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INVESTMENT UPDATE: BREXIT AND THE OUTLOOK FOR UK INVESTORS

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Brinksmanship certainly appears to be part of Boris Johnson and Dominic Cummings' negotiating strategy. Just eight months after signing the terms of the UK's withdrawal from the EU, this week saw the prime minister risk breaching international law to renege on that agreement. Though the true motive for this latest twist in the Brexit saga is debatable, one line of thought is that the UK government is aiming to increase the stakes to force some last minute concessions from the EU.

Indeed, a similar strategy was deployed in October, resulting in some small compromises from the EU and enabling Johnson to claim a victory and sign the withdrawal treaty. This week's events could be part of an attempt to repeat the trick. If so, success would likely be a continuation of trade arrangements that look broadly similar to current arrrangements.

However, the UK government's overhaul of an agreement it signed only eight months ago has not been well-received in Europe. It is possible that it could cause negotiations – which were already strained – to break down completely. This would point to a "hard" Brexit, with existing trading arrangements between the UK and Europe effectively abandoned. As trade with Europe accounts for c.12% of the UK's annual economic output, this would undoubtedly be a significant shock to the system.

While there can be little certainty over how the negotiations will end, it appears to us that recent events have increased the chances of a hard Brexit. Indeed, this view seems to have shaped moves in currency markets. The sterling-euro exchange rate has been a reliable barometer of expectations throughout this saga and, at the end of last week, the pound bought as few euros as it has done at any time since the 2016 referendum.

If a hard Brexit is looking more likely, what does that mean for UK investors? When assessing the outlook, we have to consider a number of interlinked issues:

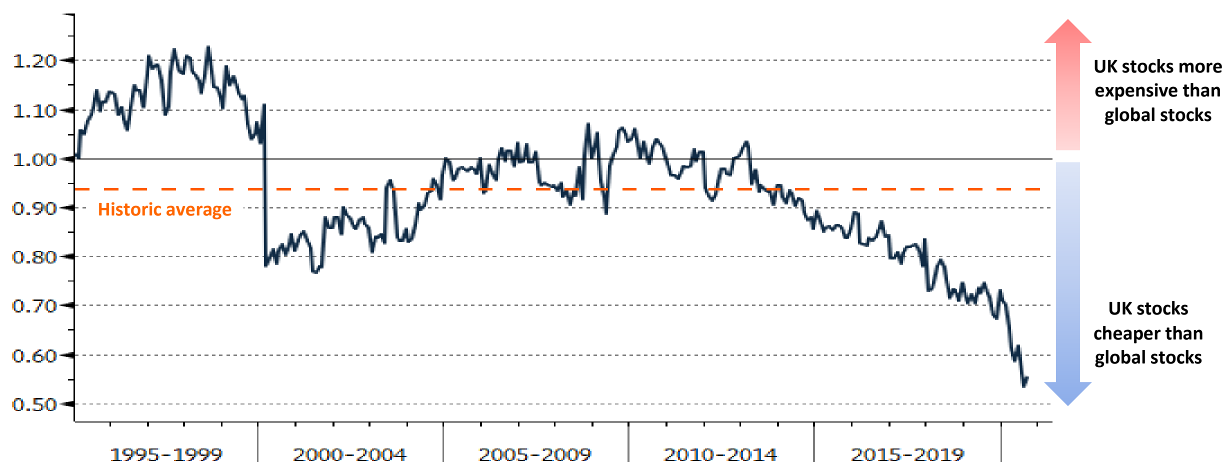
- Firstly, stockmarket moves have long made it clear that the consensus views a hard Brexit as negative for UK assets. A hard Brexit might therefore be expected to go hand-in-hand with poor returns from shares of domestic UK businesses.
- Conversely, assuming the terms of the UK's departure from Europe do not undermine international business models, companies that earn a large proportion of their profits from overseas might be expected to benefit from a decline in the pound – the shares of these companies may rise in the event of a hard Brexit.
- Though Brexit may have significant near-term economic consequences for the UK and parts of Europe, it is unlikely to register in many parts of the world. Nonetheless, assets – including stocks and bonds – denominated in other currencies, would be worth more to sterling-based investors should the pound weaken.
- A fall in the value of the pound also makes imported goods more expensive, and would therefore prompt an increase in inflation.
- We would not expect the Bank of England to raise interest rates in an attempt to offset this inflationary pressure. However, higher inflation reduces the "real" rate of return received by bond holders.

It is tempting, then, to see the rising prospect of a hard Brexit as reason to abandon UK assets in favour of international, non-sterling denominated stocks and bonds. However, there is a further – critical – issue to consider: to what extent is this outlook already reflected in the price of UK assets?

As we have already noted, the pound is currently as weak as it has ever been against the euro. Similarly, using valuations based on the worth of companies' assets, UK stocks are 45% cheaper than their international peers.

Though the UK stockmarket – with its many banks, energy and mining companies – arguably should be cheaper than markets with higher exposure to more dynamic sectors such as technology, the current discount is nearly seven times the historic average and, since 1995, has never been wider (see Figure 1).

Figure 1: Relative to international peers, the UK stock market has never been cheaper



Source: Bloomberg.
Chart shows Price-to-Book Value of MSCI UK Index relative to Price-to-Book Value of MSCI World Index

In other words, prices of UK assets already reflect the challenges of a possible hard Brexit. After years of uncertainty over Brexit, UK assets are unloved and, in our opinion, undervalued. This, we believe, is critical to the outlook for UK investors. Firstly, even in the event of a disorderly end to the UK's trading relations with Europe, there is arguably little room for either the pound or the UK stockmarket to fall much further. Secondly – and importantly for long-term investors – valuations have historically displayed a very strong relationship with future returns. The cheaper the asset when it is bought, the better the long-term returns that asset tends to deliver. At present, UK stocks are among the most lowly valued assets anywhere in the world: we believe this augers well for long-term UK investors.

With the negotiations over the UK's final withdrawl from the EU nearing their end, the coming months seem certain to deliver a constant stream of Brexit-related headlines. There will be challenges the UK will have to overcome once it severs relations with its largest trading partner. Nonetheless, we believe the largest part of such challenges are already reflected in UK asset prices.

Consequently, as fraught as the coming months may be, and as uncertain as the outcome of the Brexit negotiation remains, the closer the end comes, the greater the chances that the value inherent in the UK stockmarket is unlocked.

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