat any crisis that were to develop. In turn, U.K. risk assets should not be considered longer-term buy-and-hold candidates.*

Cyclical Outlook: Sustained Expansion

Although the structural foundations for the U.K. economy are worrying, the cyclical outlook remains constructive. Extremely easy policy is supportive of domestic activity:

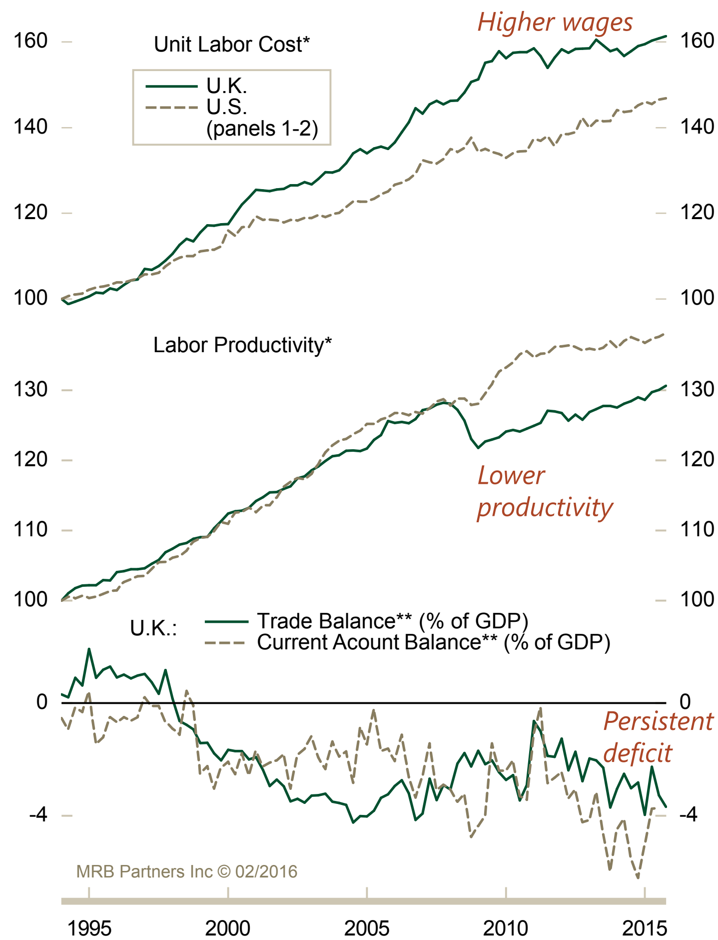
Liquidity Trends

Broad money and private sector credit trends were sluggish to revive this cycle, but have been improving steadily over the past couple of years (**chart 5**). Growth rates are still historically subdued but are rising, especially for the household sector. Moreover, the BoE Credit Conditions Survey indicates that standards are easing for both households and businesses. In short, liquidity trends should help reinforce the domestic economic expansion.

Business Sector

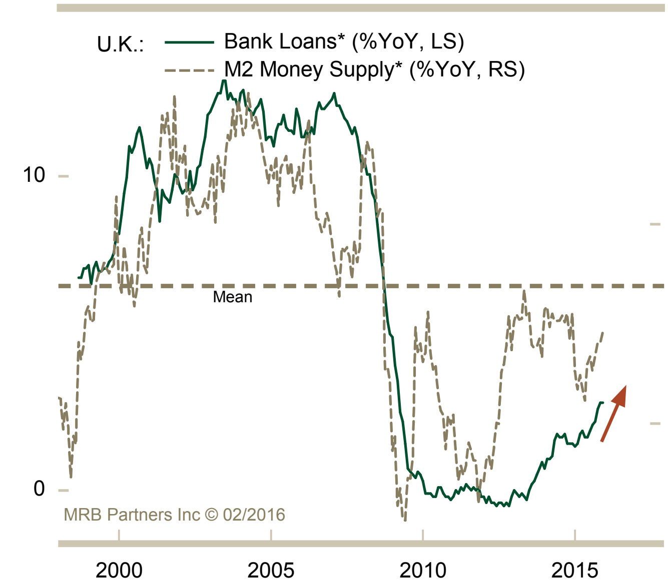
Overall business sector activity and confidence has moderated over the past year, but remains durable and will continue to support the ongoing economic expansion. Sentiment within the outsized service sector has cooled modestly in recent months from frothy levels

Chart 4 U.K. Business Sector Lacks Competitiveness



* Rebased; source: OECD
** Source: Office for National Statistics

Chart 5 U.K. Monetary Transmission Mechanism Is Gradually Working



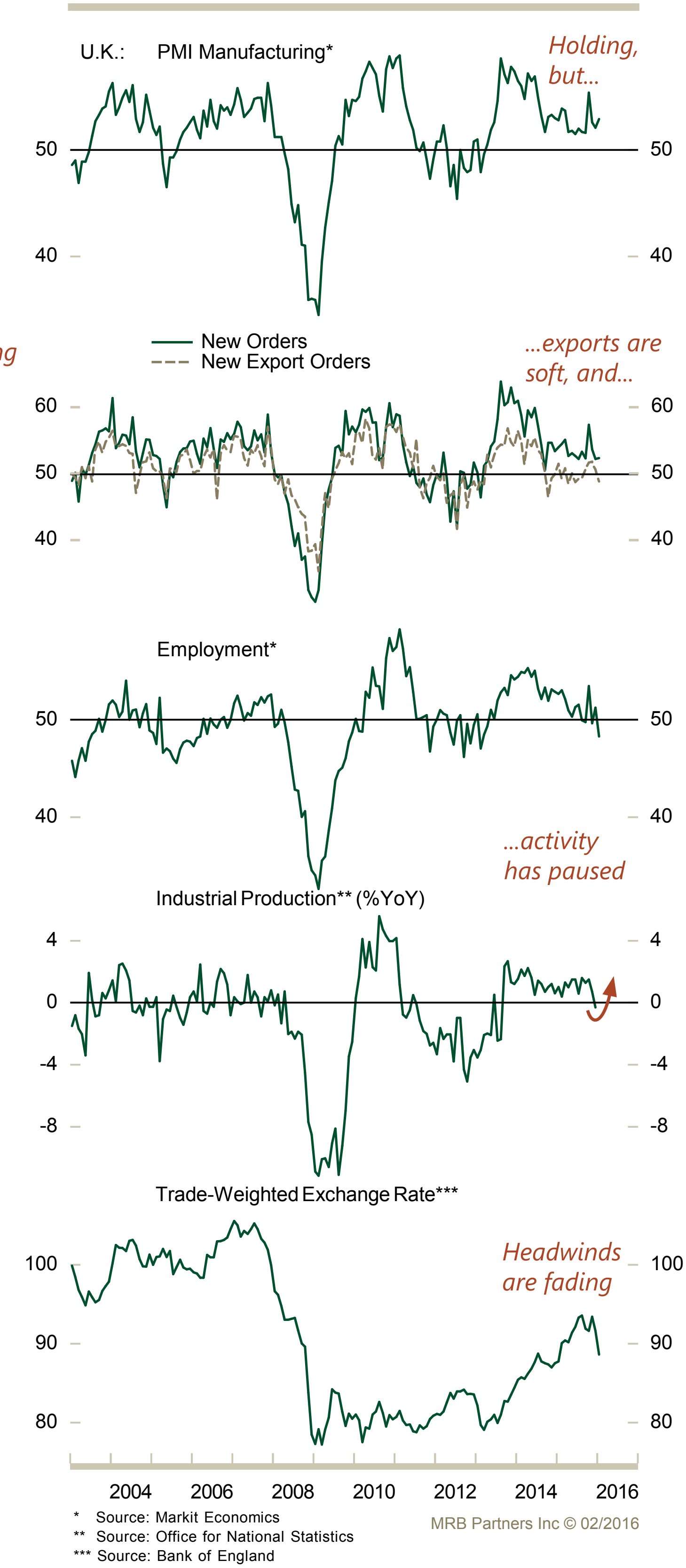
* Source: Bank of England
Note: Both series are aligned with their historical means

Chart 6 **U.K. Service Sector Is In Solid Shape**

(**chart 6**). Nonetheless, these firms remain upbeat and are reporting fairly solid new order demand as well as a desire to add further to employment. The key will be that recent turmoil in global capital markets and banking system strains related to the fallout in commodities is contained, given the importance of the financial sector in the U.K. economy. For now, we expect the service sector will remain in solid shape and continue to drive business activity within the U.K.

There has been a notable divergence between the relatively strong service sector and a more material softening in the manufacturing sector. The collapse in commodity prices, past appreciation in the trade-weighted currency, and weak global demand adversely impacted manufacturers (particularly exporters) in 2015. Indeed, industrial production has stalled over the past year, while the purchasing managers' index highlights that manufacturing confidence downshifted substantially, albeit remains above the boom/bust line (**chart 7**). Firms have reported a softening in new order

Chart 7 **Past Currency Strength Has Undermined The Manufacturing Sector**



demand, especially from abroad. In turn, manufacturers (on balance) are delaying adding further to payrolls. That said, the trade-weighted pound has recently pulled back and material appreciation is unlikely over the next year, which should help alleviate and important headwind for the sector. Also, there are early signs that export orders will firm, with businesses citing improved demand from the U.S., Europe, and China.

Employment

Employment conditions have improved dramatically in the U.K. over the past several years, with the unemployment rate dropping sharply since peaking earlier this decade (**chart 8**). Likewise, unemployment insurance claims have plunged to levels below those experienced prior to the Great Recession. That said, the pace of job growth has moderated over the past 18 months from what was a fairly rapid pace (**chart 9**). Also, wage growth in the overall U.K. economy has downshifted, albeit base pay continues to expand at a healthy clip of just over 2% per year. Looking ahead, the employment backdrop should remain robust, with service providers (which account for 83% of the labor market) signaling ongoing increases in payrolls. Indeed, the number of job vacancies are currently running at cyclical extremes.

Housing

The imbalances in the U.K. housing market pose a major longer-term threat, especially given that there is also excessive private sector leverage in the U.K. economy (see above). However, on a cyclical basis, housing activity has provided significant support for domestic growth, both directly and indirectly via its impact on consumer spending. Home price inflation has cooled since mid-2014, but has stabilized at an annual growth rate of about 5%, i.e. are rising faster than underlying inflation. Leading indicators remain positive and point to a modest pickup: new mortgage approvals have continued their steady uptrend and the tightly correlated RICS survey

Chart 8 **Big Improvement In U.K. Employment Conditions**

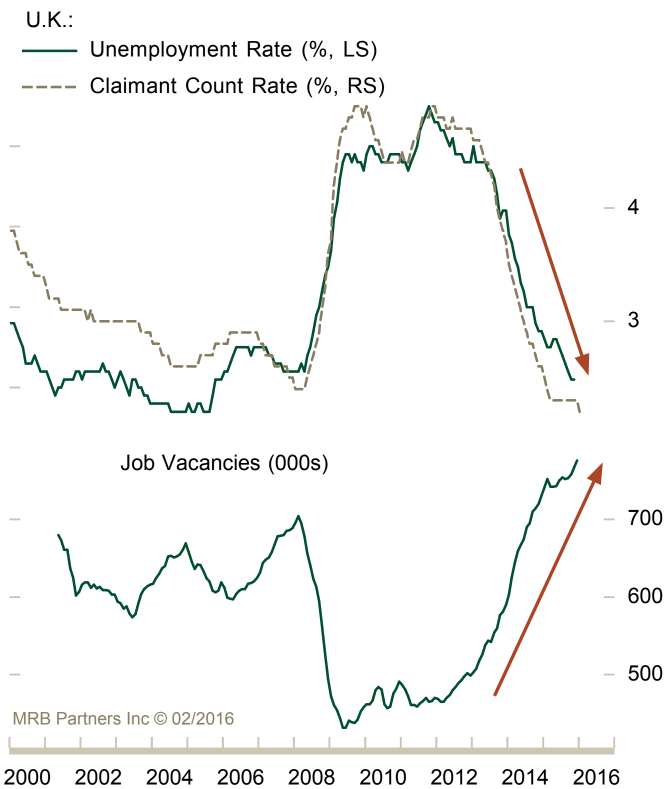
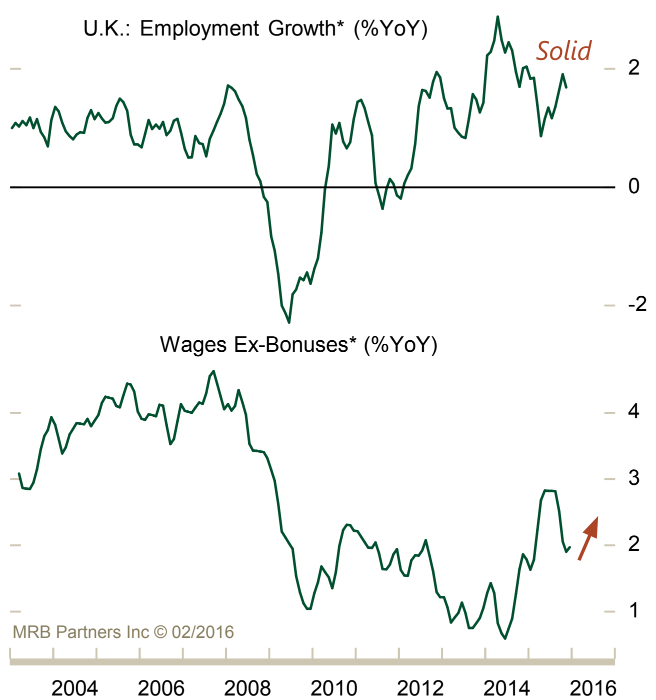
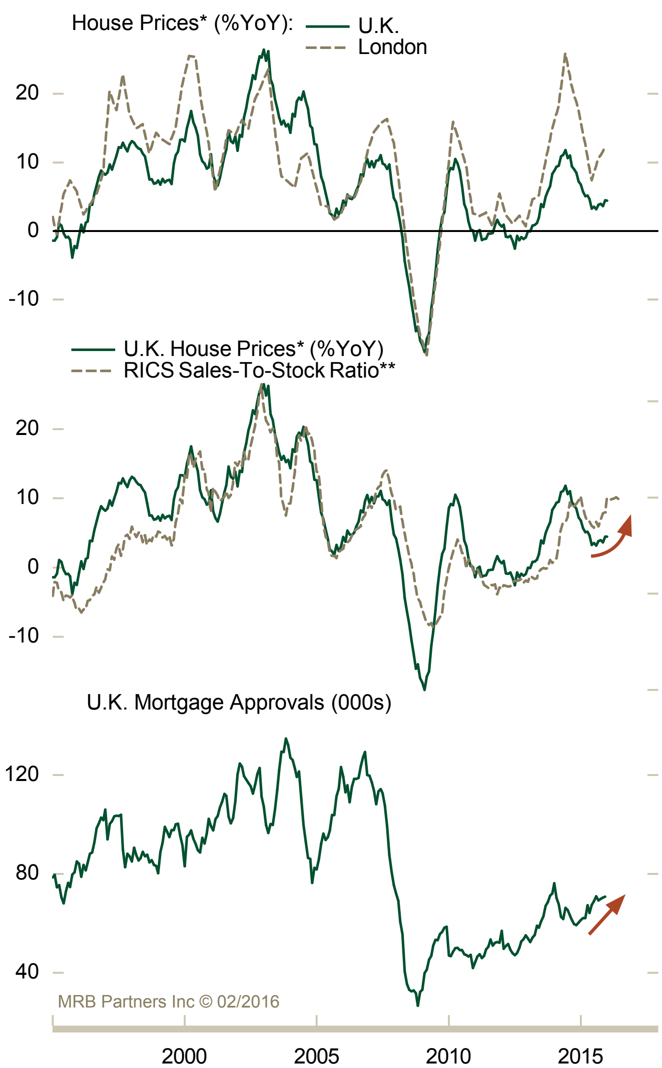


Chart 9 **U.K. Job Market Is Robust**



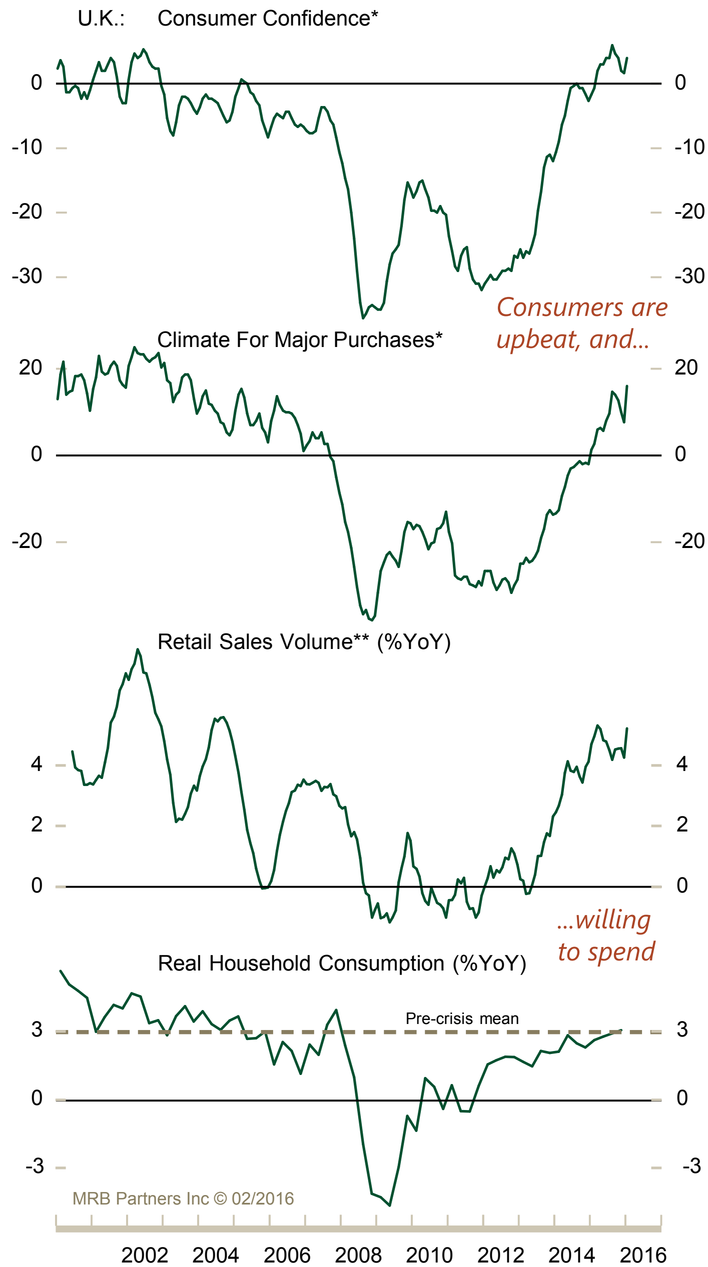
* Source: Office for National Statistics
Note: Panel 2 is smoothed

Chart 10 U.K. Housing Remains In Demand



* Source: Nationwide
** Advanced 6 months; source: The Royal Institute of Chartered Surveyors

Chart 11 U.K. Consumer Activity Is Strong



* Smoothed; source: GfK group
** Smoothed

sales-to-stock ratio signals an acceleration in home prices (**chart 10**). Moreover, depressed interest rates and a solid employment backdrop provides underlying support for housing. It is worth noting that construction activity is also making a healthy contribution to the overall economy. Employment for the sector (which account for about 7% of the labor market) is increasing at a brisk 5% pace and wages for construction jobs are expanding at just over 6% per year.

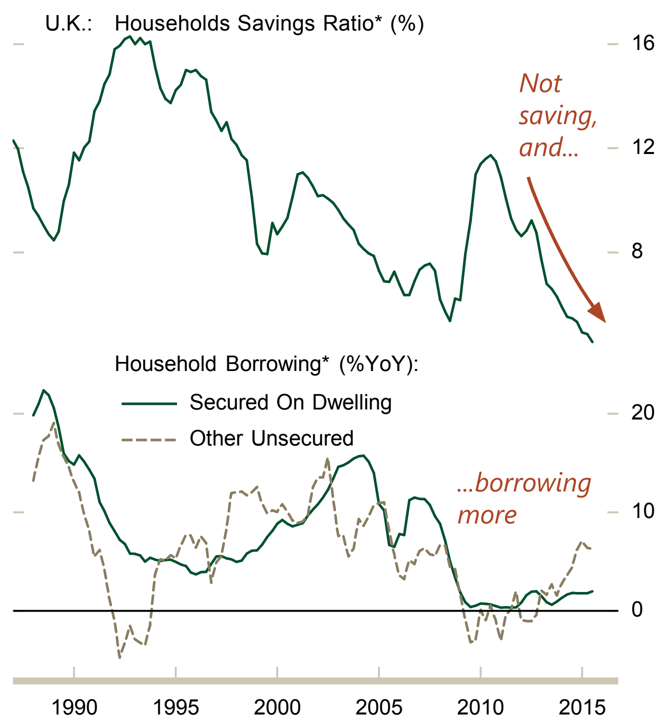
> The economy has cyclical tailwinds, due to strong consumer spending

Consumer Sector

Consumer confidence and spending was slow to revive following the Great Recession, but started to surge higher by 2013 and has held strong since (**chart 11**). The improvement in the labor and housing markets reinforced these trends, making consumers very optimistic and willing to spend. Indeed, confidence is currently near all-time highs and consumers signal a strong desire to make major purchases. In turn, retail sales volumes have been expanding around a brisk 4% year-over-year pace throughout the past three years. Likewise, real household consumption is growing at a pace consistent with the pre-crisis expansion period.

U.K. consumers are not is great shape from a structural perspective (as noted above). Households are highly levered and their balance sheets are poor. This should limit the amount of buying power over the next few years. However, an overly accommodative monetary policy setting and easy credit conditions are currently encouraging reduced savings and increased leverage (**chart 12**). This is not a positive longer-term story, but it supports cyclical consumption trends and the overall economy while excesses continue to build. One near-run risk factor heading into spring is whether the inevitable tensions associated with the referendum will hold back spending and dampen overall sentiment (see below).

Chart 12 **U.K. Households Are Spending Beyond Their Means**



* Source: U.K. Office for National Statistics
Note: Panel 1 is smoothed

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Inflation

U.K. CPI inflation has fallen steadily in recent years to depressed levels (**chart 13**). Headline inflation measures flirted with deflation throughout 2015 and are now running at a mere 0.3%, well below the BoE's 2% target. Core CPI inflation has also declined materially, although remains at a much higher rate of 1.2%. Likewise, both consumer and investor inflation expectations have collapse to historically depressed readings (**chart 14**).

That said, it is likely that CPI inflation has already bottomed and should recover over the next year. Headline inflation has been dragged lower by the collapse in energy and food prices. With the fallout in commodities now well extended and the price of Brent crude oil showing signs of stabilizing, the year-over-year change will start to reverse and the deflationary effects will subside (**chart 13**, panel 2). In addition, the multi-year appreciation in the trade-weighted pound pushed down import prices, dampening both headline and core CPI inflation. With the currency now having given back some of its previous gains, these drags should wane.

The U.K. is not as deflationary as it appears

In terms of the domestic supply/demand balance, much of the spare capacity has now been absorbed in the U.K. economy: the domestic output gap has closed and the U.K.

unemployment rate has fallen below equilibrium (**chart 13**, panels 4 and 5). Economic slack will continue to be absorbed by a continued expansion over the next year, putting upward pressure on wages and providing retailers with the ability to lift prices. Already, a diffusion index of the CPI components shows that the majority are experiencing increased price pressures. We do not expect a sizable burst of inflation ahead, but a significant unwinding of the drop in inflation expectations is probable.

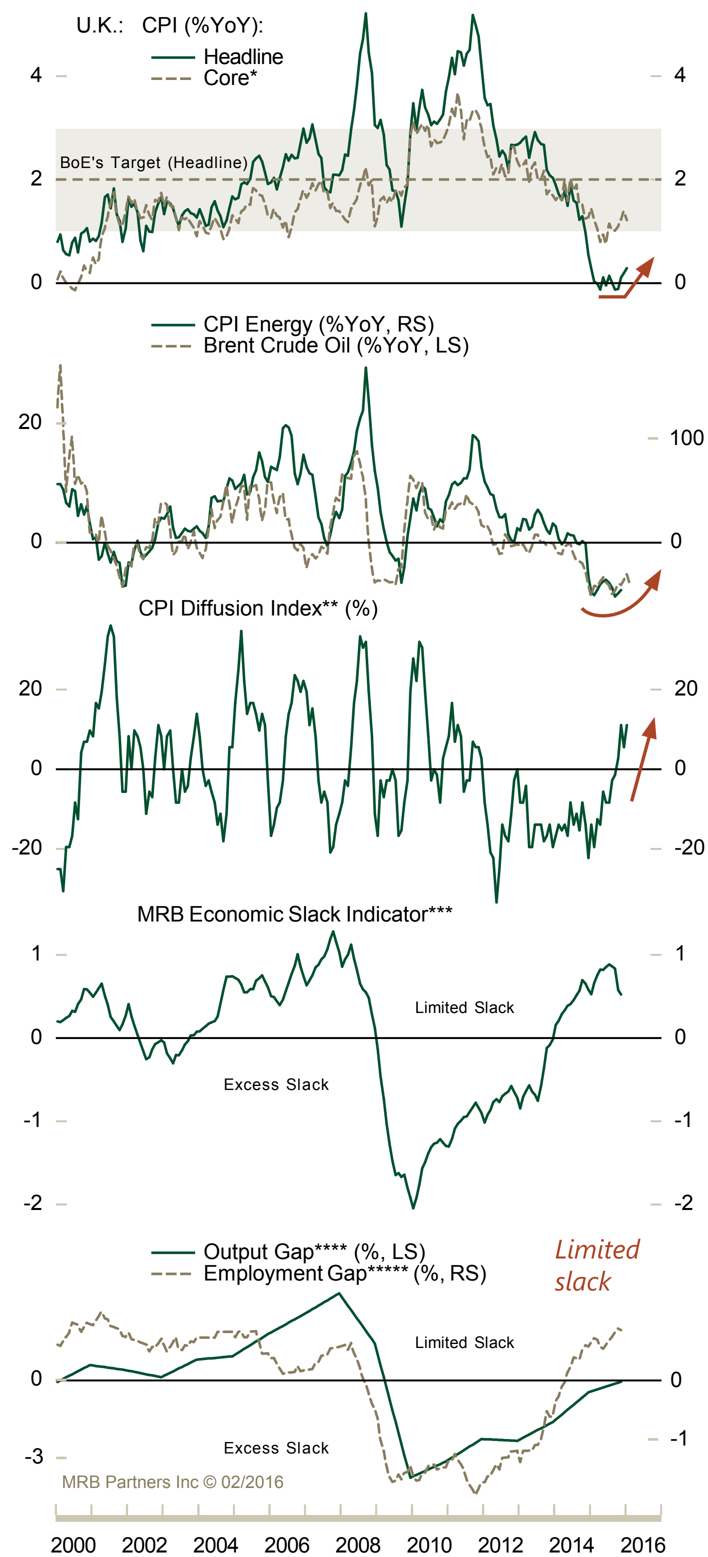
Final Word: *The cyclical economic expansion in the U.K. economy should remain durable. However, with the economy littered with structural imbalances, the onus is on policymakers and investors to monitor potential threats that could bring these longer-term problems home to roost (see below).*

Economic Threats

The U.K. is currently enjoying a self-reinforcing economic expansion. However, the outlook is vulnerable to anything that adversely impacts the global financial system or could burst the domestic housing/credit bubble. Aside from another global recession, the most significant risks currently include Brexit, commodity-related contagion, and the bursting of the global luxury bubble:

- **Brexit:** The latest polls and betting odds still favor Briton staying within the European Union. Although we will avoid the political debate, a Brexit scenario would be a clear net negative for the U.K. economy. The first order impact would present a material headwind for trade, given that the European Union is the U.K.'s largest trading partner, accounting for about 45% of total exports. However, the much larger drag would result from the tremendous uncertainty for businesses (especially the financial sector) and consumers that it would create, leading to a retrenchment in spending and investment. The risk is that this occurs in the lead up to the June 23 referendum regardless

Chart 13 U.K. Inflation Pressures Will Gradually Build



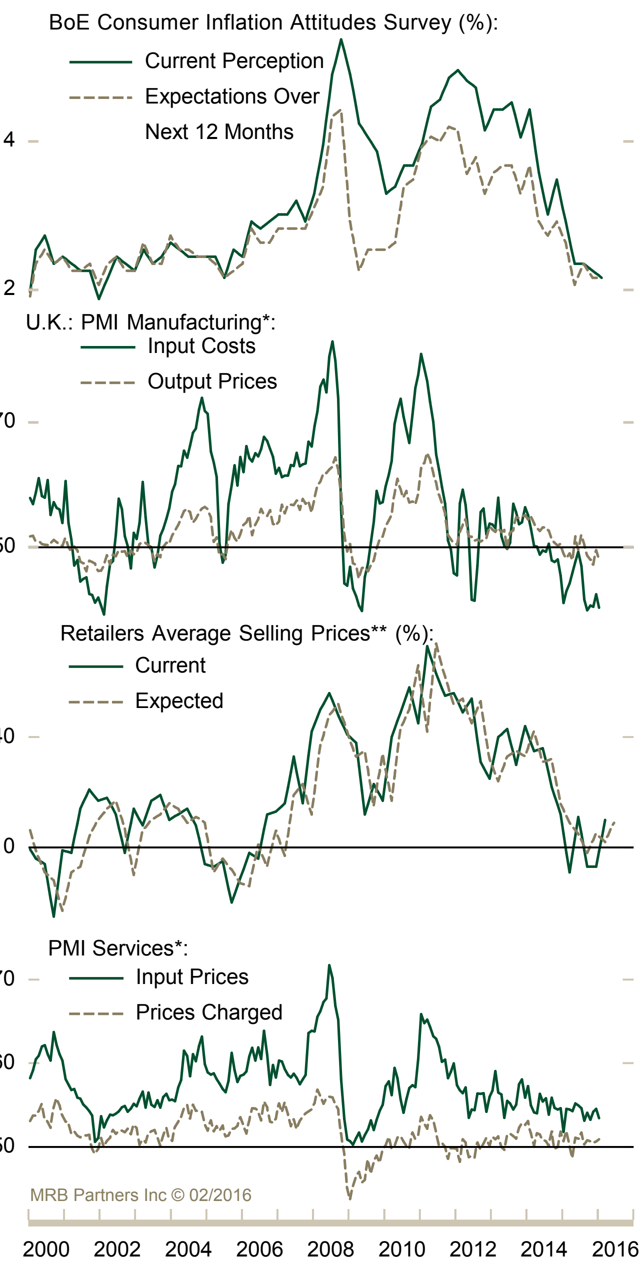
* Excludes energy and unprocessed food
** Net percent of CPI components with rising annual inflation rates; smoothed
*** Includes output gap, capacity utilization, & labor market variables; standardized
**** Source: OECD
***** Non-accelerated inflation rate of unemployment minus unemployment rate

of the outcome as the debate intensifies. Business investment will almost certainly grind to a halt over the next few months until the clouds clear. The key is to watch the behavior of households and foreign real estate investors in response to the negative rhetoric being played out in the press from both sides. A sharp reduction in demand (even if temporary) could set in motion a painful adjustment process, given the imbalances in the U.K. economy. So far, this is just a risk to monitor, albeit a material one.

- **Commodity Contagion:** There are a number of commonalities between the current fallout in the commodity based economies and that of emerging Asia during the debt crisis of the late-1990s (see the February **MRB *Strategic Trader Report***). Similar to that episode, the risk for the U.K. is that contagion is allowed to spreads into the global financial system. For this outcome, we expect it will first require a significant number of commodity-based economies to experience housing fallouts, recessions and deleveraging pressures that create havoc for their domestic banking sectors and allow contagion to spread abroad (much like in 1998 or at the height of the 2011-2012 European debt crisis). We are not near that point yet, although this is a credible future threat.

- **Luxury Housing:** There are some potential risks for the top end of the London property market, which has been caught up in the global luxury bubble. Specifically, the collapse of the Commodity Supercycle has evaporated wealth of the extremely affluent in commodity based countries, many of which have been buyers of the high-end London property market (**chart 15**). Material appreciation of the pound (especially versus commodity currencies) has made London property significantly more expensive for many foreigners. Moreover, the newly enacted Stamp Duty Land Tax increases the tax bill for properties above £938,300 will help dampen demand. All of these factors contributed to a cooling in house prices in London's most expensive boroughs throughout 2015. If commodity-related contagion leaked into the global financial system, it would add to headwinds by threatening jobs within London. Prime London

Chart 14 U.K. Inflation Expectations Remain Depressed

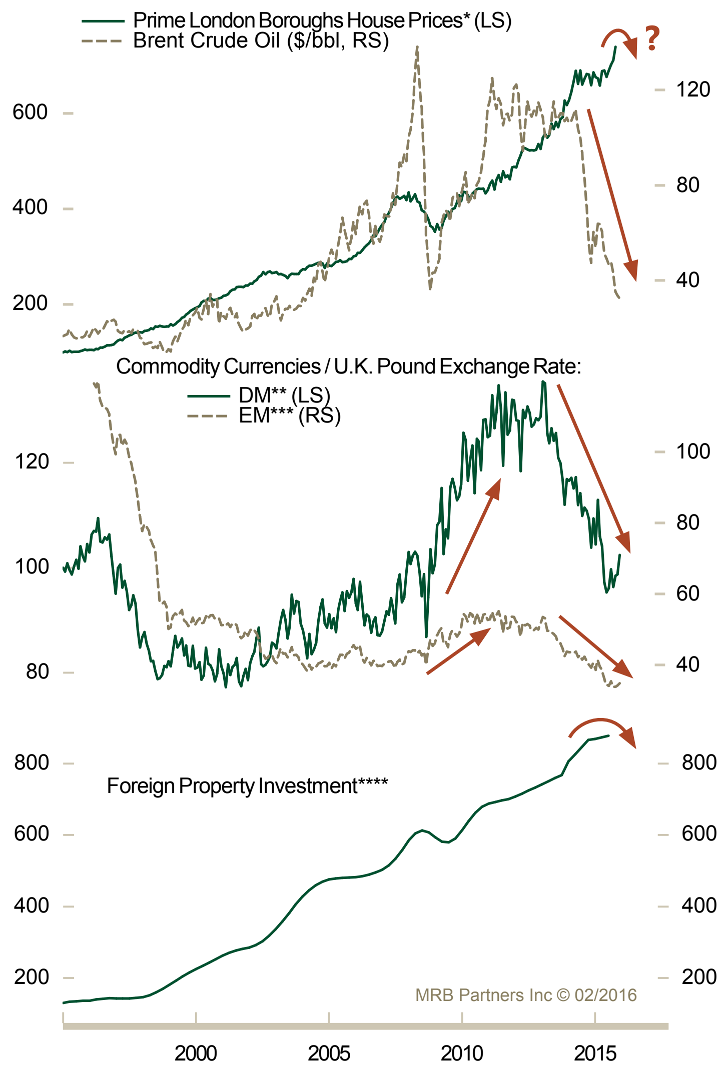


* Source: Markit Economics
** Source: Confederation of British Industry

Brexit and commodity contagion are the greatest risks for 2016 real estate is a small subsect of the overall U.K. market, but it has the greatest imbalances and could become a threat if prices were to topple and put downward pressure on house prices throughout the rest of London. For now, this is merely a risk to monitor, since the latest data suggests that prices may be firming anew.

Final Word: *The cyclical outlook for the U.K. economy is constructive, but there are some near-term potential threats (as well as major longer-run threats) that both policymakers and investors will need to pay close attention to throughout 2016.*

Chart 15 **Prime London Housing Is Vulnerable To Commodity Contagion**



* Rebased; equally weighted aggregate of Kensington & Chelsea, Westminster, Camden, and Hammersmith and Fulham; average house price; source: U.K. Land Registry
** Rebased; equally-weighted aggregate includes: Australia, Canada, New Zealand & Norway
*** Rebased; equally-weighted aggregate includes: Brazil, Chile, Indonesia Malaysia, Mexico, Peru, Russia & South Africa
**** Rebased; source: U.K. Office for National Statistics

Policy Balancing Act

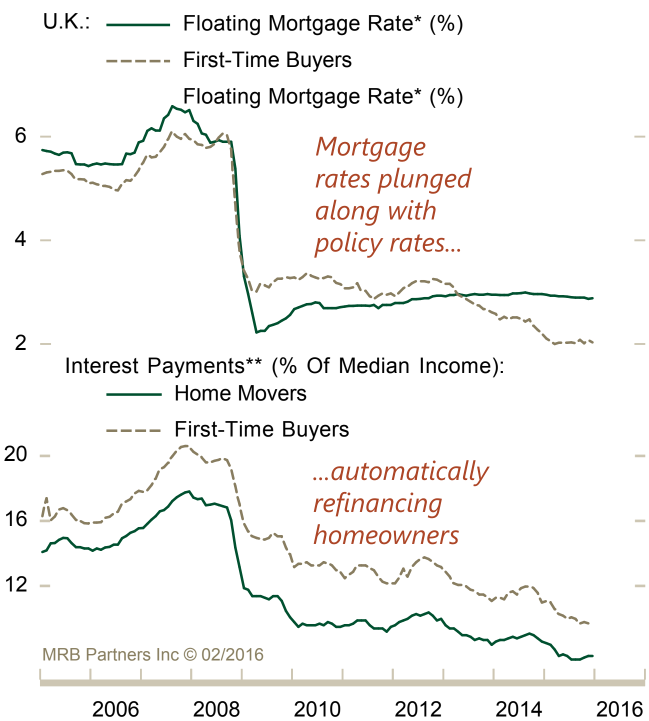
U.K. policy was inappropriately easy in the run-up to the Great Recession, fueling dramatic housing and credit imbalances. This substantial mistake heightened the vulnerability of the domestic economy and dramatically curtailed the flexibility of policymakers in the years since.

Although facilitating the development of excesses was a major error, domestic policymakers are not proponents of "cleansing the system" and allowing deleveraging to run its natural course. If this approach had been adopted, the 2007-2008 fallout in the U.K. would have been much worse than experienced in the U.S., and public sector coffers would have proven insufficient to halt the corresponding debt deflation spiral. Fortunately, the vast majority of mortgages were linked to short-term floating interest rates in the late-2000s. This allowed the BoE to automatically refinance most homeowners and stabilizing property prices by slashing policy rates, which was not possible in the U.S. (**chart 16**).

Once conditions were stabilized, the appropriate initiative would have been to set the policy mix to support employment and income growth, while largely capping nominal home prices and private sector debt levels via the use of multiple policy tools. The only benign way to deflate an asset or credit bubble is to restrain it while the economy and incomes slowly grow into the overhang. This approach takes many years to complete, especially given the size of the excesses in the U.K. economy. Nonetheless, any progress would limit the potential fallout during the next recession.

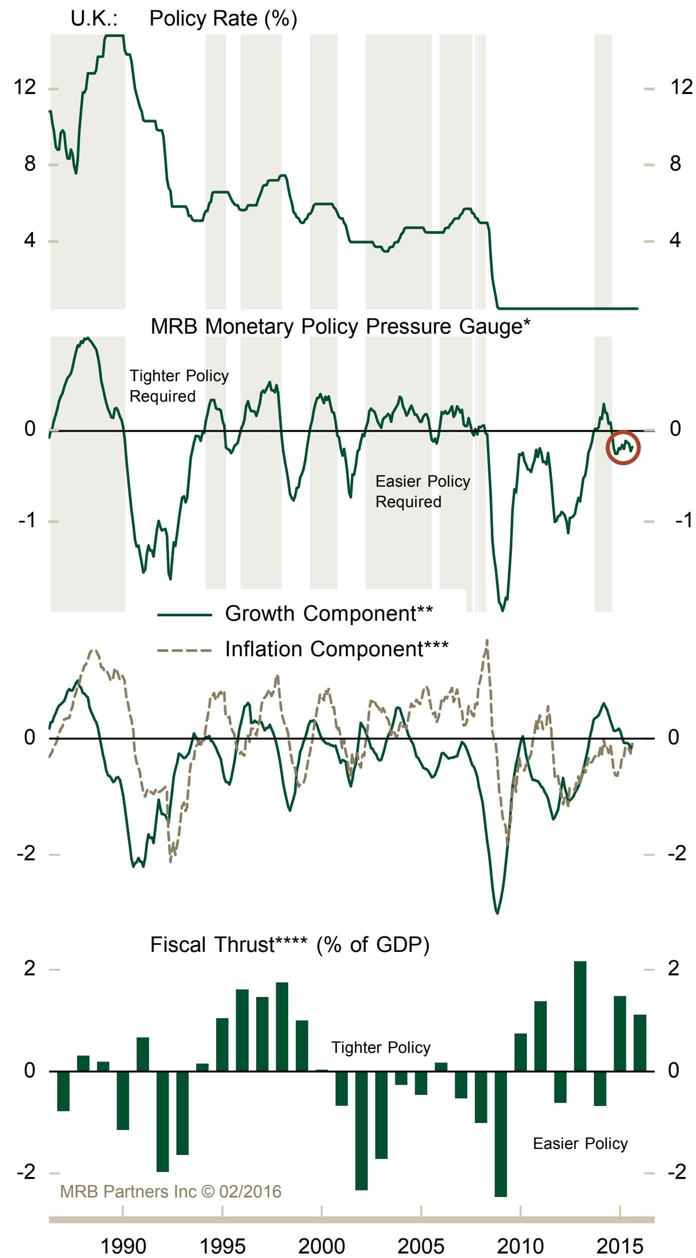
The goal of policymakers should be to cap imbalances while supporting growth

Chart 16 **BoE Was Able To Bailout Housing Market During Great Recession**



* Source: Bank of England
** Source: Council of Mortgage Lenders

Chart 17 **No Immediate Pressure On BoE To Tighten**



* Includes a growth and inflation component; standardized
** Includes business and consumer sectors, labor market and financial conditions
*** Includes core prices pressures, economic slack and inflation expectations
**** Annual change in cyclically adjusted government budget balance; source: OECD

In the context of this framework, the policy mix was largely appropriate until 2013. After dropping initially by about 20%, nominal home prices trended sideways throughout this period and eroded relative to household incomes (**chart 1** on page 2). Of course, there was a material divergence between London (which held firm) and the rest of the U.K. (where prices deflated). Private sector credit also halted throughout this period and steadily eroded relative to incomes (**chart 2** on page 2). However, by 2013, the U.K. government adapted an ill-advised help-to-buy program, at a point when the domestic economic recovery was becoming self-reinforcing and unemployment was falling sharply. Since then, home prices in London and the rest of the country (to a lesser extent) have surged in nominal terms and relative to household earnings. Private sector credit started to rise at the same point and is now slowly outstripping incomes.

Policy is currently too easy

In short, the policy mix has been too accommodative over the past three years and is fueling greater imbalances. Thus, it is appropriate for policymakers to tighten conditions. Fiscal policy will present a drag over the next couple of years and help to dampen overall conditions (**chart 17**, bottom panel). However, policy initiatives should really be focused on restraining housing and credit. BoE rate hikes would help, given that home prices are now rising in almost all regions and household credit growth is gaining momentum. The percentage of mortgages linked to short rates has declined materially in recent years (reducing the potency of monetary policy somewhat), but still accounts for more than half of the market (**table 1**).

Table 1 **U.K. Mortgages Are Still Largely Based On Floating Rates**

	Percent Of U.K. Mortgages At Fixed Rates				
	2011	2012	2013	2014	2015
Net Issuance During Year	53.5	56	77.3	82.6	80.7
Total Outstanding	28.1	27.5	30.7	39.3	46.6

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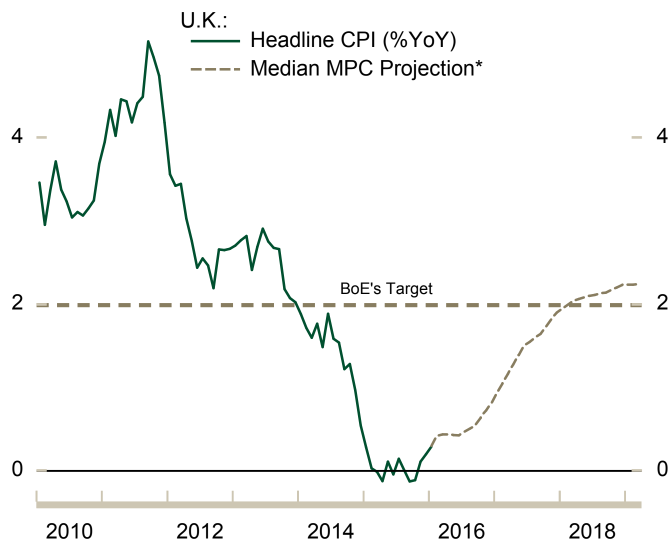
That said, it is unlikely that higher policy rates alone will be able to contain home prices in London without deflating those in the rest of the country. Macroprudential tightening measures are also required. While credit restraints fixated on London property may be politically unpalatable, additional stamp duties on high priced housing and/or increased required down payments (particularly on secondary homes) are indirect ways that would accomplish this objective. Also, more restrictive bank lending standards that limit household borrowing beyond certain debt-to-income thresholds would be appropriate. The key will be to tighten the policy mix in measured increments to avoid deflating the housing bubble.

Chart 18 **BoE Expects Inflation To Gradual Rise**



* Based on market interest rate expectations

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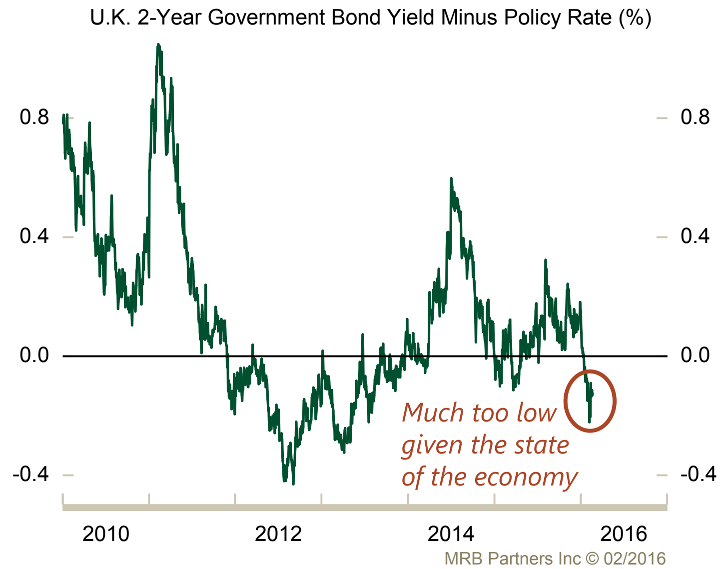
While it may be appropriate, we are not expecting the BoE to tighten until at least the end of this year, and more likely early 2017. The central bank will be reluctant to take any immediate risk until the outcome of the Brexit referendum is known, global growth firms, and the extent of the commodity-related contagion is better understood. At the same time, our indicators suggest that the BoE has some flexibility, given subdued price pressures and the recent moderation in the economy. Specifically, the *MRB Monetary Policy Pressure Gauge* has pulled back from "tighter policy required" territory (**chart 17**). Likewise, headline inflation is subdued and expected to rise only gradually towards the central bank's target over the next two years (**chart 18**). Finally, Governor Mark Carney has a history (in Canada) of being dovish and dismissing and/or failing to respond to the creation of housing bubbles.

Market expectations for the BoE are too dovish

Ultimately, we expect that pressures will gradually build on the BoE to tighten policy as the year progresses, provided that none of the economic threats outlined above erupt. Our base case is that the central bank will lag the Fed's profile by about a year, making the first rate hike early next year. Needless to say, we disagree with current market expectations that the Fed will abandon its tightening campaign this year and the BoE will stay on hold until 2018.

Final Word: *A series of policy mistakes over the past twenty years has contributed to the sizable imbalances in the U.K. economy and is limiting the flexibility of both fiscal and monetary authorities. The current policy setting is too accommodative, but the BoE will stay sidelined, at least until the clouds of Brexit and commodity-related financial contagion pass. That said, the market is likely overly dovish in its rate expectations, baring a bursting of the domestic real estate bubble and/or global recession (which we are not currently expecting).*

Chart 19 **No Change Expected From The BoE For Two Years**



Market Views & Strategy

Fixed Income

Investor expectations for BoE rate hikes have been reduced significantly, with the U.K. 2-year yield now trading below the policy rate (**chart 19**). This implies that investors believe there will be no rate action in the U.K. until early 2018 at the earliest. We expect that this is far too dovish of an outlook, given the cyclical strength in the U.K. economy and the pending rebound in CPI inflation. Recent market turmoil has likely pushed the start of a BoE tightening campaign out somewhat, but rate expectations are likely to be brought forward to early 2017 as current global growth fears subside and the Fed continues gradually tightening. Gilts may outperform U.S. Treasurys in this backdrop, but should underperform global hedged fixed-income benchmarks.

Gilts should underperform

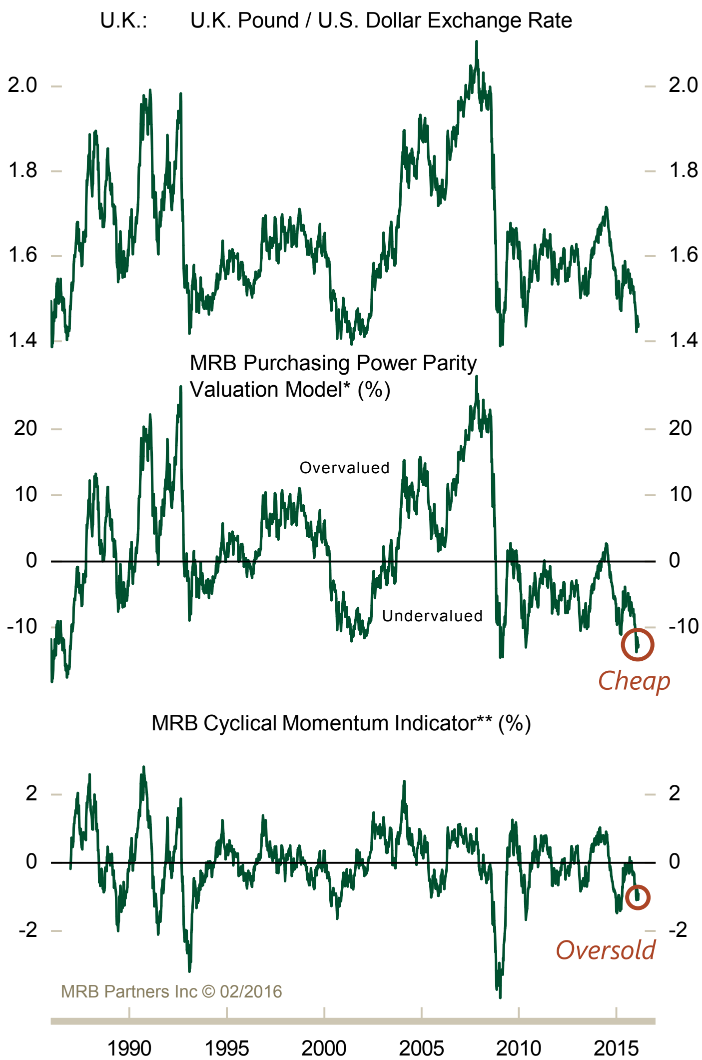
The main risk to an underweight stance in U.K. Gilts is in the event of a Brexit. Although we acknowledge that a change in stance may be warranted following the result, we prefer to wait rather than trading against the cyclical fundamentals of the U.K. economy, especially given that current betting odds are against a Brexit.

Final Word: *Stay underweight U.K. Gilts within a global hedged fixed-income portfolio.*

Currency

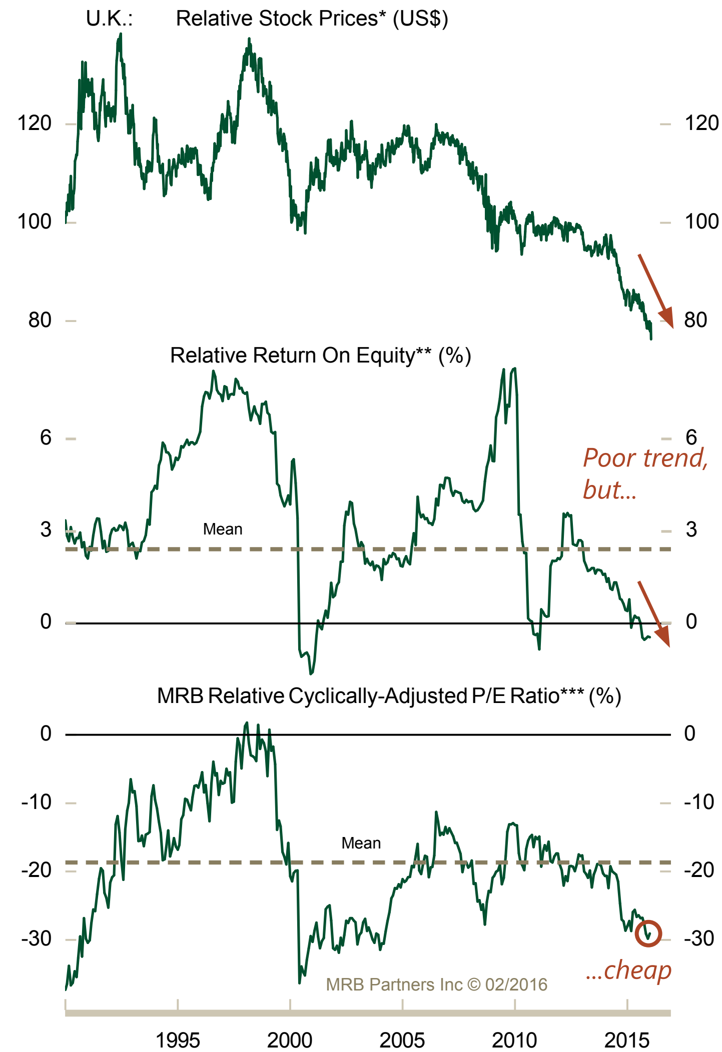
The pound has experienced broad-based weakness, largely in response to Brexit fears, a moderation in domestic growth, and the material shift outward in BoE rate expectations. This has benefited our underweight allocation versus the U.S. dollar. That said, recent selling pressure has left the pound oversold and undervalued versus the U.S. dollar (**chart 20**). At the same time, we expect the U.K. economy to firm somewhat and expand in line with the U.S. and slightly faster than the euro area over the next year.

Chart 20 **The Selloff In The Pound Is A Bit Overdone**



* Percent deviation of currency from MRB Purchasing Power Parity Measure
** U.K. pound / U.S. dollar exchange rate; standardized

Chart 21 **U.K. Equities: Weak Earnings Have Driven Underperformance**



* Relative to global equity benchmark; rebased; source: MSCI
** Relative to global equity benchmark; mean since 1975; source: MSCI
*** % Premium (+), discount (-) to global equity benchmark; mean since 1995

Netting these forces out, the pound is likely to experience a near-term bounce, provided that Brexit tensions do not escalate substantially in the weeks ahead. Thereafter, we expect the pound to trade soft versus the U.S. dollar, but gain versus the euro as rate differentials move in opposite directions (see the February 19 **MRB *Weekly Macro Strategy Report***).

Selling pressure on the pound should subside

Final Word: *We remain underweight the pound versus the U.S. dollar, but maintain an overweight allocation against the euro. Note that we also hold the pound versus the Swiss franc in the* **MRB *TradeBook*** *as a play on diverging policy trends among two global financial centers. Our timing was poor as increased Brexit fears have adversely impacted the cross rate. We still like the position, but will set a stop-loss at GBP/CHF 1.35 to limit further downside.*

Equities

U.K. stocks have dramatically underperformed global equity benchmarks, benefitting our underweight allocation (**chart 21** on page 15). U.K. earnings have extended declines relative to the global benchmark across a broad range of sectors over the past several months. Earnings remain under intense pressure in the resource sectors. The market's large weight in defensive sectors, and comparatively smaller weight in non-resource cyclical sectors, also indicates the market will have comparatively limited operating earnings leverage as the global economic expansion regains traction.

Fundamentals are poor for U.K. equities, but...

That said, the *MRB Relative Cyclically-Adjusted P/E Ratio* indicates that U.K. equities are now cheap relative to historical norms. Also, return on equity is at historic lows, implying potential for a meaningful turnaround if global conditions surprise to the upside. This is especially true in the financial sector which carries significant exposure to European and emerging market economies.

...under-performance is becoming extended

Final Word: *We remain underweight U.K. stocks relative to the global equity benchmark. However, much of the underperformance trend may now have been realized and we may soon consider upgrading this market (see tomorrow's* **MRB *Weekly Macro Strategy Report*** *for further details on U.K. equities and sectors).*

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Independent Investment Strategy

February 25, 2016

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