August 24, 2016

Betting On U.K. Fallout: An Update

Markets rioted immediately following the U.K. referendum vote to "leave" the European Union (EU), but have since calmed. The latter has been driven in part because U.K. politics has improved markedly in a matter of weeks (despite still elevated uncertainty, **chart 1**), Brexit negotiations have been pushed out, and the BoE has ramped up its reflationary efforts. These factors will help slow the pace of the domestic economic fallout, but are unlikely to prevent it from eventually occurring.

We have covered the economic and investment implications of Brexit extensively in our recent research reports[1]. We also made several investment recommendations within U.K. asset markets prior to, and immediately following, the referendum outcome. These have largely proven rewarding. However, it has now been two months since the Brexit vote and much has changed, making it appropriate to revisit the outlook for the U.K. economy and financial markets.

Today's **MRB *Research Highlight*** provides a U.K. economic update and reviews our investment recommendations. We also assess if there are any other investment opportunities remaining within the U.K. fallout theme, concluding that there are still a few appealing long and short positions.

U.K. Economic Update

Efforts by the new U.K. government and BoE have diluted a major political mistake and pushed out what could have been an imminent economic implosion.

1 **MRB *U.K. Research Highlight***, "***U.K. Brexit: Watch The Tail Risks***", June 22, 2016; **MRB *Theme Report***, "***The Brexit Aftermath: Impact On Global Growth And Strategy***", June 29, 2016; **MRB *Theme Report***, "***The Brexit Dominos***", July 7, 2016

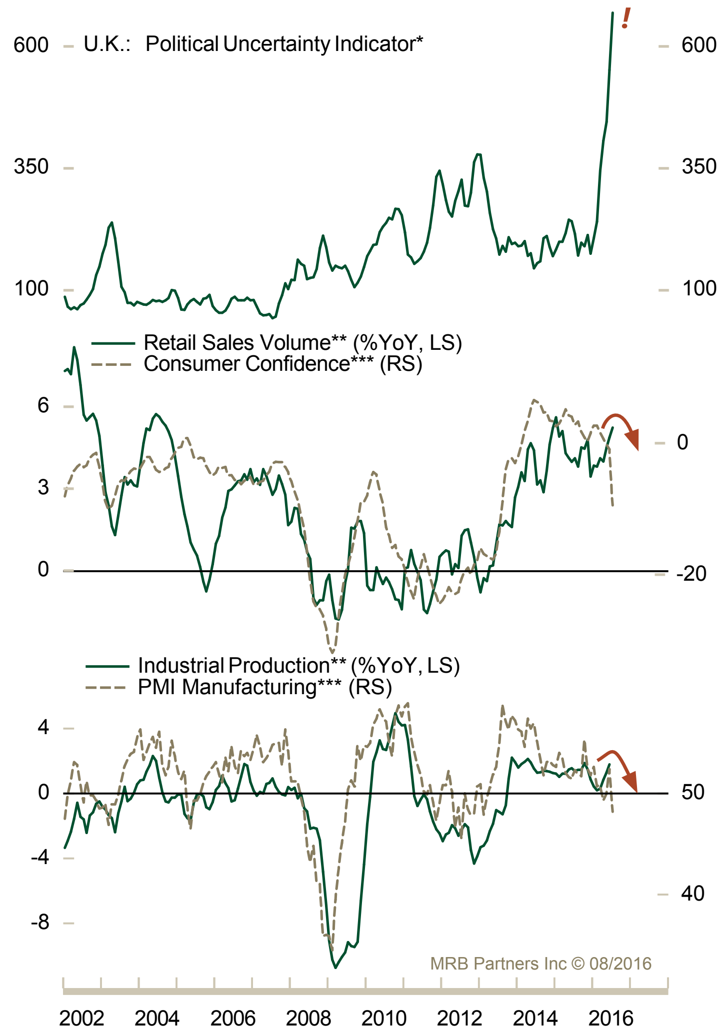
- Efforts by the new U.K. government and BoE are helping push out what could have been an imminent economic implosion.
- Brexit negotiations will eventually occur and will not go well for the U.K., but the decision to postpone invoking Article 50 delays the impact on exporters.
- Still, the sharp deterioration in economic confidence is worrying and threatens to cause activity to halt. Unless this soon recovers meaningfully, some economic fallout is likely.
- Any downturn would be amplified if the credit and housing bubble bursts, which would cause banking system strains and kickstart a deleveraging cycle. Leading real estate indicators are concerning.
- The British pound, U.K. airline stocks, homebuilders and REITs were all trashed in late June and are now digesting their losses. Further downside is likely, but only once housing starts to topple.
- Stay underweight/short U.K. consumer discretionary versus the broad market and small caps versus large caps. The recent technical bounce should prove fleeting.
- We do not recommend shorting U.K. banks at this point, unless credit strains start to develop. The BoE will try to protect bank profitability and the sector includes global names with limited U.K. exposure.
- Buy U.K. exporters, particularly industrials, versus the broad market. Currency depreciation is providing a competitiveness boost and widening their profit margins. However, the case for exporters will deteriorate once Article 50 is invoked.
- Commercial and professional services stocks should outperform in a Brexit scenario.
- It is too early to bet on wider CDS spreads, although they offer cheap insurance against a bleak U.K. economic outcome.

Still, the Brexit decision will not be reversed and the foundations supporting the U.K. economy are weak and starting to crack. Policymakers are buying time and trying to prevent the economy from simultaneously experiencing a series of macro shocks (i.e. delay the day of reckoning). In this regard, we previously identified four key areas of risks for the U.K. economy that are worth reviewing:

- **Reduction In Trade**: The U.K. economy, exports and financial sector have benefited from membership in the EU and would not be their current size without it. Although difficult to quantify, some shrinkage will occur in response to Brexit. The EU countries account for almost 45% of U.K. exports and disrupting the trade agreements with the region is a major potential economic threat. It is also probable that some global headquarters will also shift to other nations, taking jobs and wealth.

  Update: The eventual Brexit negotiations will not go nearly as well for the U.K. as the "leave" side had hoped. However, the decision by the new U.K. government to postpone the invoking of Article 50 until potentially the end of 2017 substantially reduces the adverse impact on exports over the next year. As an offset, recent currency depreciation should provide some support for exporters in the interim.

Chart 1 **Sentiment Indicators Point To A Slowdown In U.K. Economy**



* Smoothed; source: United States Economic Policy Uncertainty
** Smoothed
*** Smoothed; source: GfK Group
**** Source: Markit Economics

- **Anxiety & Retrenchment**: Brexit will create tremendous economic uncertainty among U.K. consumers and businesses (especially the financial sector). This could lead to a retrenchment in spending and a further freezing or (in some cases) a permanent shelving of business expansion plans. Activity in London is likely to be hit particularly hard, excluding tourism.

  Update: Confidence measures have started to deteriorate markedly and warn that economic activity will slow sharply in the months ahead (**chart 1**). Consumer sentiment plunged last month, with a notable hit to the general economic situation component. Likewise, the manufacturing PMI survey dropped below the boom/bust line as companies suggested they planned to cut output and employment in response to weak new orders. The drop in the service sector PMI was particularly worrisome, with reports of new business and business expectations freefalling.

Economy is still holding up, but the meltdown in confidence is worrying

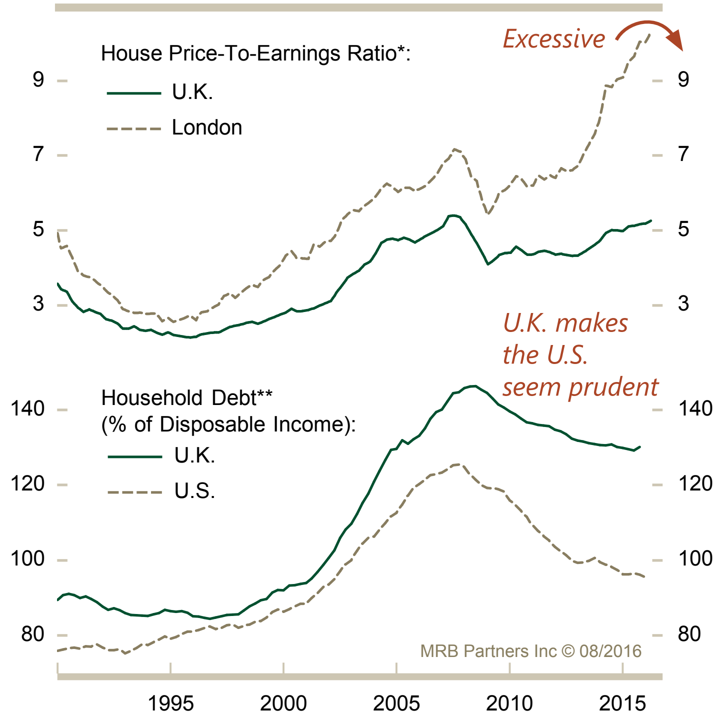
That said, last week's data showed that retail sales volume growth actually accelerated in July, although it is unclear if this was primarily driven by foreigners reacting to a cheaper pound. The political situation has surely improved perceptions about Brexit and may encourage sentiment measures to rebound somewhat in the near run. We doubt this strength will persist, but suggests that the path towards a U.K. recession may be gradual.

- **Bursting Of Bubbles**: The U.K. has a housing and credit bubble (**chart 2**). Home prices are excessive based on any metric. The overall U.K. housing market is probably 30-50% overvalued, while London is considerably more stretched. At the same time, the private sector is heavily indebted and makes the U.S. circa 2007-2008 look prudent. It was inevitable that U.K. housing and credit excesses would eventually come home to roost, causing a severe deleveraging cycle. We had expected this would occur during the next global recession, but Brexit and the deterioration in economic confidence provides a potential catalyst to speed up the timeline (and the U.K. may be a cause of global recession).

Update: London home prices were already softening heading into the U.K. referendum, with the top end of the market starting to deflate in response to the increased Stamp Duty and reduction in global oil money. The latest RICS survey provides a larger warning sign, with the new buyer enquires, sales expectations and prices expectations components all falling abruptly in London and the broader U.K. market (**chart 3**). The RICS survey also provided a warning for the U.K. commercial property market, with occupier demand, rent expectations and investment enquiries all falling sharply (**chart 4**). Any deterioration in domestic consumption and final demand would exacerbate the recent trend.

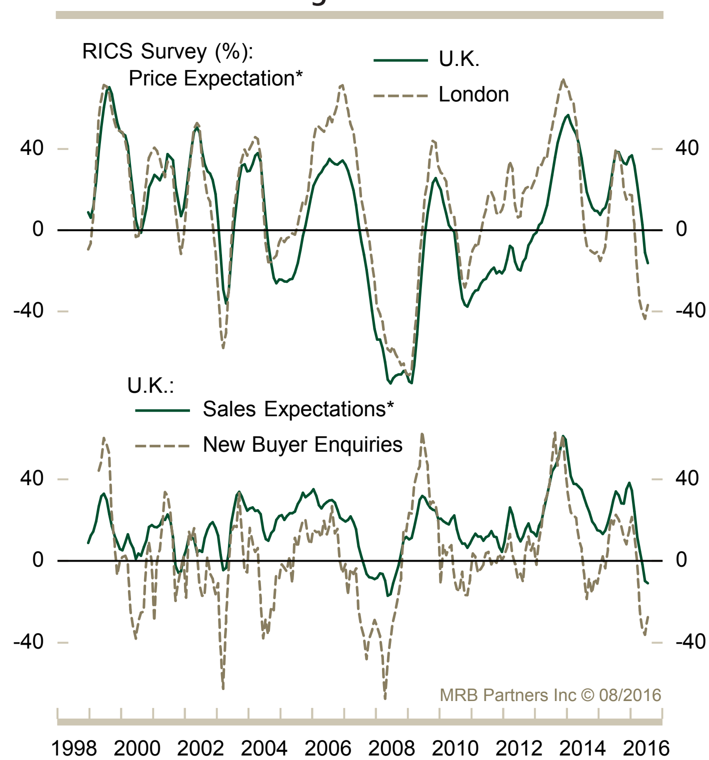
Higher interest rates are typically the catalyst to burst real estate and credit bubbles, and kickstarting a deleveraging phase. In the case of the U.K., the BoE

Chart 2 **U.K. Housing And Credit Are In A Bubble**



* First-time homebuyer; source: Nationwide Building Society
** Sources: Bank for International Settlements and national sources

Chart 3 **Survey Data Points To Weakness In The Housing Market**



* Smoothed

has stepped up its reflationary program and will be aggressive in preventing interest rates from rising. Instead, higher unemployment will be the driving force. Last week's release of jobless claims ticked down which is encouraging, although the series is extremely volatile and forward looking confidence measures point to a deterioration in employment in the months ahead (**chart 5**). This should be monitored.

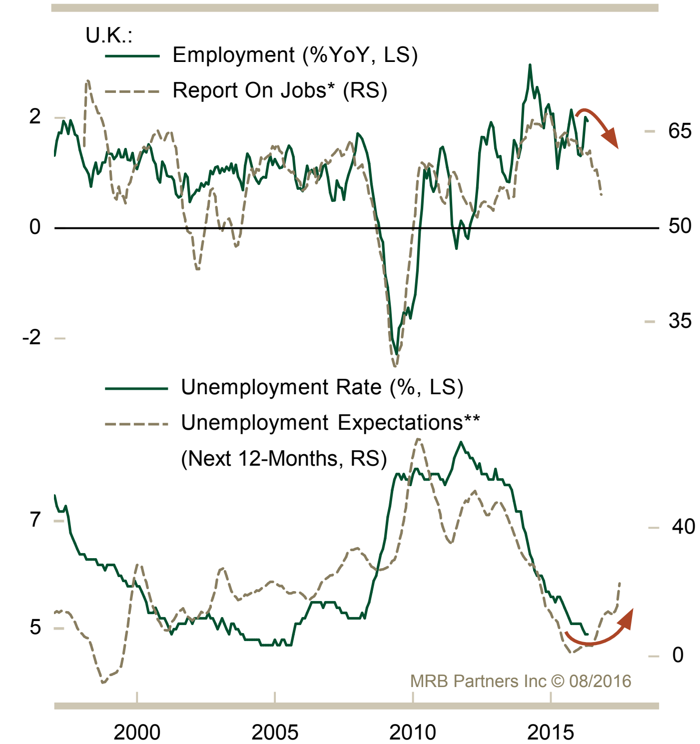
- **Financial System Strains**: A major eventual concern is that deleveraging and falling collateral values could create strains for the U.K. banking system, which is too big to fail, but also too big to bail out (**chart 6**). Government revenues would already be plunging in this scenario due to a weak economy (i.e. causing the budget deficit to blowout). This, plus a banking system bailout, would materially increase the debt-to-GDP ratio.

  Update: Heightened banking system stress and a credit crunch would be a substantial threat. However, it would require residential and/or commercial property prices to deflate first. This has not yet occurred.

Note on Policy: The major challenge for U.K. authorities will be that monetary policy is largely impotent to deal with deleveraging pressures, banking system strains, and the exiting of businesses. Fiscal policy will be needed if conditions deteriorate materially, but public coffers are not likely to be deep enough to handle the problem.

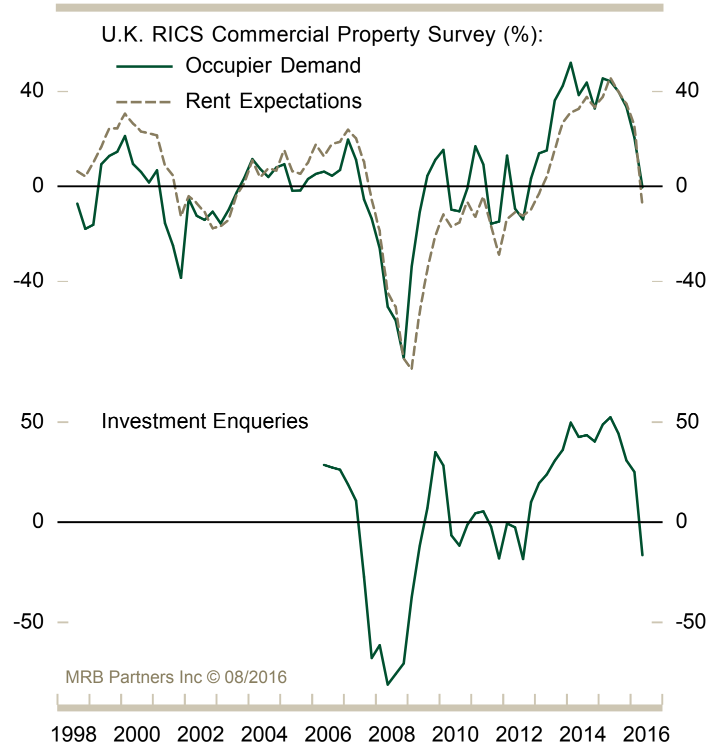
Final Word: *Efforts by the new government to kick the Brexit can down the road will help delay the adverse consequences to U.K. trade and the overall economy. Nonetheless, the deterioration in economic confidence threatens to cause activity to freeze up, something that needs to be monitored. Any downturn would be amplified if the credit and housing bubble burst. The latter already appears wobbly. Banking system strains are a huge future risk, but unlikely a 2016 story. So far, the fallout in the U.K. economy appears to be on a gradual path, although the challenge is that policymakers lack sufficient tools to reflate conditions as needed.*

Chart 4 **U.K. Job Market: Set To Slow**



* Advanced; source: Markit Economics / REC
** Advanced; smoothed; source: European Commission

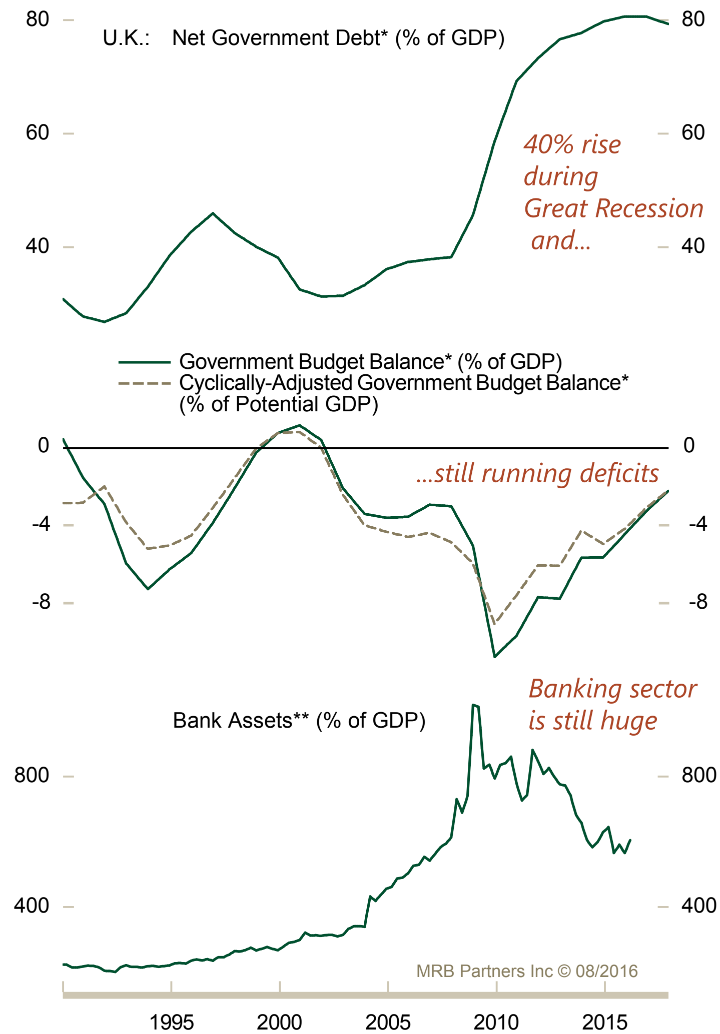
Chart 5 **U.K. Commercial Real Estate Market Appears Wobbly**



Short Opportunities

Investors should continue to position for some sort of fallout in the U.K. economy. However, given that the latter is likely to be more drawn out than an imminent collapse, short positions should be relative to less exposed assets, rather than in absolute terms. Some of these positions remain attractive even after the post-referendum shakeout, while other will now require clear evidence of domestic economic weakness before further gains will be realized. Specifically:

Chart 6 U.K. Public Finances: Not Great



* Source: IMF
** Source: Bank of England

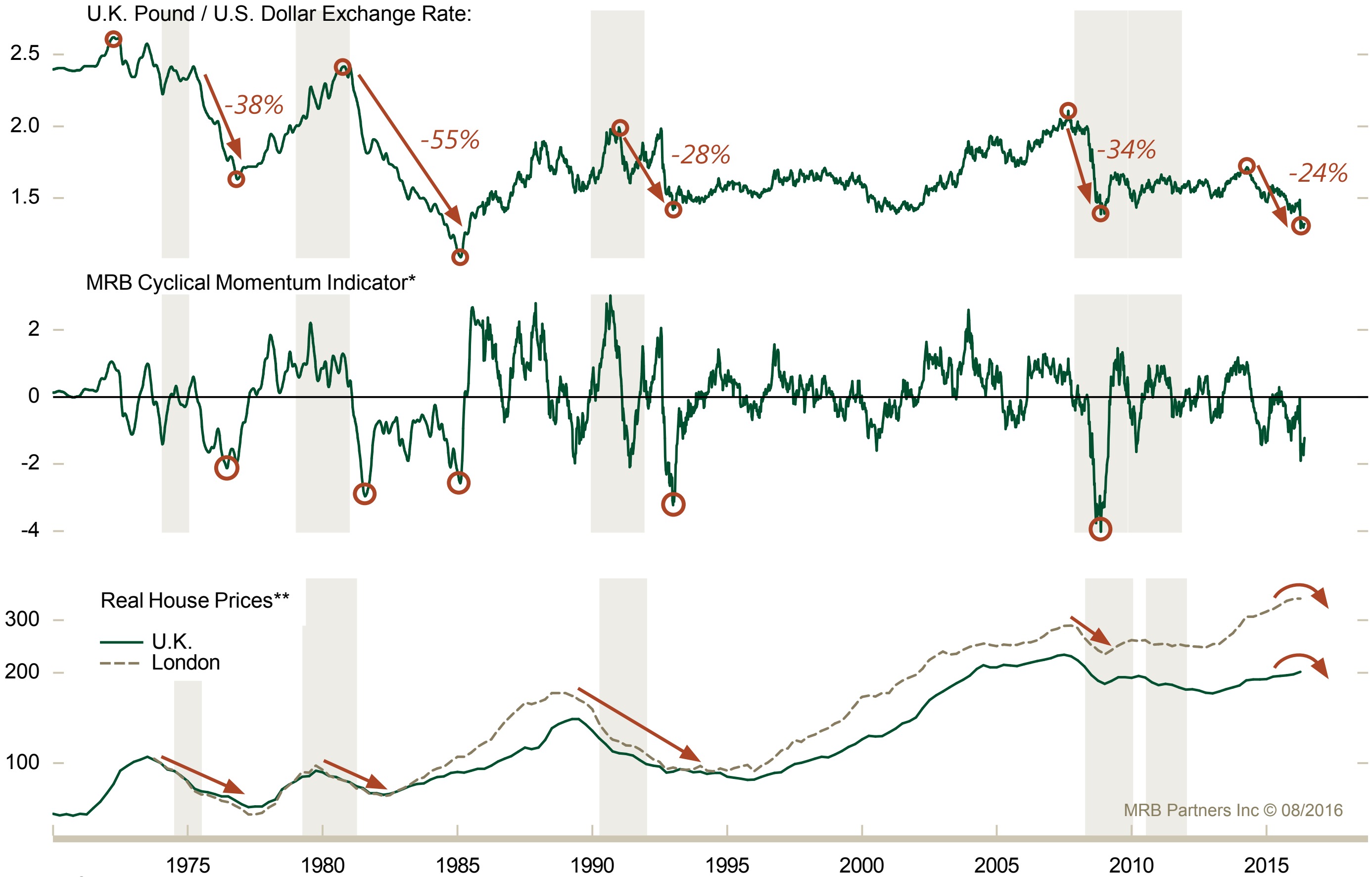
- **GBP**: The British pound has collapsed to a 30-year low (**chart 7**). The currency is now cheap and oversold versus both the U.S. dollar and the euro, suggesting that significant economic weakness is now priced. We doubt any rebound in the pound will be material or sustained, given that relative growth and interest rate differentials should both work against the currency. In turn, we remain underweight versus the U.S. dollar and euro but recognize that an underweight/short position is increasingly reliant on a recession outcome.

  The pound tends to melt either during or immediately following U.K. recessions, in part because real U.K. home prices have fallen during every recession since the 1970s (i.e. U.K. real estate is a boom/bust market and amplifies swings in the economy). The typical peak-to-trough decline during past recessions has 35-40%, which (if repeated) would cause the currency to retest its 1985 low of US$ 1.10. Indeed, we expect the pound to weaken notably further when the domestic housing and credit bubble finally bursts. This process started to develop during the Great Recession, but was halted, and still caused the currency to depreciate by roughly 35%. Granted, the pound is much cheaper now, but the threat is arguably greater (i.e. the imbalances are larger) and policymakers have fewer tools to reflate. Thus, the pound will do much of the adjustment.

  The pound is oversold, but will fall further when housing topples

  Recommendation: We maintain an underweight/short bias on the pound, but would not aggressively bet on a further depreciation until the currency has digested some of its losses and deeply oversold momentum measures are unwound somewhat. Any near-term bounce is likely to prove fleeting, but material further weakness will require U.K. housing to topple.

Chart 7 **U.K. Pound: Oversold, But Further Downside Potential**



* Standardized
** Shown in log scale; deflated by RPI; source: Nationwide Building Society
Note: Shaded for ECRI designated U.K. recessions

❍ **Airlines Vs Broad Market**: Airlines stocks (particularly discount airlines) are a pure play on a currency depreciation and economic weakness. These stocks were hit hard in late June and have not recovered, much like the pound (**chart 8**, panel 1).

Recommendation: This is an equity proxy for a short pound position, particularly one that is driven by U.K. economic weakness, rather than U.S. strength. Investor should maintain a short bias, but a digestion phase is likely before renewed weakness.

Small cap stocks and consumer discretionary are the most appealing shorts at the moment

❍ **Homebuilders & REITs Vs Broad Market**: Homebuilders and REITs stocks plunged 38% and 21% respectively versus the broad market in the wake of the referendum vote, although have since retraced about a third of the decline (**chart 8**, panels 2 and 3). These stocks were disproportionately punished on the referendum outcome, even before there have been any meaningful signs of weakness in the domestic economy. This is largely because of how visible the real estate bubble has become. There will be another major downleg ahead in these stocks (in both absolute terms and relative to the benchmark) if residential and commercial property prices weaken as suggested in the RICS survey (see above). There is an alarming amount of construction (mostly commercial) underway in London as the city grows vertically (i.e. plenty of inventory set to come on stream). Real estate firms are likely to have difficulty selling or renting, at least at the yields they had been expecting. In some cases, development projects will be scrapped causing losses to be recognized.

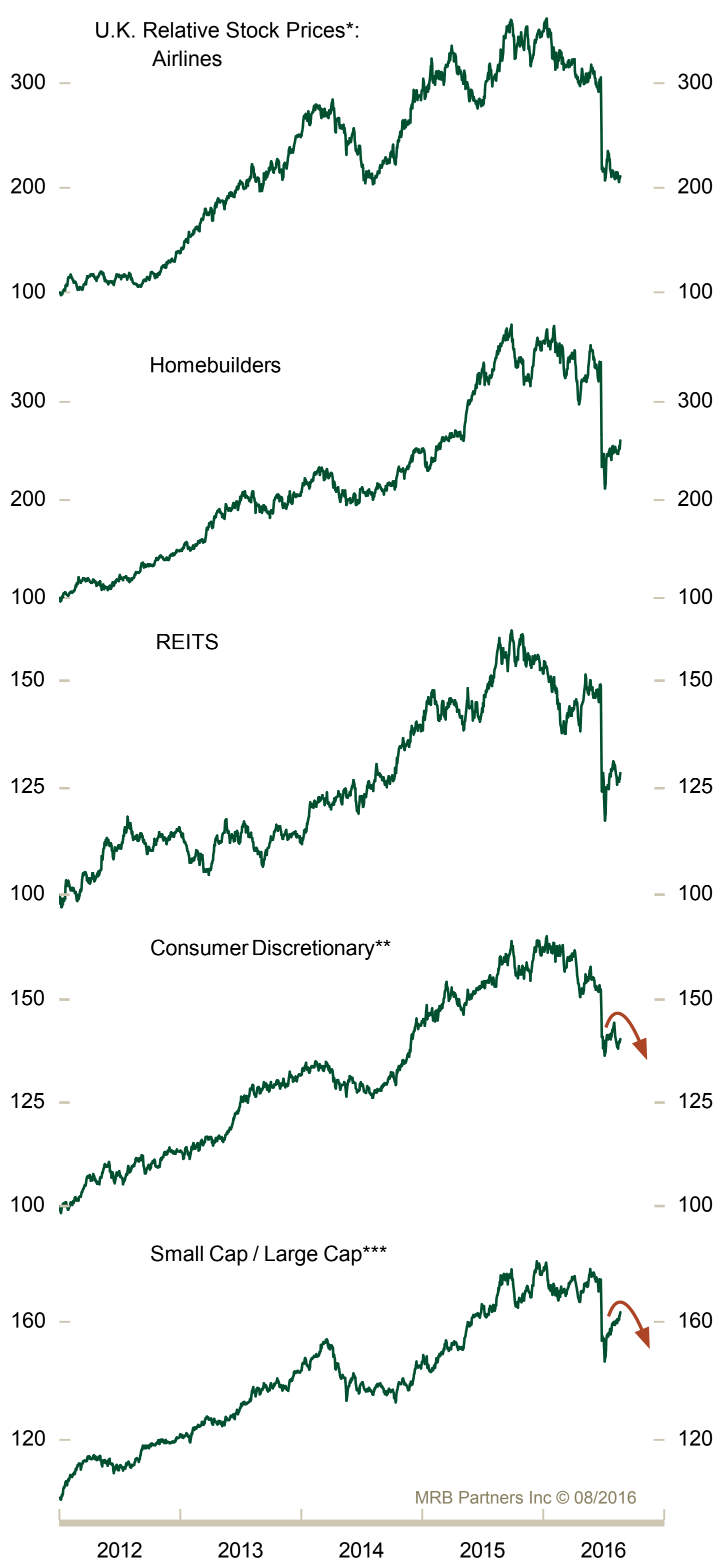
Recommendation: Maintain an underweight/short bias, although further gains will be reliant on real estate prices rolling over.

- **Consumer Discretionary Vs Broad Market**: Within U.K. equities, we have been negative on the consumer discretionary sector (**chart 8**, panel 4). These stocks were already underperforming heading into the June 23 vote and plunged on the news. The bounce since has been fairly fleeting and we expect underperformance to soon reemerge. For absolute return investors, we have recommended shorting this sector versus the U.K. benchmark in the ***MRB TradeBook*** (currently up 6%). Consumer discretionary should continue to underperform as it includes domestically-focused retailing, housing and leisure stocks. Many retailers also import goods for resale and margins are being squeezed by the weak pound. In contrast, the overall U.K. market is comprised of defensive stocks (40% of total market cap) and globally-exposed cyclical sectors (25%) that benefit from a weaker pound.

  Recommendation: Stay underweight/short consumer discretionary stocks versus the U.K. equity benchmark. This recommendation still has legs.

- **Small Caps Vs Large Caps**: Small caps plunged by 16% versus their large cap counterparts immediately following the referendum, but have retraced about half of the decline in the weeks since (**chart 8**, bottom panel). We expect renewed weakness in the months ahead and maintain an equity pair trade recommendation in the ***MRB TradeBook*** (currently up 7%). Small caps have more cyclicality and greater domestic orientation, compared with their large cap counterparts which includes major exporters. This will lead to underperformance as the pound weakens and the U.K. economy deteriorates. Moreover, relative

Chart 8 **Short Brexit Related Trades**



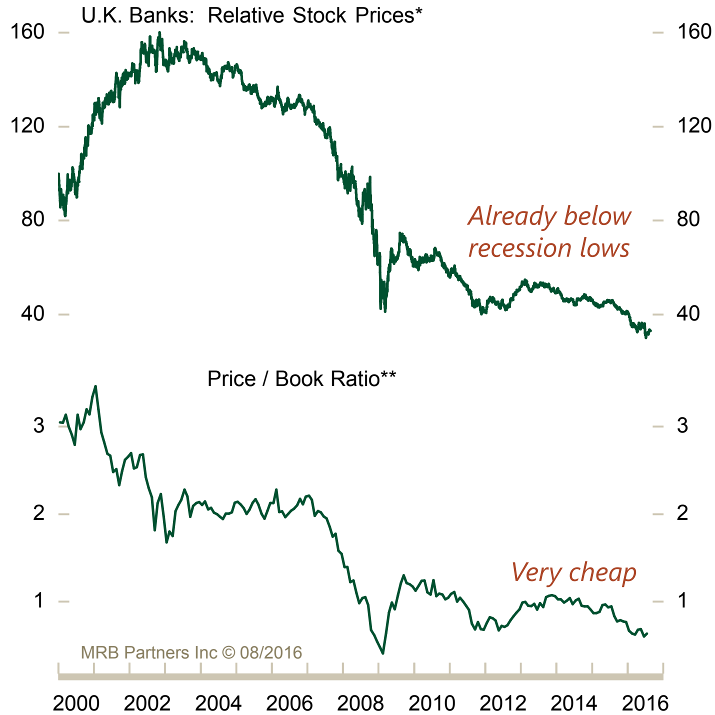
* Local currency; rebased; relative to the U.K. equity benchmark; source: Datastream
** Local currency; rebased; relative to the U.K. equity benchmark; source: MSCI
*** Local currency; rebased; source: MSCI

valuations are unappealing for small caps.

Recommendation: Small caps have merely begun what should prove to be pronounced cyclical underperformance. Stay underweight and/or short versus large caps.

❍ **Banks Vs Broad Market**: U.K. banks have been another short opportunity, plunging in late June, before recovering modestly. However, this is not our preferred short bet at this point, since the sector includes large global names and was already very affordable heading into Brexit (and is now even cheaper, **chart 9**). Also, the BoE is trying to protect profitability of U.K. banks through creative unorthodox policies and by not dropping policy rates into negative territory. Although we expect the sector to eventually face strains, this is not a 2016 issue (see above). There is likely to be significant volatility in bank stock prices, reducing the risk/reward tradeoff of directional bets.

Chart 9 **U.K. Bank Stocks: Extremely Depressed**



* Rebased; local currency; relative to the U.K. equity benchmark; source: Datastream
** Source: MSCI

Recommendation: The money has largely been made for now in shorting U.K. bank stocks versus the benchmark, and we find more appealing short opportunities in other parts of the U.K. equity market. Once the home prices start to fall, we will revisit the case for shorting banks.

Long Opportunities

❍ **Global Exporter Stocks Vs Broad Market**: Global exporters will benefit from the competitiveness boost from a weaker pound (**chart 10**). Those with substantial domestic costs will also benefit from wider operating profit margins. For the most part these are included in large caps (see above) as well as the industrials and energy sectors. Our preference is industrials, particularly capital goods or aerospace stocks, which have only modestly outperformed so far. Of course the case for exporters will evaporate once Article 50 is invoked, albeit this is likely to be at least a year away.

Opportunities remain in U.K. exporters...

...until Article 50 is invoked

Recommendation: Investors should go long/overweight stocks of U.K. exporters relative to the broad market. We are adding a long position in U.K. industrial stocks versus the benchmark to the ***MRB TradeBook***. This position removes currency and generalized market risk.

❍ **Commercial & Professional Services Vs Broad Market**: The Brexit-induced relocation of corporate headquarters and corresponding shift in employment should benefit some commercial and professional services stocks (at least in relative terms), given that these companies will help facilitate the transition. Their equities should also outperform in a recession scenario. Commercial & professional services stocks have not yet started to outpace the U.K. benchmark (**chart 10**, bottom panel).

Recommendation: Maintain an overweight/long bias. Commercial & professional services stocks are likely to gradually outperform, although the windfall gain of any equity pair trade will be upon the start of Brexit negotiations, which is likely to be late 2017.

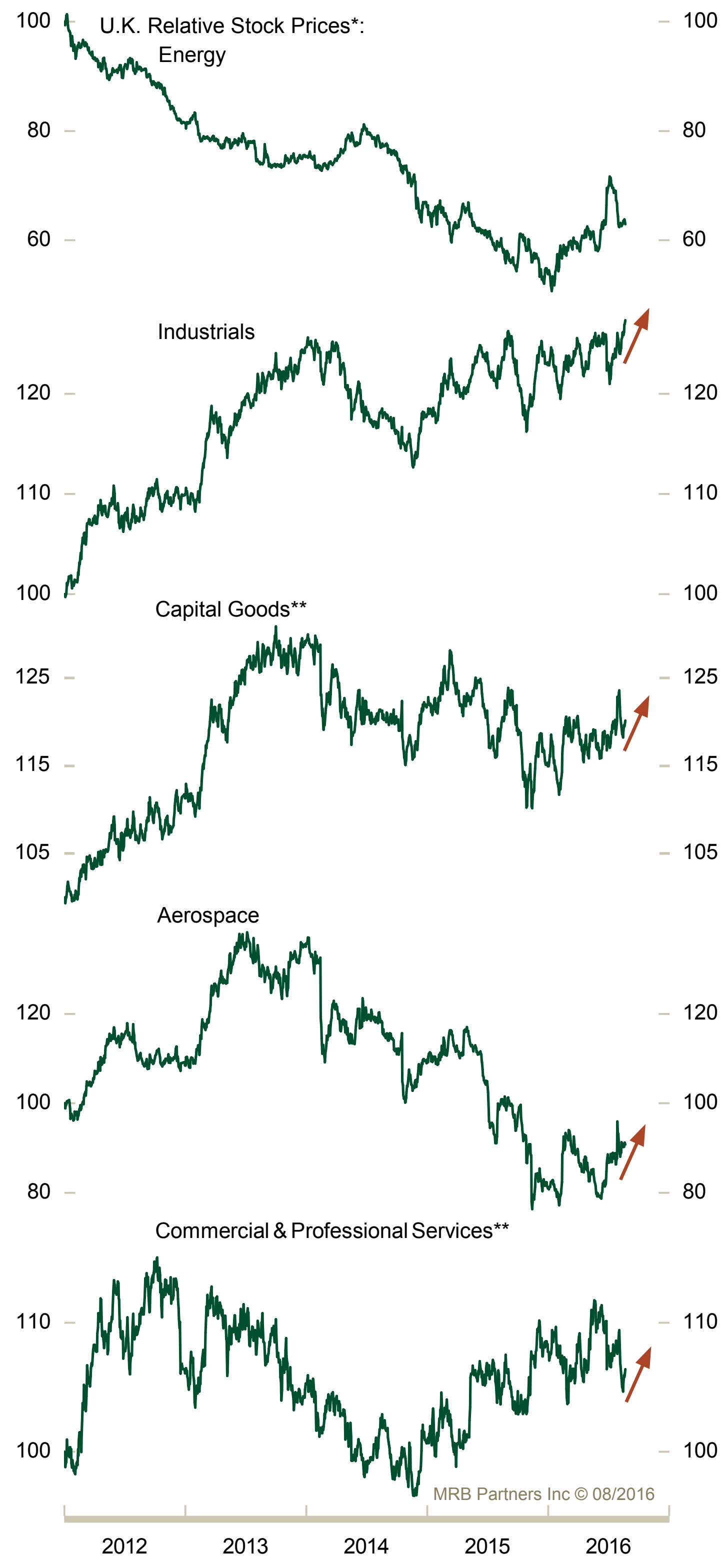
❍ **CDS Spreads**: U.K. CDS spreads are still at an historically low level, especially relative to levels seen during the double-dip euro area recession in 2011-2012. As such, they provide relatively cheap insurance for investors looking to bet on a U.K. recession. The caveat is that a couple of U.K. dominos need to fall before U.K. CDS spreads widen substantially. Specifically, the real estate and credit bubbles will need to start deflating and inflict stress on the domestic banking sector. The latter is a massive contingent liability of the U.K. government and a bailout (or recapitalization efforts) could rapidly deteriorate what is an okay starting point for public sector debt.

Recommendation: It is too early to bet on wider CDS spreads, although this is affordable insurance against a bleak U.K. economic outcome. Also, spreads are unlikely to narrow significantly, limiting downside risk for this position.

Phillip Colmar

Frank Petrocca

Chart 10 **Long Brexit Related Trades**



* Local currency; rebased; relative to the U.K. equity benchmark; source: Datastream
** Local currency; rebased; relative to the U.K. equity benchmark; source: MSCI

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