BREXIT POLICY OUTLOOK A LITTLE CLEARER

It has now been more than six months since the UK voted to leave the European Union. In that time financial markets have suffered significant volatility, but not all to the downside. Prime Minister Theresa May has been criticised at home for her indecision on Brexit, but she has now finally announced her vision on Britain’s Brexit negotiating strategy. In brief, the prime minister has advocated a hard exit, clarifying that Britain will leave the single market and renegotiate its relationship with Europe, to re-take control of its immigration controls and free itself from European lawmakers. May will seek transitional arrangements, a nod to concerns expressed by businesses in the UK, and will want a customs arrangement with the EU, whilst still being able to negotiate its own trade deals. Importantly, both Houses of Parliament will be offered a vote on the final Brexit deal, which was welcomed by markets as the deal will have to be good for Britain to be voted through. Sterling jumped 2.5% whilst May was speaking, its best day since 2008. With Article 50 of the Lisbon Treaty due to be invoked by 31 March 2017, the Prime Minister has called for a “phased approach” to ensure “a smooth and orderly Brexit”. The hard work now begins for a country that still remains divided – there continues to be turmoil in the conservative camp, where Sir Ivan Rogers, the UK ambassador to the EU and key negotiator, resigned amid his criticism of the UK Government’s approach to Brexit.

POSITIVE ECONOMIC DATA SUPRISES...

In the absence of direct action by the government post the Brexit vote, Mark Carney, Governor of the Bank of England (“BoE”) and the Monetary Policy Committee (“MPC”), acted to support the UK economy by voting to reduce interest rates in early August and to expand Quantitative Easing (“QE”). This has continued to support the UK economy, with data continuing to surprise to the upside. Bloomberg GDP consensus forecasts have moved again, with 2016 growth remaining at 2.0%, whilst 2017 has been marginally upgraded to 1.2% from 1.0%.

UK PMI suggests growth is pointing to the upside. The latest composite PMI reading (with positive moves for UK Services, Construction and Manufacturing PMIs) indicates that the UK economy will deliver another positive growth surprise following the referendum, particularly thanks to the continuing strength of the British consumer.
UK labour market remains resilient. The UK labour market does not appear to have been impacted by the Brexit vote, due to the economy holding up better than had been anticipated. Growth however is likely to be slowed by an increase in inflation and uncertainty, and any changes to unemployment may take time to feed through.

UK consumers continue to spend. The Brexit vote has not reduced the UK consumer’s appetite for spending, accounting for nearly all Q3 2016 economic growth of 0.6%. November retail sales were particularly strong at an annualised rate of 6.6%. However, these figures could have been distorted by Black Friday, and have not yet been impacted by consumer confidence, which has rebounded since the Brexit vote. Higher prices in 2017 could be detrimental to spending (a view expressed by BoE Chief Economist Andy Haldane), which is also impacted by the outlook for the housing market.

UK consumers continue to borrow. Although mortgage approvals have disappointed relative to expectations, UK households have continued to have an appetite for credit, with levels rising consistently from the lows in 2009, to levels previously seen in 2005. If credit continues to flow into the real economy in 2017, this should offset a squeeze on incomes as inflation increases.

WHILST FINANCIAL MARKETS REACT TO BOTH…,

Despite concerns over the impact on financial markets during the Brexit referendum, returns have been mixed in 2016, and not necessarily as negative as many commentators envisaged immediately following Brexit.

Currency volatility has continued. Sterling was the biggest loser in 2016, as it fell 16%, initially falling by more than 11% against USD following the referendum. It has subsequently fallen by a further 9% to 1.2050 on 16 January 2017, its lowest closing level since 1985, as concerns over a hard Brexit rose.

Fixed income returns more pedestrian than previously experienced. Ten year UK government gilts have provided a total return of 2.9% in 2016, lower than investors have experienced over the last ten years. However, it should not be forgotten that this was despite S&P and Fitch cutting ratings immediately after the Brexit vote. UK government bond yields have shown significant volatility, falling to their lowest ever levels, with the 10 year yield falling from 1.37% on the day of the referendum to 0.52% in mid-August, recovering to 1.24% at the end of December.

Philip Hammond, the Chancellor of the Exchequer, did provide some clarity as well as fiscal support in his autumn statement on 23 November, in particular, abandoning the austerity measures of his predecessor, extending the timeline for a budget surplus to “as soon as practicable”, and increasing infrastructure spending.

CHALLENGES IN 2017

Upgrades to Q3 growth, and recent decent PMI data indicate the UK economy maintained positive momentum following the Brexit vote. However, 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.
UK REAL ESTATE – AFTER THE VOTE

Average commercial property yields in the UK are currently 5.2%\(^1\). By traditional measures of fair value, there remains a healthy spread between property and equivalent equity, corporate and government bond yields. However, this average is misleading and there is a stark contrast between ‘prime’ and ‘secondary’ properties and locations. The latter has suffered from a general aversion to risk which has left many secondary markets and properties in stagnation. Prime commercial property in most major cities is now considered to be almost universally expensive with prices and rents for the best real estate significantly in excess of their pre-financial crisis peaks. This was previously seen as the absolute ‘high water mark’ given the credit excesses of the early 2000s. In spite of headwinds from the UK vote to leave the European Union (the so-called “Brexit”) and question marks about the sustainability of occupational demand in a low growth environment there is still too much money chasing too few assets, particularly in a major international gateway city like London. The price of prime office properties here, a key indicator, are now 50%\(^2\) above their historical peaks with yields at all-time lows and rents at all-time highs. This is likely to be sustained in the near term by the continuing weight of investment capital and general lack of supply although both values and rents look increasingly vulnerable to downside shocks from Brexit disruptions.

Chart 1: UK Price Commercial Property Yields Dec-16 vs 10-Yr Range

Source: Cushman & Wakefield, CBRE, Strutt & Parker 2016

The Central London residential market has already started to experience a correction. A succession of UK tax reforms over the past few years have specifically targeted second home owners and buy-to-let investors, especially those with higher value properties of which Central London has the highest concentration. There have also been rising concerns about oversupply of new build luxury properties in certain sub-markets. On top of these factors, investor sentiment has been affected by the uncertainty generated by the Brexit vote. Although the next move in the high-end London residential market is certainly downwards, the subsequent fall in GBP may stimulate overseas buyers (c.50% of prime Central London purchasers\(^3\)) and stop a deep correction in market values like the -22% fall experienced between March 2008 and May 2009\(^4\).

Chart 2: Central London Office Price Index

Source: Real Capital Analytics / Moody’s, 2016

Chart 3: YTD 2016 Price Growth in GBP of Select Prime Central London Residential Areas

Source: Knight Frank, 2016

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\(^1\) As at November 2016. Source: MSCI 2016


\(^3\) Source: BPF, CBRE, 2014, Savills, 2015

\(^4\) Source: Knight Frank, 2016
UPCOMING EVENTS IN THE UK

- London Boat Show - 7-16 Jan
- Salmon fishing season starts in Scotland - 11 Jan
- Salmon fishing season starts in England – 15 Jan
- Shooting season comes to a close with the end of the pheasant and partridge seasons – 1 Feb
- RBS Six Nations Rugby Internationals begin 4-Feb – 18 Mar
- RHS Early Spring Plant Fair, London – 14-15 Feb
- Crufts Dog Show NEC Birmingham – 9-12 Mar
- Grand Military Gold Cup, Sandown Racecourse, Surrey – 10 Mar
- National Hunt Festival, Cheltenham Racecourse – 14-17 Mar
- RBS Six Nations Rugby Internationals continue (Mar 12)
- Shire Horse Show, Stafford – 18-20 Mar
- Trout fishing season starts in England – 15 Mar
- Brown trout fishing season begins in Scotland – 15 Mar
- St. Patrick’s Day – 17 Mar
- BADA Antiques And Fine Arts Fair, London – 15-21 Mar
- British summer time begins – 26 Mar
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