EQUITY

Why We're Not Obsessing over the Brexit Effect

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It’s approaching crunch time for Brexit. The resolution is far from clear, but Colin Morton, vice president and portfolio manager, Franklin UK Equity team, believes the time has come to start looking past the short-term effects of the United Kingdom’s divorce. He suggests investors should focus on factors that might influence their portfolios once the outcome has been decided.

Understandably, concern and uncertainty over the outcome of Brexit are overshadowing most analysis of the United Kingdom’s investment landscape at the moment.

As long-term investors, we don’t put Brexit entirely out of our minds, but we do try to take a more pragmatic view. Indeed, we recognise the uncertain environment that abounds may actually have created some valuation opportunities for investors.

But, even more than that, if we can screen out Brexit considerations just for a moment, a very different picture of the UK economy emerges.

While we recognise Brexit will undoubtedly cause some short- and even medium-term volatility, our experience suggests that over the long term its impact may not seem so significant.

Reaching an Inflection Point

Currently, we seem to be at a period of maximum pessimism.

Uncertainty over the United Kingdom’s post-Brexit relationship with the European Union (EU) and other trading partners has hurt UK domestic stocks in particular. Meanwhile, concern that sterling might weaken further has dissuaded many companies from investing.

But it’s not all bad news. And there are signs we could be at an inflection point.

In recent months we’ve seen evidence of average earnings in the United Kingdom rising above inflation.[1] So, after a very difficult year in 2017, we’re going to start seeing some improvement for household cash.

If we park Brexit thoughts for the time being, the underlying position for the United Kingdom looks encouraging at the moment from the perspective of employment, average earnings and inflation.

Of course, not all macroeconomic news is rosy. But we still see reasons to be positive.

The latest projections from the Office for Budget Responsibility (OBR) suggest a slowdown in gross domestic product (GDP) over the coming years.

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

Building for the Future

One area of opportunity that stands out for us—almost regardless of how Brexit plays out—is UK housebuilding.

We recognise there may be reasons for investors to be sceptical about the construction industry amid Brexit uncertainty. However, there is undoubtedly a shortage of appropriate housing in the United Kingdom. And any post-Brexit UK government will still need to address that shortage.

The listed house-building industry is likely to play a pivotal role in any solution, which makes it an interesting place to look now for attractively valued investment opportunities, in our view.

Our analysis suggests the dynamics for the sector are very encouraging. Many UK house-building companies are in very rude financial health, often with net cash in the bank. Furthermore, the competition for land in the United Kingdom is nowhere near what it used to be. A decade ago, just before the financial crisis, there was a lot of competition for land.

Today, we consider land pricing to be a good value for the housebuilders, taking into account the build cost plus the likely eventual selling price.

Getting Used to Brexit

Overall, our view continues to be that Brexit may cause some short-term discomfort as markets digest whatever outcome the United Kingdom and EU hammer out.

But in time we believe most companies and businesses will eventually adapt to how they have to transact with Europe and other trading partners.

A lot of UK companies are already transacting with the rest of the world anyway, they know how to do it.

So we feel Brexit is unlikely to define the United Kingdom in five to 10 years and that suggests to us there should be potential opportunities to be found in the current environment.

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: UK Office of National Statistics, as at 11 December 2018.