How Brexit Affects Our Funds

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By:
Eugene Barbaneagra, CFA, Portfolio Manager
Jason Collins, CFA, Portfolio Manager
Hardeep Khangura, CFA, Portfolio Manager
James Mashiter, CFA, Portfolio Manager

- The eleventh-hour EU-UK trade deal averted a cliff-edge exit; however, important questions remain about the UK's future economic prospects.
- In our view, prices in the UK will likely end up being a bit higher, gross domestic product a bit lower and supply chains a bit more unreliable, post-Brexit.
- While the Brexit "risk factor" will remain for years to come, we see reasons to remain optimistic on UK equities.

The UK's departure from the European Union (EU) promised to be messy and full of uncertainties from the start. This time last year, we had figured that some sort of deal with the EU would eventually be made in order to avoid a hard Brexit. That turned out to be the case, although the negotiations went on for as long as they possibly could before 1 January, when the Brexit withdrawal agreement is implemented.

The skinny on the skinny deal

The result is a "skinny" deal that allows the UK to gain preferential access to the EU market for its goods as long as it follows many of the EU's rules and regulations as they apply to governance, labour and the environment. If those standards change in the future, the UK will be permitted to deviate from them and will be able to challenge future disputes in an independent court.

Despite years of talks, the deal only relates to traded goods (such as manufacturing and agriculture). This zero-tariff/zero-quota trade arrangement comes at a cost, as businesses that trade with the EU will now be burdened with additional expenses and red tape. Although politicians and the media will likely point to tariff-free trade, the UK's significant—and higher value-add—services sector (which accounts for about 80% of the UK's economy) will face challenges in continued access to the single market.

For financial services, meanwhile, the elephant in the room remains the concept of equivalence. The EU can unilaterally decide whether to allow UK-based financial businesses to continue selling directly to EU-based clients. It also reserves the right to withdraw equivalence at short notice. To mitigate this risk, some banks have already started moving assets and staff from London to EU financial centres, such as Frankfurt, Paris and Dublin.

In short, the deal avoids the prospect of an economic rupture, but at the cost of increased trade friction and ongoing uncertainty in several important areas.

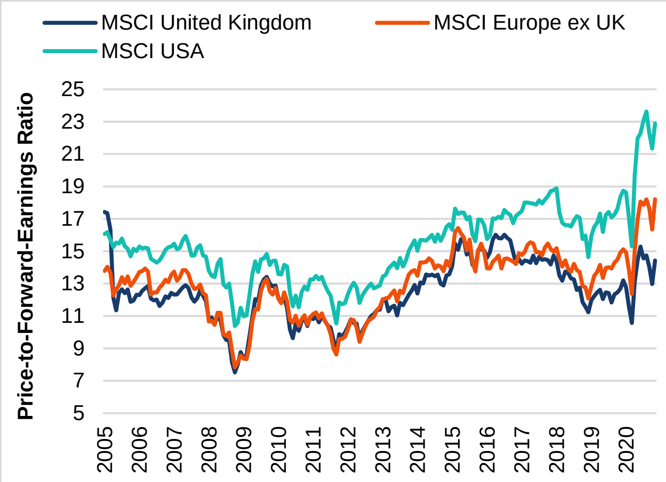
The market's response to the deal has been relatively muted—and is not easy to disentangle from the ever-changing news on COVID-19. Investors have had four years to digest the economic damage from Brexit; it is well understood by now and we believe it is reflected in the prices of UK equities and currency. One notable reaction was a sell-off in UK banking stocks, which implies that the market was hoping for a bit more clarity from the deal.

Our view

While the negotiated outcome is better than a no-deal Brexit, the UK has suffered from a long period of intense uncertainty (which continues to a degree, as the divorce from the EU addressed the transfer of goods, but not commerce in services). We still expect Brexit to weigh on economic growth in the years ahead, with the UK likely set to underperform other regions in the world, such as the US and Asia.

Earnings expectations follow the economic trends. Exhibit 1 looks at the forward price-to-earnings ratio of the MSCI United Kingdom, MSCI Europe ex-UK and the MSCI USA Indexes. UK equities appear cheap. But there are a few bright spots on which investors may choose to focus.

Exhibit 1: The UK Stock Market Looks Cheap



Sources: MSCI, SEI.

First, the development and distribution of the COVID-19 vaccines should drive the global economy to higher ground in 2021—and should benefit the large energy, materials and industrial multinationals that comprise almost one-third of the market capitalisation of the MSCI United Kingdom Index.

Second, the UK appears competitive versus other advanced countries when measured by various benchmarks, such as relative unit labor costs.

Finally, as a hard Brexit has been avoided, we also believe that investors may be more likely to hunt for bargains in 2021, pushing equity prices closer to global averages. This would also benefit sterling.

Sterling rallied in the days leading up to the deal announcement, but has since retraced most of its gains. UK government bonds, meanwhile, have been one of the strongest-performing G7 markets through 2020. However, there has been a noticeable decoupling from other core sovereign bond markets in December. Gilt yields have rallied (fallen), whereas government yields in the US, core Europe and elsewhere have sold off (risen). Developed-market government yields are usually correlated; therefore, this suggests to us that, despite the agreed-upon deal, investors are concerned about the UK's future economic growth trajectory compared to its peers. The market has priced in an increased likelihood of another Bank of England interest-rate cut that could take the base rate into negative territory.

Our funds

Equities

It's worth remembering that the UK equity market is not representative of the UK economy. With the exception of banks, the largest benchmark constituents are global energy, materials, consumer staples and pharmaceuticals stocks. That sector make-up largely explains why the UK equity market is trading on a relative discount (certainly to the US)—investors are seeking high-tech growth stocks (of which the UK has close to zero representation) rather than those in financials, commodities and low-growth defensives.

The shadow of Brexit has also hurt investor sentiment towards many stocks that are not exposed to Brexit risk directly due to their global footprint. This poor sentiment towards the UK market (due to sector make-up and Brexit woes) has created opportunities for value-aware stock pickers, as the concerns are arguably already priced in.

The UK Equity Fund has a definite domestic bias and is overweight economically-sensitive cyclical stocks, such as those in the financials, industrials and consumer discretionary sectors. It is underweight global sectors—such as consumer staples and health care (largely on valuation grounds, as these sectors are cheap, particularly given the potential earnings growth from any cyclical recovery)—as well as energy and materials on quality considerations. Any adverse impact on the UK economy that arises from the new trading regime is likely to affect the Fund.

The Europe ex-UK Fund does have some off-benchmark UK exposure—a combination of domestic industrials and global media-related stocks. These are held on valuation grounds; however, given the low exposure and the range of stocks held, these stocks should not be notable drivers of Fund performance.

The Global Equity Fund and Global Select Equity Fund are exposed to UK equities through their value-oriented managers who purchase undervalued securities and avoid the expensive parts of the market. We expect these managers to benefit from a likely economic recovery in 2021, which should add significant fuel to the nascent value rotation.

A bursting of the tech bubble would also be relatively beneficial as our managers avoid the richly valued securities in that sector. Our currency specialist Rhicon is trading purely on technical indicators and should continue benefit from an environment of rising foreign exchange volatility; however, the manager may experience headwinds if risks subside.

Finally, we do not take directional bets on the UK equity market, and we hedge our country exposure back to the MSCI World Index.

Fixed income

Our global bond funds' benchmarks have single-digit exposure to sterling-denominated bonds.

We currently have an underweight bias to UK duration, but a modest overweight to sterling. UK assets have been unloved for a number of years (for understandable reasons) and this is reflected in the currency, which remains undervalued according to most long-term valuation metrics. We therefore see some potential upside from here; although we acknowledge that negative sentiment could continue to weigh on sterling for some time.

The underweight to UK duration is based on the view that UK gilts offer poor value, pushing investors out to 7 years on the curve to find positive yield. We think we can find better value in other sovereign bond markets, where real yields are more attractive (in other words, less negative) and the debt dynamics less burdensome.

Issues outside of the UK account for nearly half of the UK Credit Fund’s benchmark, and contribute close to 40% of the benchmark’s spread. Foreign issuers in the benchmark include US-based McDonald’s and Comcast, EDF in France (which is partially owned by the French government) and Korea Development Bank and East Japan Railway Company. These issuers take a global currency approach to funding their balance sheets, opportunistically tapping attractive funding rates. As a result, the Fund benefits from a globally diversified portfolio of companies with sterling exposure common to investors’ base currency.

The Fund’s spreads have tightened within their January 2020 starting point, and are now marked at 99 basis points over UK gilts. There has been marginal risk reduction; although the Fund continues to maintain its focus on financials and securitised sectors.

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