EQUITY

What Might Be More Important than Brexit to UK Equities Is…

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There's just a little more than a year until the United Kingdom leaves the European Union in 2019 and (understandably) uncertainty about the future relationship of the two parties is casting a shadow over investor sentiment. However, Colin Morton, vice president and portfolio manager, UK Equity team, believes Brexit won't define the United Kingdom in years to come. He suggests investors should focus their attention on the potential impact rising interest rates could have on UK equities.

Despite the ubiquitous media coverage of the divorce talks between the United Kingdom and European Union (EU), we think there are reasons to believe Brexit should represent just a blip on the country's long-term economic prospects.

Although it may feel like a major issue right now, we think Brexit likely won't define the United Kingdom in 5-10 years.

Of more significance, we believe, are wider macroeconomic developments such as shifting monetary policy in the United Kingdom and globally.

Global Influences

After a long period of lacklustre growth following the 2007-2009 global financial crisis (GFC), global growth finally seems to be picking up and is forecast to edge up to 3.1% in 2018.[1] It could be the first year since the GFC that the global economy will be operating at, or near full capacity.

In these circumstances, including near full employment in several major economies, we would normally expect to see wages rising. In turn, rising wages would traditionally contribute to rising inflation.

Should UK inflation begin to rise significantly, we'd expect to see the Bank of England (BOE) push for rate hikes to limit inflationary pressures.

We've already seen the BOE raise interest rates once in November 2017 since the Brexit vote in the previous year—although the move simply reversed a prior rate cut in the immediate aftermath of the vote.

International factors could also affect UK equities. The US Federal Reserve's (Fed's) decision to keep its rate outlook unchanged for 2018 with projected three interest rate hikes led to a dip in the US dollar and weakened against major currencies. This guarded outlook could hit earnings from mid- to large-cap UK stocks that generate dollar earnings overseas.

Some UK Stocks Still Robust in the Face of Brexit

In the year and a half since the UK's vote to leave the EU, the country's equity markets have proven more buoyant than many observers had expected them to be.

Drivers of that staying power include the resilience of some exporters and the attractive pricing of some sterling-denominated shares of London-listed multinationals.

Many of these large-cap companies are already experienced in navigating the complexities of trading agreements between different countries.

Rising Rates Pose a Far Greater Risk than Brexit

Despite all the Brexit fears, we believe the potential for rising interest rates could actually pose a greater medium-term risk to UK equities.

Some investors might consider rising interest rates, and the consequential rising bond yields, to signal confidence in the economy. However, a rising-rate environment has implications for other asset classes.

A market that's accustomed to ultra-low interest rates would likely have some adjustments to make as interest rates normalise. We think raising interest rates as a means to curb inflation might dampen investors' appetite for UK-listed stocks, particularly those which we'd consider to be already overvalued. Some of these stocks could therefore become less attractive over time. Tighter credit conditions as a result of higher interest rates could limit potential earnings and eat into company cash flow.

In particular, rising interest rates could, to some extent, dampen the gains we've seen in UK bond-proxy stocks, such as utilities, consumer staples, pharmaceutical and property companies. These companies traditionally offer low but stable growth, steady dividends and low volatility. These are all attractive qualities to investors in a low interest-rate environment, but could become less attractive should interest rates begin to rise.

An incremental increase in interest rates could also impact smaller UK businesses. Cheap credit may become less available, and rising interest on existing loans could dilute company earnings.

Amid an improving economic backdrop, these types of stocks could lose their appeal in the face of competition from other asset classes, such as bonds. Despite all the attention Brexit has received, we'd be foolish not to consider other macroeconomic factors close to home—including monetary policy—that we believe could prove even more impactful to UK equity markets.

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. Source: World Bank, Global Economic Prospects, January 2018. There is no assurance that any forecast, projection or estimate will be realised.