EQUITY

Have We Reached Maximum Brexit Pessimism Yet?

January 24, 2019

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Newspaper headlines might suggest there’s little reason to cheer for UK equity investors right now. However, Colin Morton, vice president and portfolio manager, Franklin UK Equity team, believes the current despondent sentiment that pervades the United Kingdom could present some interesting opportunities to pick up a bargain. Just don’t ask him about catalysts for improvement.

Let me share a particular bugbear I’ve experienced many times in my 36 years of investing. When I buy a stock that appears quite cheap, I often get the question: “What’s the catalyst?”

Biting my tongue, my response is generally: “If there was a catalyst it wouldn’t be cheap.”

If everyone knew what was going to happen in the future—for example if the company is going to receive a takeover approach, or divest part of its business, or improve profitability—obviously the stock wouldn’t be where it is.

I think about that a lot as I survey the UK equity landscape at the moment, overshadowed as it is by uncertainty about the outcome of Brexit.

The UK equity market currently seems to be pricing in a negative Brexit scenario.

Many observers believe the House of Commons’ rejection of Theresa May’s proposed Brexit deal has increased the chances of the United Kingdom leaving the European Union with no withdrawal deal in place. UK stock valuations suggest the market now feels that is a very real prospect.

We’re not going to try to predict catalysts, but at this moment of maximum pessimism, if there were to be any positive developments towards a deal, we’d expect a quite bullish market response.

On the other hand, if we did get what is perceived to be a terrible Brexit outcome, I wouldn’t be surprised if UK stocks did fall still further. We would see that as a further buying opportunity.

Already, we consider Brexit uncertainty has created a potentially attractive equity market. For investors willing to look through the likely short-term volatility and invest for the medium to long term, we think there could be some potentially interesting opportunities out there.

As income investors, we think it’s particularly significant that last year’s Brexit sell-off came even as many UK-listed stocks enjoyed some really solid dividend growth across a whole range of sectors.

We’ve talked in previous articles about our positive view for housebuilders. Another good example of positive dividend growth was among life insurance companies. As part of the financials sector, many of these companies have been caught up in the Brexit sell-off, but a number posted between 7% and 10% dividend growth last year.

Other UK consumer stocks, including prominent names in the health and hygiene and beverage arenas, have also experienced attractive dividend growth and we would expect this could continue.

But because of uncertainty about the next six to 18 months, the share prices for many of these companies do not reflect the good earnings and dividend growth they have been achieving.

Like any other market observer, we can't predict how significant Brexit could be in the short term, but looking simply at underlying businesses and the current dividend yields and dividend growth on offer, we see lots of promising opportunities across the market spectrum at the moment.

We aim to take a Brexit-neutral approach to building out UK portfolios, but feel that in five or 10 years' time Brexit may not have proven the major concern that it seems today.

In fact, we reckon that five years down the line, investors might look at some of these current valuations and think what a great buying opportunity it was.

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