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RESEARCH HIGHLIGHT
EQUITIES

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Implications of a "Hard" Brexit On U.K. Equities

- A hard Brexit poses an increasing risk to U.K. equities.
- The rally in U.K. equities is entirely attributable to pound weakness, and does not reflect improving corporate fundamentals.
- Domestic investors should favor consumer staples and health care within a U.K. equity portfolio. Both are defensive and will benefit from a weak pound.
- A hard Brexit will exacerbate financial sector woes and jeopardize a long-awaited earnings recovery.
- Global investors should underweight the U.K. in equity portfolios.

Investor concerns about the future of the U.K. economy have recently mounted following government rhetoric about a "hard" Brexit. The pound has again fallen sharply and is at its lowest level since the mid-1980s. Yet U.K. stocks are challenging all-time highs, boosted by the falling currency and global equities.

Brexit is unequivocally negative for the U.K. economy, with adverse long-term implications for corporate earnings. Its implementation could introduce a substantial shock to earnings, which will dampen investment and could potentially send the U.K. economy into recession. It will also challenge London's status as a global financial center. We discussed the economic and financial implications of Brexit in a recent report[1].

Brexit is unequivocally negative for the U.K. economy

This report focuses on the likely effects of Brexit on the U.K. equity market, and is a follow-up to reports published in the aftermath of the vote[2]. Since then, the Conservative government under the leadership of Prime Minister Theresa May has signaled its intention to trigger Article 50 sometime in the first quarter of 2016, whereby access to the single EU market will become restricted and the free-flow of labor from the EU ceases. We discuss equity market implications from the viewpoints of domestic and foreign investors, and identify opportunities at the sector level.

The Political Backdrop

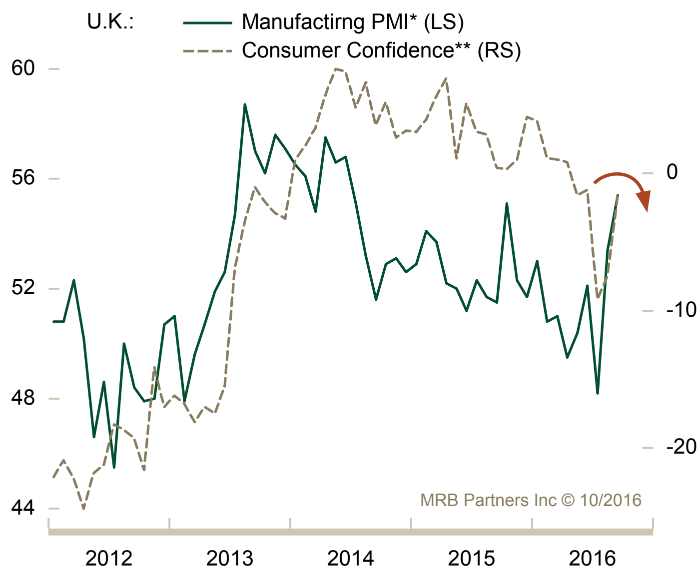
In aftermath of the Brexit vote, initially it appeared that the Conservative government would take its time before triggering Article 50. Politicians on both sides were setting up

[1] MRB *Theme Report*, "*The Brexit Dominos*", July 7, 2016

[2] MRB *U.K. Report*, "*Betting On U.K. Fallout: An Update*", August 24, 2016
MRB *U.K. Report*, "*U.K. Equity Positioning After Brexit*", June 24, 2016

for a long, drawn-out period of talks which might (if ever) result in an agreement similar to that of Norway, Sweden or Switzerland, which enjoy some preferential access to the EU common market and retain important political linkages with the EU. Such an outcome would have represented a "soft" Brexit. This optimism coincided with a rebound in consumer and business confidence after the Brexit vote (**chart 1**).

Chart 1 Post-Brexit Confidence Rebound Is At Risk



* Source: Markit Economics
** Source: Directorate General for Economic and Financial Affairs

May scuppered any hopes for a soft Brexit at the recent Conservative Party conference, indicating that Article 50 would be triggered by March 2017 and would entail a complete divorce from the EU. She declared that the financial sector would not receive any preferential treatment in negotiations with the EU and reaffirmed that immigration would be sharply restricted. Rhetorically, at least, May has indicated that the U.K. was willing to make considerable economic sacrifices to achieve its Brexit objectives, which would be unambiguously negative for stocks. Precisely how and over what period a hard Brexit will be implemented remains unclear, but downside economic risks have increased markedly given the government's stance.

It is important to stress that a hard Brexit will have an especially negative effect on traded goods and services, albeit only after divorce has occurred. The U.K. cannot formally undertake new trade agreements until after it leaves the EU, creating tremendous uncertainty for both exporting and importing companies for the next few years. Note also that U.K. exporters would be subject to tariffs under WTO rules that may apply until bilateral trade negotiations are eventually completed.

The U.K. cannot formally undertake new trade agreements until after it leaves the EU

Post-Brexit Rally

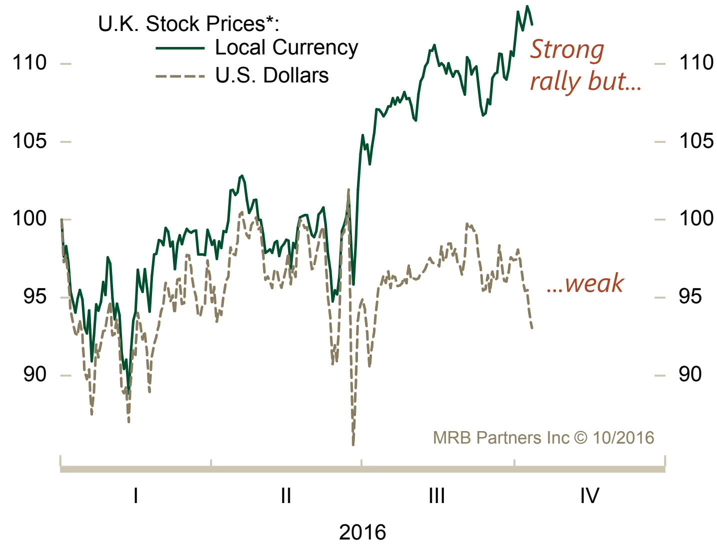
The U.K. equity market has rallied substantially in the aftermath of the Brexit vote, with the benchmark challenging its all-time highs. Health care, consumer staples, energy and mining have led the gains.

The strong performance is misleading, however, as it has primarily been driven by the weakness in the pound, which has fallen nearly 20% since Brexit. Indeed, in common currency terms, the U.K. market has largely traded sideways since the initial post-Brexit selloff (**chart 2**).

The divergence between local- and common-currency performance reflects the composition and orientation of the U.K. market. It is dominated by large, multi-national firms, whose profits derive primarily from abroad. The decline in the pound boosts the local currency value of overseas earnings, which in turn have driven local-currency stock price gains. The best performing sectors since Brexit have been those with comparatively large foreign earnings that will benefit from the weak pound.

Financial stocks also recovered initial losses and rallied further, as the Bank of England swiftly enacted policies aimed at limiting the fallout for the sector. This provided support to the overall market since financials make up 20% of total market capitalization.

Chart 2 **Weak Sterling Is Solely Responsible For The U.K. Equity Rally**



* Rebased; source: MSCI

Conversely, the trading range of the benchmark when measured in common currency terms highlights that investors are more cautious about the underlying earnings outlook. This is especially evident since global equities (excluding the U.K.) have risen smartly since Brexit in common-currency terms.

Domestic Market Perspective

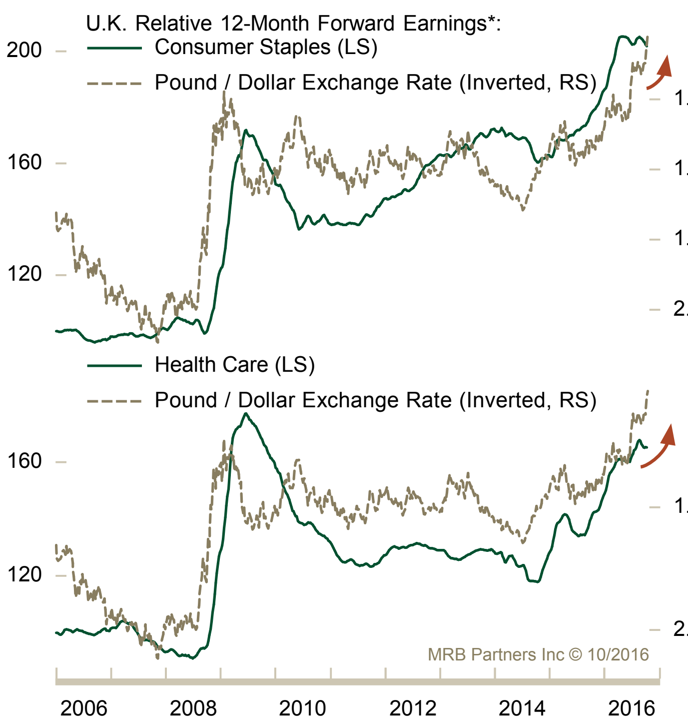
Sustained weakness in the pound favors the continued outperformance of globally-oriented sectors

The increasing risk that Brexit could have a pronounced negative effect on domestic economic activity implies that investors should tilt portfolios at least mildly toward defensive sectors (consumer staples, health care, telecoms, and utilities) while underweighting cyclical sectors (consumer discretionary, industrials, and resources). However, a more nuanced approach is necessary given the confluence of factors that will drive sector performance. Overall, U.K. investors should increase offshore equity exposure to enhance absolute returns.

Our outlook for sustained weakness in the pound favors the continued outperformance of globally-oriented sectors. These include energy and materials, consumer staples, healthcare, and to a lesser extent telecom services. Stock prices and earnings of consumer staples and health care in particular typically outpace the broad market when the pound weakens given the high weight of overseas sales (**chart 3**).

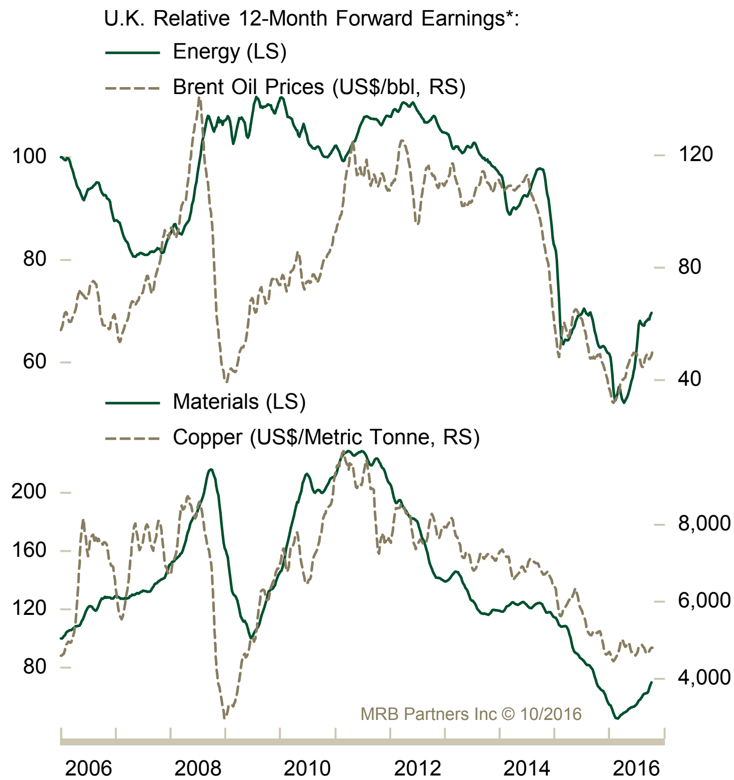
The resource sectors (energy and materials) also offer insulation against a domestic economic slowdown given their global operations. However, both sectors continue to face global headwinds from low commodity prices and the global supply glut in

Chart 3 **Consumer Staples & Health Care Outperform When Pound Weakens**



* Relative to U.K. equity benchmark; rebased; smoothed; source: Thomson Financial / IBES

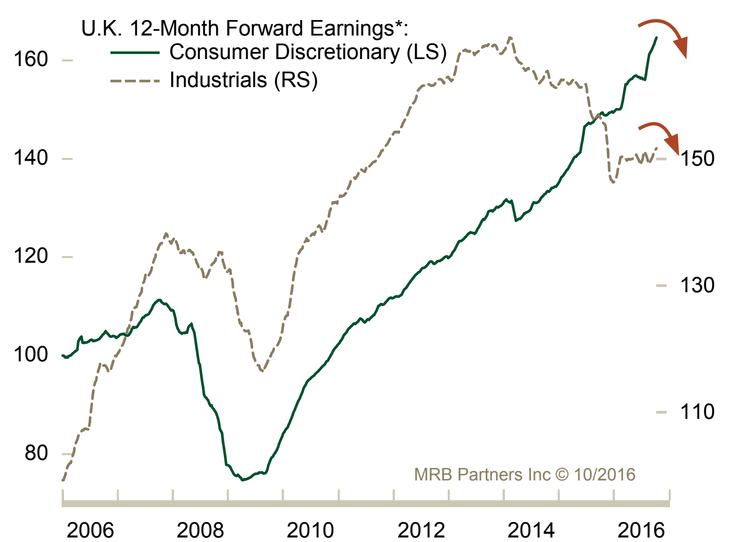
Chart 4 **Resources Hamstrung By Supply Glut**



* Relative to U.K. equity benchmark; rebased; source: Thomson Financial / IBES
Note: All panels smoothed

industrial metals and oil (**Chart 4**). While crude oil prices have recently broken out of a trading range, we expect that ongoing oversupply conditions will cap prices and earnings. Overall, resource sector earnings will likely outperform those of more domestically-oriented sectors, while lagging other globally-oriented sectors.

Chart 5 **U.K. Consumer Discretionary & Industrial Sectors At Risk**



* Rebased; smoothed; source: Thomson Financial / IBES

Consumer discretionary and industrial companies are vulnerable given their comparatively greater exposure to the domestic and EU economies. Earnings expectations are elevated in consumer discretionary companies, and are at notable risk of downgrade as Brexit gets priced in (**chart 5**).

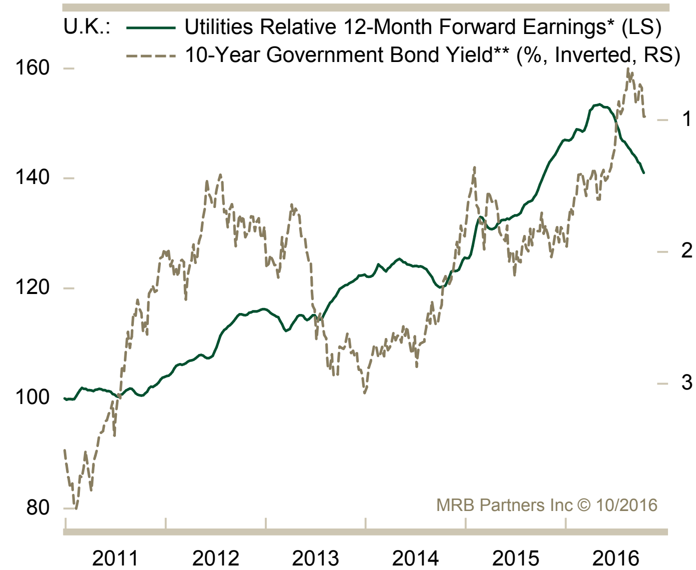
The telecom services sector is more complicated given that the EU and U.K. comprise the bulk of its profits. Historically, the sector benefitted from currency weakness, but it has recently lagged (partly due to the spike in gilt yields) and earnings have been a drag on the overall market. The sector's defensive character will be significantly offset by its potential loss of open access to the EU market.

The utilities sector has comparatively more domestic exposure and has lagged the broad market in the aftermath of Brexit. While defensive, it will likely lag even if the economy weakens given its limited external exposure. A short-term rise in Gilt yields as inflation expectations rise would also be detrimental to relative performance (bottom of **chart 6**). The offset is that the sector is heavily regulated and hence it could get relief from authorities from any inflationary pressures.

The financial and real estate sectors are notably vulnerable both from external and domestic factors. Externally, key financial institutions rely heavily on business with the EU, which will be imperiled under current government policy. The Conservative government has put the financial sector in its crosshairs, and stated that no special considerations will be made to ensure banks' access to the common market. May has also been highly critical of the Bank of England's efforts to shield U.K. banks in the aftermath of the Brexit vote and further clashes between the BOE and Downing Street are likely to weigh on confidence, although we do not rule out an eventual softening of her stance. Financial sector earnings are extremely depressed, but both the macro and sector backdrops temper scope for a rebound, while increasing risks.

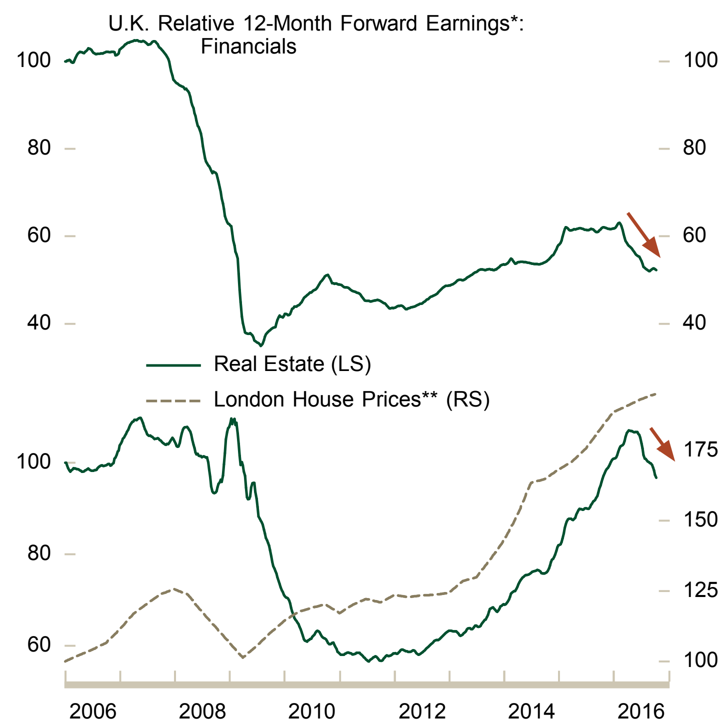
Any fallout in the U.K. real estate market, which is an increasing probability, would only compound the sector's problems (**chart 7**).

Chart 6 **U.K. Utilities Are Vulnerable If Yields Rise Further**



* Relative to U.K. equity benchmark; rebased; source: Thomson Financial / IBES

Chart 7 **Financials & Real Estate Are Vulnerable As Brexit Unfolds**



* Relative to U.K. equity benchmark; rebased; source: Thomson Financial / IBES
** Source: Nationwide Building Society
Note: All panels smoothed

U.K. Equities In A Global Context

Our expectation of further weakness in the pound and downside economic risks warrants underweighting the U.K. in a global equity portfolio. The threat of a hard Brexit reinforces the comparatively negative view we held prior to the June vote because relative earnings are at even greater risk of underperformance (**chart 8**). Our underweight stance reflects the market's comparatively defensive sector composition, as well as its large weight in resource sectors whose profits will remain weak. Our forecast of sluggish (though positive) global growth led by the U.S. points to a mild pro-growth global equity portfolio posture, albeit with only a slight tilt in favor of cyclical sectors.

Globally, the U.K.'s significant exposure in health care is a positive, since the sector has structural growth tailwinds. Less positively, the domestic sector has been struggling and has not been able to capture the underlying global earnings uptrend. Earnings for the U.K. telecom sector have also badly lagged their global counterparts, and a hard Brexit would further undermine the longer-term earnings outlook.

U.K. financial sector underperformance is destined to persist (especially versus the U.S.) given the policy backdrop. As noted earlier, range-bound commodity prices likely imply that the U.K.'s resource sector will act as a mild drag on overall performance.

All told, a hard Brexit exacerbates risks for U.K. relative performance, which already faces headwinds. The most optimistic take is that U.K. earnings are already extremely depressed, such that fallout could be limited if a recession is avoided over the next 6-12 months (**chart 9**). Even so, the divorce from the European Union is an unprecedented event which will undoubtedly change the very nature of the U.K. economy and equity market.

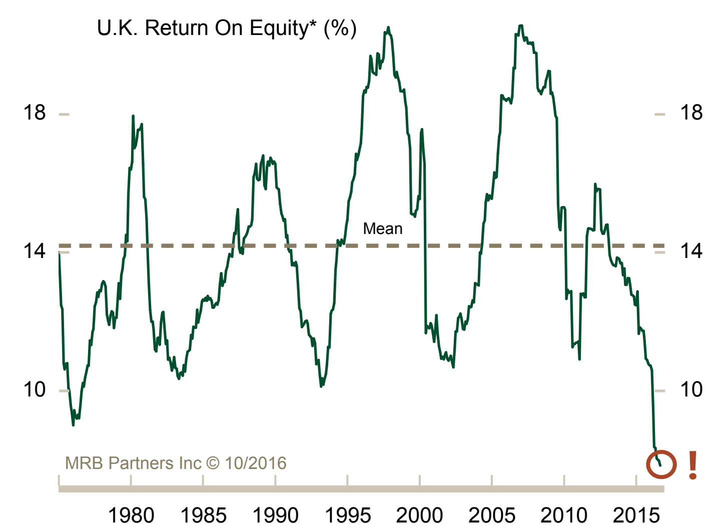
Final Word: *A hard Brexit is likely to have profound ramifications for the U.K. equity market and has the potential to spark a domestic recession as worries about access to the EU market undermine corporate confidence. There are select opportunities for domestic investors in the health care and consumer staples sectors, but we caution against bottom-fishing for global investors given downside risks to domestic growth, exports and the pound.*

Erik Franco
Peter Perkins

Chart 8 **Stay Underweight U.K. Equities**

* U.S. dollars; smoothed; rebased; source: Thomson Financial / IBES

Chart 9 **U.K. Earnings Are Depressed But Headwinds Remain**



* - - - historical mean; source: MSCI

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