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Brexit and the Difficulty in Forecasting UK Market Fortunes

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After a tumultuous couple of years, making predictions for the UK market is a challenging task, particularly with Brexit on the horizon. Instead, Colin Morton vice president, portfolio manager, UK Equity team, highlights the events that he thinks will have the greatest influence on UK markets in 2018.

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Only the very brave would hazard predictions for the next 12 months, and the situation the United Kingdom finds itself in at the end of 2017 means making forecasts for 2018 is even more difficult.

Several significant unknowns hang over the country, each of which could have a significant impact on its economic fortunes during 2018.

The first, and most obvious, is the progress in negotiations between the UK government and European Union (EU) over the United Kingdom's departure from the EU, aka, Brexit.

Currently, the way forward looks anything but clear, but by this time next year, we'll only be a few months out from the official Brexit deadline. We'd hope by then to have clarity on issues such as the cost, the transition period and perhaps most importantly, the likely post-Brexit trade agreements.

These are things that we as investors have no control over. Our best hope is that common sense prevails and that both sides will move forward towards an outcome that's mutually reasonable.

Politics in the Balance

The political balance in the United Kingdom is equally uncertain. After its disastrous performance in the 2017 general election, the Conservative Party holds power in a minority government, supported by the Northern Irish Democratic Unionist Party (DUP).

If for whatever reason there were to be a fallout with DUP or within the Conservative Party, the chances of a fresh general election would increase considerably. A new election would present the chance of a new government, potentially led by the reinvigorated, left-leaning Labour Party.

Even if the Conservatives can remain in power and stave off a fresh election, Prime Minister Theresa May's position seems precarious, and a leadership challenge could prove unsettling for markets.

Economic Uncertainty

Economically, it's a mixed picture for the United Kingdom. Recent growth projections from the Office for Budget Responsibility (OBR) suggest a slowdown in gross domestic product (GDP) over the coming years.

The OBR is now projecting GDP growth of just 1.3% for both 2019 and 2020, compared with previous estimates of 1.7% and 1.9%, respectively[1]. The OBR is also suggesting UK inflation will peak this year before coming down towards the government's 2% target during the subsequent 12 months. That's in line with our expectation, too.

We view the significantly lower GDP growth numbers, coupled with an expectation of falling inflation, as further evidence that UK interest rates are likely to remain lower for longer. And that would likely be positive for UK equities in general.

In our eyes, the OBR assumptions—if they are right—reinforce the feeling that interest rates probably won't be going up very much in the near future.

The gilt market already seems to be working on the assumption that the Bank of England will only implement one or two more rate increases between now and December 2019.

If UK interest rates remain subdued, we think the search for attractive equity returns could continue to underpin the UK equity market.

Seeking Interesting Stories

We recognise that we cannot influence macro factors, so our approach continues to focus on seeking out interesting stories among companies we think can perform well irrespective of what's going on in the wider world.

We take an interest in companies that we consider to have attractive valuations, good cash flows and a nice potential upside, regardless of what macro situations throw at them.

And while, in our larger-capitalisation strategies, it may not feel like the time to be going wholeheartedly into UK domestic stocks, a lot of those valuations are reflecting a pessimistic sentiment towards UK issues. We're prepared to consider taking a bit of extra risk if we feel it's adequately reflected in a company's stock valuation and demonstrates the potential to be rewarded.

Having said that, I'm not expecting radical turnover in our portfolios in the short-term. We think 2018 will be a time to look for interesting ideas, irrespective of the macro considerations, while being sensible and adopting a balanced approach.

What Are the Risks?

All investments involve risk, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

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1. Office for Budget Responsibility, November 2017.