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What about Brexit?

1 September 2020

While Brexit may not have featured regularly in the news recently, the fact remains that the UK's new relationship with the EU will come into force in just four months' time. From an economic perspective the key issue to be resolved within the current transition period is the withdrawal from the EU's main trading arrangements: the single market and the customs union.

As a reminder there are, ultimately, two possible outcomes. Either the UK leaves with a free trade agreement ('FTA') or it fails to reach an agreement in which case it will leave and trade on World Trade Organisation ('WTO') terms. The latter scenario would see the potential introduction of trade tariffs, more red tape in terms of customs requirements and, potentially, could lead to companies being excluded from supply chains due to regulatory differences. The loss of the existing 'passporting' rights in some service industries could also have a significant impact, particularly on financial companies. Those who favour a 'hard' Brexit would argue that there would be opportunities too, as the UK would be entirely free to negotiate trade deals globally.

The major sticking point in the negotiations still revolves around the UK's desire for full sovereignty and the EU's unwillingness to grant significant access to the single market without guarantees from the UK of a 'level playing field' i.e. assurances that it will not seek to gain competitive advantages in certain areas, such as taxation and subsidies.

Perhaps predictably the newsflow on how these negotiations are progressing is not particularly positive. The process is undoubtedly not being helped by the impact of the Covid-19 virus and the restrictions and demands it is putting on both sides. Many would argue however that it is normal for such negotiations to go to the wire and for both sides to posture in the run up to the deadline only to offer last minute concessions and ultimately agree some sort of deal. It would seem that reaching a deal is ultimately in both sides' interests and some kind of fudged agreement, which may be relatively high level and far from complete, is currently our base case scenario.

So, what could all this mean for markets and our positioning? As was the case during the first phase of negotiations, the most direct impact is again likely to be on sterling. A successful deal resulting in an acceptable FTA might push sterling higher against the US dollar whereas a failure to reach an agreement could see sterling weaken. It is difficult to ascertain what is currently priced in at present and, of course, the impending US election and Federal Reserve policy expectations will also impact currency markets. We saw very clearly during the phase one negotiation period the effect of currency movements on UK companies with substantial overseas earnings, which are boosted by sterling weakness and dampened by sterling strength. This effect is strongest at the large cap end of the market – around 80% of FTSE 100 Index earnings come from overseas. As such we may return to a period of quite diverse performance from overseas and domestic orientated companies within the UK market.

There will of course be offsetting impacts on the equity market in either scenario. A no deal outcome could weaken sterling, boosting overseas earnings, but markets would then be concerned about the disruption to trade. An agreement would be welcomed in terms of a much smoother trade transition but would likely have the opposite effect in terms of currency.

We will monitor events very closely and, where necessary, we will be prepared to opportunistically adjust our exposure both to the UK market as a whole and to the different sectors within it, as we have done since the referendum.

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You will be aware, however, that we have already reduced our UK exposure quite significantly this year in favour of the US and Asia. Regardless of the outcome of the trade negotiations, we continue to believe that these regions offer superior economic growth prospects relative to the UK and also host a far wider range of market leading companies in key sectors such as technology and healthcare. With only 2,000 of the 40,000 global companies listed in the UK we are very comfortable with now having three quarters of our equity exposure in overseas markets, particularly given the headwinds faced by the UK in the coming months.

Risk warnings

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