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Brexit: Keeping calm in uncertain times

October 2020

As the UK and European Union teeter on the edge of a 'no-deal' Brexit caused by an ongoing game of political brinkmanship, what does this actually mean for investors?

The UK officially left the European Union on 31 January 2020, yet in reality the transition period agreement has meant very little has changed for the UK public and investors from a Brexit point of view in the past nine months.

While trade negotiations have been ongoing in various guises, the coronavirus pandemic has understandably overshadowed what have been somewhat fraught trade talks, with neither side apparently willing to compromise on issues such as a level playing field and access to UK fishing grounds. And in June, the deadline for the UK to extend the transition period past 31 December 2020 passed almost without notice aside from the confirmation that there would be no extension.

Raising the stakes

Then in early September the UK's actions brought Brexit front and centre and rattled markets. The UK's prime minister Boris Johnson announced a self-imposed deadline for a deal of 15 October – the start of a two-day EU summit – with the UK prepared to walk away on world trade organisation terms and 'no-deal'.

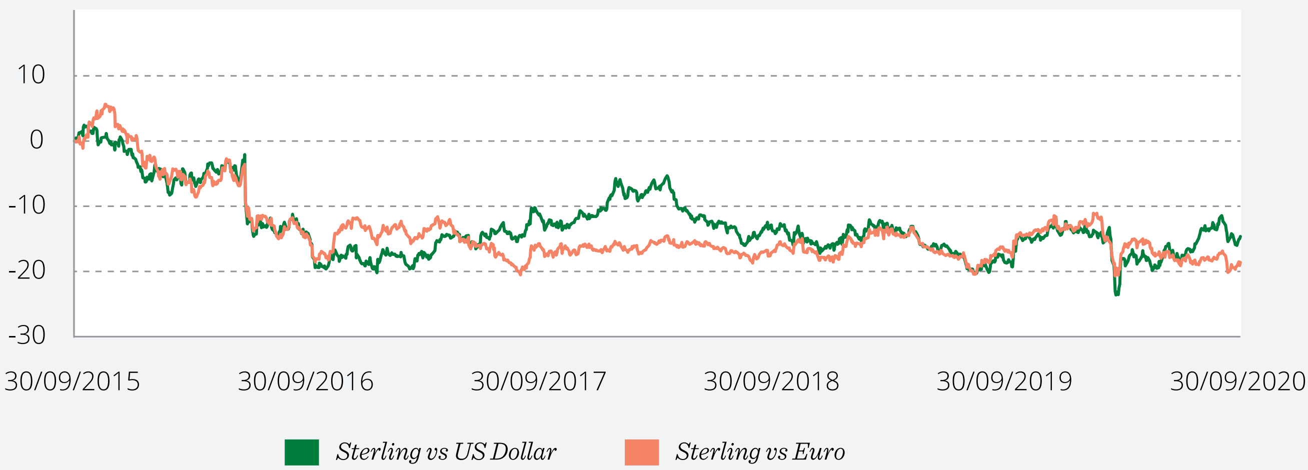
This rhetoric was followed up a few days later by the publication of the UK Internal Market Bill in Parliament of which certain sections appeared to be incompatible with the Brexit Withdrawal Agreement the UK had signed in January.

When the UK Secretary of State for Northern Ireland, Brandon Lewis, confirmed that the Bill would "break international law in a specific and limited way", the EU demanded that the relevant sections of the Bill be amended or face legal proceedings on the basis that the UK had breached the terms of the withdrawal agreement.

The consternation caused by the move saw sterling sink against the euro in September, while UK equity markets slumped on the increased uncertainty, keeping the country firmly positioned in the 'unloved' section for most overseas investors.

Sterling vs euro and US dollar

Since June 2016 sterling has gradually spiralled downwards against both the euro and the dollar, with additional slumps during more negative periods and a few cautious rallies when there has been more positive news.



Source: *Quilter Investors as at 30 September 2020. Pound sterling vs US dollar and euro exchange rate over period 30 September 2015 to 30 September 2020.*

Adapting to uncertainty

The UK equity market has certainly struggled in 2020, but not just because of Brexit. The UK has probably the biggest weighting to 'old economy' or economically sensitive companies (known as 'cyclicals') of any major developed market. It has large weightings to utilities and banks both of which will continue to struggle to grow their assets in a near-zero interest rate environment.

Meanwhile, its historic reliance on oil, energy and commodity companies, which have always underpinned the FTSE's generous dividend yield, leaves the UK market poorly positioned at what's looking increasingly like the dawn of a new age of sustainable, clean energy investment.

However, there are a number of interesting and well-placed mid and small-cap companies that have performed well in the uncertainty and that could prosper post-Brexit, once the fate of the UK is finally known.

Widen your net

Clearly, investors should be aware of the reality of the UK economy and equity market and its strengths and weaknesses. While UK equities are generally cheap compared to other developed markets, there are clear reasons for this and until there is a clear-cut decision on the outcome of Brexit uncertainty is likely to continue to weigh on UK markets and the currency.

That said, over 70% of the earnings of companies situated in the FTSE 100 index come from overseas, and so these businesses are likely to be less impacted by the after-effects of a 'no-deal' exit from the EU than more domestic-orientated businesses.

Equally, diversification is a proven investment tool to help spread risk and mitigate the impact of market falls and the outcome of uncertain events. While the UK is often seen as a key market for UK investors because of home bias, the UK accounts for just 4% of the MSCI World Index, which is a broad global equity index covering 23 developed markets.

The biggest investment market globally remains the US, which accounts for 66.5% of the index, while even Japan takes a bigger share than the UK at 7.9%.

Where next?

As the 15 October deadline passed, in public Boris Johnson called on the EU to compromise and deliver a Canada-style deal, while spokespeople and sources claimed negotiations were over and there was no point in future meetings. Just a few days later, however, the same sources were suggesting the door 'was still open' for more talks, clearly highlighting the confusion that is making planning more difficult for businesses and investors.

There is a reasonable chance of getting some form of deal in late December if there is another UK government U-turn, as the combination of an ongoing pandemic, a recessionary economy and a no-deal would be unpalatable to both politicians and the British public. Until then, however, the ongoing rhetoric of 'no deal is better than a bad deal' is likely to continue, and the risk of ending on World Trade Organisation (WTO) terms remains a real possibility.

Brexit may seem like an insurmountable obstacle to UK investors, but on a global scale it is more of a domestic issue, and the resolution of Brexit with either a deal or no-deal is unlikely to have a seismic effect on markets, and as such the situation for investors remains very much keep calm and carry on.

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