BREXIT THE REALITY

Nine months after the UK voted to leave the European Union (the so-called ‘Brexit’), Prime Minister Theresa May signed a letter on March 28th notifying the European Council of Britain’s intention to leave after 44 years of membership. The letter was delivered the following day to Donald Tusk, President of the European Council, formally invoking Article 50 of the Lisbon Treaty. The PM also addressed the House of Commons, where she said that it was now “the moment for the country to come together”. Notably, her tone was more conciliatory than it has been in recent months, dropping the “no deal is better than a bad deal” rhetoric that has not been met well by law makers. Britain is the first country to trigger Article 50 and clearly as May has said, “there can be no turning back”.

What is Prime Minister May hoping for?

May wants to leave the Single Market for goods and services, initiating a hard Brexit with a number of priorities, including taking back control of immigration, laws, and the UK’s budget over economic concerns. May has espoused the need for the best possible deal for trading with the EU, although this will also be the case for other nations such as the US.

What does the EU want?

The remaining 27 members of the EU do not want the UK to “cherry pick” the benefits of membership without the responsibilities (such as the free movement of people). European countries will also want to guarantee the rights of their citizens already living in the UK, as the UK will want for their citizens living in Europe. A clear area of contention will be the amount of money that the EU will demand from the UK to leave in order to cover existing commitments, amongst other things.

And Scotland?

As the Prime Minister signed her Brexit letter, Scotland’s lawmakers voted in favour of a second independence referendum, following Scottish First Minister Nicola Sturgeon’s demands. She has called for another referendum in late 2018/early 2019 as Scotland voted emphatically to remain within the EU unlike large areas of England and Wales. Theresa May has rejected this demand for the time being, saying “now is not the time” and that the focus needs to be on negotiating the best deal for all of the United Kingdom.

POSITIVE ECONOMIC DATA SOFTENING...

Immediately following the Brexit vote last year, the Bank of England moved to support economic growth by extending its Quantitative Easing programme, which continued to bolster the UK economy in Q4 2016, with economic data surprising to the upside. Q1 2017 has seen this growth continue, albeit to a lesser extent than last year as expected.

UK PMI suggests growth has lost some momentum. The latest composite PMI reading (with negative moves for UK Services, Construction and Manufacturing) indicates that the UK economy will deliver positive growth, albeit at a lower level than in Q4 2016, with the February survey falling to a five month low of 53.8. The greater than expected drop in Services impacted the headline figure significantly, and leads to consensus Q1 2017 GDP growth of 0.4%, versus 0.7% in Q4 2016. At the same time, the Chancellor Philip Hammond’s first March budget did not contain any significant boost to fiscal spending.

Chart 1: UK Composite PMI & GDP

Weaker sterling has impacted UK CPI inflation. CPI inflation has continued moving upwards, with an annualised rate of 2.3% in February, exceeding both the Monetary Policy Committee’s (“MPC”) and markets’ expectations. Although this has increased expectations of a first rate hike since the global financial crisis given the uncertainty surrounding Brexit negotiations, it is unlikely that the MPC will move before 2018. This is despite CPI being above the MPC’s target of 2%, and an expectation that inflation will peak at 2.8% next year. Investors’ expectations of higher inflation have resulted in the rising cost of inflation protection over the last year, as shown by the increase in the UK five-year inflation breakeven rate to
3.1% currently. However, markets have become less concerned in recent weeks with rates falling from a peak of 3.6%.

**Chart 2: UK CPI**

Source: Bloomberg, 2017

**UK labour market remains resilient.** The UK labour market still does not appear to have been impacted by Brexit, due to the economy holding up better than anticipated. Unemployment is at its lowest level since 1975, although this may be affected by a slowdown in growth due to the increase in the inflation rate and Brexit uncertainty. Any changes to unemployment will take time to feed through.

**Despite higher inflation, UK consumers continue to spend.** The Brexit vote has not yet reduced UK consumer spending, with retail sales rising by 1.4% from January to February, significantly higher than consensus forecasts of 0.4%. This has pushed the annual growth rate up to 3.7% from 1.0% in January. Credit conditions and consumer confidence remain relatively strong, which supports the view that there will be a slowdown in consumer spending in 2017, rather than a collapse. Adjusted for inflation, household disposable incomes fell 0.4%, the most since early 2014. More worryingly, there was a fall in the Q4 2016 household savings ratio to 3.3% from 5.3% in the previous quarter.

**FINANCIAL MARKETS HOLD UP…**

Despite concerns about the impact of Brexit on financial markets and the increase in volatility in the immediate aftermath, UK financial markets continued to reflect the performance of global markets in Q1 2017.

**Currency volatility has continued, albeit less pronounced.** Sterling was the biggest loser in 2016, falling 16%, although Q1 2017 saw a 1.7% gain to 1.2550, the first rise since Q2 2015. Throughout the first quarter, it has traded in a relatively tight range, between 1.2050 and 1.2650. However, there is now more downside risk given that interest rate spreads are more US dollar favourable, and the UK continues to have an enormous current account deficit, despite it narrowing to 2.4% of GDP in Q4 2016.

**UK equities have performed well.** UK equities, as measured by the FTSE100 index, had a great year in 2016 with a total return of 19.2%. It continued this tremendous run in Q1 2017, rising by 3.7% and reaching an all-time high of 7,430 on 20 March, reflecting the strength in global equities in general. A weakened sterling has boosted UK corporate profits growth. Two-thirds of FTSE100 companies’ earnings comes from overseas which means that they are affected more by global rather than domestic issues.

**Fixed income securities well supported.** 10-year UK Government gilt yields ended the quarter at 1.15%, falling from 1.24% at the beginning of the year, and a peak of 1.51% at the end of January. Support has been provided by relatively upbeat growth expectations, as well as the government’s prudent fiscal policy keeping new bond issuance at a minimum. The UK 10-year bond spread over the US 10-year is close to a one year low which probably reflects the view that Brexit is a growth and inflation dampening event for the UK economy over the medium term.

**CHALLENGES IN 2017**

The UK economy has maintained positive momentum following the Brexit vote, although this appears to be slowing. Additionally concerns remain over the increasingly widening current account deficit, low household saving rates and a squeeze on real income as inflation begins to bite in 2017.
The hard work for Brexit has only just begun. It has taken nine months to reach this stage, and it is clear that there is a long way to go before any significant progress is made. As recent days have shown with the request for another Scottish independence referendum, the journey to Brexit day is going to be rather bumpy.

UK REAL ESTATE

The uncertainty caused by last year’s ‘Brexit’ vote continues to affect the UK commercial property market. Investment activity is subdued compared to 2015 and 2016 levels but is robust by historical standards albeit with a higher deal failure rate than usual as investors become increasingly nervous about future growth prospects. The continuing weakness of GBP has strongly encouraged overseas investors, particularly those from the Far East, but this ‘hot money’ combined with a general lack of supply may be artificially inflating investment activity in the short term. Certainly there is still too much money chasing too few available assets, particularly for Central London offices and ‘core’ properties with long-term income already in place. This continuing weight of money, now firmly spreading to the UK regions, has caused the market to surprise on the upside in Q1 2017.

Chart 1: Central London Office Investment Transactions Q1 2017

With seemingly no let-up in the demand for assets, UK commercial property continues to be almost universally expensive with yields approaching their pre-Global Financial Crisis lows. However, unpredictable and potentially waning occupational demand due to Brexit uncertainty means that investors are making a clear distinction between those properties that are already producing a steady income and those that are not. The latter looks increasingly vulnerable in the current environment and general risk aversion means that investor interest, and therefore pricing pressures, in these ‘transitional’ assets remains limited. Although there has only been a minor fall in capital values since July last year, we maintain that the UK commercial property market is due a low double digit price correction over the next 12-months. Alternative real estate is best placed to weather the storm with return and valuation drivers largely insulated from the uncertain economic and political environment.

Residential property in London is also facing certain headwinds. The luxury or ‘prime’ sections of the residential market continues to experience a correction under the twin burdens of higher taxes and lower demand due to Brexit uncertainty. Although the combination of falling prices and a weak GBP means that high-end residential seemingly represents good value, the possibility of further falls is causing hesitation which is holding back investment activity and thus prolonging the correction. There is no catalyst for change at present, certainly not during H1 2017, but prices may find a floor in the latter part of the year. By contrast, non-luxury or ‘mass market’ house prices in London, and indeed the rest of the UK, remain buoyant due to robust demand, limited supply and improving mortgage availability.

Chart 2: Price Growth in GBP of Select Prime Central London Residential Areas 12-mths to 28 Feb-17

Source: Knight Frank, 2017
UPCOMING EVENTS IN THE UK

April
- Grand National Meeting, Aintree 6th-8th April
- Rugby – Saracens Vs Harlequins, Wembley Stadium 8th April
- Tall Ships Event, Greenwich, 13th-16th April
- Queen Elisabeth II’s 91st Birthday, 21st April
- Virgin Money London Marathon, 23rd April
- Tour de Yorkshire, 28th-30th April
- Horse racing – Bet365 Gold Cup, 29th April

May
- Polo Season Begins 1 May (through to September)
- Badminton Horse Trials, Gloucestershire 3rd-7th May
- 2000 Guineas, Newmarket, 6th May
- RHS Chelsea Flower Show, Royal Hospital SW3, 23rd-27th May
- FA Cup Final, Wembley Stadium, 27th May
- Glyndebourne Festival, 20th-27th May
- PGA Championship, Wentworth, 23rd-28th May

June
- The Epsom Derby, 2nd-3rd June
- Queen Elizabeth II’s official birthday, Trooping of the Colour, Horse Guards Parade, 10th June
- Royal Academy Summer Exhibition, London 13th June -20th August
- British Tennis Championships, Queen’s Club, 19th-25th June
- Royal Ascot, 20th-24th June
- Henley Royal Regatta 28th June – 2nd July
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