AllianzGI's House View on Brexit

March 2017

The UK's triggering of Article 50 on 29th March is like firing the starting pistol on the process of leaving the EU – but this race will be slow and tortuous, with many dangers along the way. Here is our view on what investors should expect and how they should prepare.

Key takeaways

- After eight months of the UK establishing its negotiating position, the imminent triggering of Article 50 will mark the beginning of Brexit negotiations
- As time passes, awareness is rising about the sheer complexity of the issues that must be addressed
- The complexity of the Brexit undertaking will require tenacity and a technocratic attention to detail, which is at odds with some of the populist rhetoric and political expediency on show
- We expect negotiations to take at least two years, with reasonable scope for accidents along the way
- Election outcomes in the EU may change the tone and context of the discussions – for better or worse
- If negotiations sour, undervalued sterling could move lower, spurring foreign purchases of discounted UK assets; firms with large UK exposure could suffer, but active strategies can capitalize on undue weakness

Introduction

In the immediate aftermath of the UK electorate's decision on 23 June 2016 to leave the European Union, Allianz Global Investors shared its House View on some of the implications of this landmark plebiscite. With the UK now readying itself to trigger Article 50 of the Lisbon Treaty, and thereby begin exit negotiations with the EU and its members, it is time to review how events have unfolded in the past eight months and offer our updated view on currencies, politics and economics, as well as implications for investors.

Currencies

As we and most others anticipated, the most immediate and pronounced effect of the referendum's outcome was on the value of the British pound sterling, which dropped by around 13.2 per cent against the dollar and 10.7 per cent against euro in the weeks following 23 June 2016. The currency was further dampened on two additional occasions:

- in August, when the Bank of England further loosened monetary policy to cushion the UK economy from economic shocks that had not yet materialized; and
- in October, when it became apparent that the UK government was unlikely to prioritize continued membership of the EU single market in its negotiations – all but ensuring that Brexit would be a "hard" one.

While sterling's fall was pronounced and immediate, the consequences of this devaluation are not yet fully apparent. Thanks to the benefits of currency hedging and differences in product life cycles, the full inflationary effects of the pound's devaluation are just now starting to materialize. Indeed, we expect to see UK inflation rise uncomfortably for consumers, especially as we expect the BOE to continue to err on the side of monetary stimulus at the expense of its inflation-targeting mandate.

Sterling is undervalued on a longer-term fundamental basis, which would suggest that much of the UK-specific Brexit-related uncertainty is priced in. Nevertheless, we would not be surprised to see further bouts of weakness in sterling during exit negotiations, which in turn may attract global investors looking to acquire UK assets at discount prices.

The euro also is relatively unloved and undervalued, but there is little chance it will appreciate much as the European Central Bank continues its quantitative-easing programme, and as uncertainty lingers about the outcomes of upcoming elections in France and Germany – and possibly Italy. However, from a fundamental perspective, the euro is well-supported by current economic growth and by the huge current account surpluses it is running, especially from Germany.

While the ECB will tread very carefully and be wary of actions that could further destabilize its banks, its monetary policy may be more difficult to balance than the BOE's. If the ECB begins to rein in its bond purchases later this year, it will be done while confronting potential redenomination risks, euro-zone banking-solvency threats and perennial problems such as Greece's debt sustainability.

Economics

The long-term economic impact of Brexit will depend on what type of new UK-EU relationship is established in the forthcoming negotiations.

On the surface, and for now, the UK economy is holding up much better than many had feared. In part, this can be explained by the palliative effects of its currency devaluation, an accommodative central bank and a more benign global economic climate. But a more significant factor may be that many UK companies are waiting for clarity on the shape of future relations before making investment and relocation decisions.

Whereas the BOE has been criticized for over-reacting to the systemic and economic threats to the UK posed by Brexit, the UK government has maintained a "wait-and-see" approach to fiscal stimulus (though it has conceded the inevitable: the government knows it must rein in its deficit-reduction ambitions).

Just because the UK has averted the economic shock some had predicted, it would be naïve to assume that the costs in absolute and lost-opportunity terms will not weigh on its economic prospects. At some stage in the Brexit process – as corporations, consumers and investors all hold back to see what emerges – economic pressure will mount. The stock market offers a glimpse into the pricing of these prospects: While equites around the world have risen notably in recent months, the UK stock market is, in dollar terms, still below its pre-referendum level. Our pre-referendum expectations of a Brexit-related drag of around 5 per cent of UK GDP over a five- to ten-year period remains in place – though this will naturally be subject to the outcome of Brexit negotiations.

As these negotiations unfold, the EU – and especially some of its members, sectors and industries – will also face some degree of economic uncertainty associated with Brexit's impact. The UK is a particularly important export market for EU producers of autos, food, wine and clothing, even if at a macro level the UK exports a larger proportion of its output to the rest of the EU than the other way around.

The potential distraction of Brexit negotiations and its political populist imitators could also put a brake on structural reforms that could increase confidence in the European bloc and its single currency. The effects of this may become more apparent if some of the current economic tailwinds start to subside. Indeed, depending on the degree to which the EU muddles through instead of enacting meaningful reforms, and depending on the outcome of the upcoming elections, the EU could find itself once again using austerity measures at some point in 2018.

Politics

The outcome of Brexit – and what it will mean for economic growth prospects, asset valuations and investments – hinges on politics. Here, there are many scenarios to ponder.

The political events of 2016 seem to be challenging the core tenets of the so-called "Davos Consensus", which holds that established democracies will prioritize globalization and economic growth, recognize the logic of the market and accept that the benefits of trade are not zero-sum.

Indeed, the position that UK Prime Minister Theresa May set out in January makes explicit that issues of control over immigration and sovereignty will take precedence over membership in the EU's single market. At the same time, the EU establishment has spoken with one voice in defence of the freedom-of-movement principle, even if it ends up being the only thing standing in the way of the UK remaining a member of its single market.

These conflicts will be put to the test in Europe again and again during 2017, with general elections in the Netherlands in March, in France in April and May, in Germany in September and in Italy at any time between June and early 2018. In these and other countries, we are seeing a rise in national populism that rails against current levels of immigration and treats free-trade agreements with increasing suspicion. While we think it is more probable that the more destructive parties will be kept from power, some of their policies or rhetoric may be taken up by more mainstream politicians.

So far, the UK government looks relatively stable, despite its wafer-thin parliamentary majority. It has been able to address the anti-EU right wing of its own party without fear of being challenged by the most divided and ineffectual opposition in the UK in a generation. How this holds up throughout the Brexit negotiations will be worth paying close attention to in the coming two years.

The prospect of a second referendum on Scottish independence represents another source of potential political instability within the UK. While Scotland's economic prospects on a standalone basis look far shakier today than they did in 2014 – when Scotland voted to stay part of the UK – unionists will find it far harder to play the same "economic rationality" argument the next time around.

The situation in Ireland is also thorny. While the UK government wants to maintain an open border between Northern Ireland and the Republic of Ireland, this would likely create a hard border between Ireland and Great Britain, which could precipitate another constitutional challenge.

All this represents a complicated starting point to what will undoubtedly be one of the most complex negotiations in history. As well as establishing and agreeing to the terms of divorce from a 45-year marriage, the UK and EU will be attempting to establish a new association for which there are no real precedents.

Indeed, the first point of negotiation is likely to be the terms of negotiation, as there is an open question as to whether the UK/EU divorce and ensuing trading relationship should be negotiated in sequence or in tandem. Even if the discussions take place in tandem, it seems unlikely that they can be concluded within the two-year timeframe envisaged in Article 50. After all, even the departure of Greenland – with its GDP of USD 2.4 billion and its population of 56,000 – from the European Common Market in 1982 took three years to sort out. The UK's economy dwarfs Greenland's, and even a more fair comparison like Hong Kong doesn't bode well for a speedy Brexit negotiation: that required 13 years of negotiations before its ultimate handover from the UK to China.

A critical factor over the coming months, if not years, will be whether or not the EU and UK maintain a cordial approach and refrain as much as possible from damaging negative rhetoric. As negotiations proceed, this will be hard to do. So far, most of the noise has been heard around the UK's position, while the EU has stuck to very brief, controlled statements that have delivered a message along the lines of "our rules are known, and the ball is in the UK's court". Once Article 50 is triggered, and the proverbial ball comes the EU's way, that discipline may be harder to maintain.

In summary, triggering Article 50 moves Brexit closer to reality, but we should expect the ensuing journey to be long and torturous – with significant scope for accidents as politics sits in the driving seat and economics puts up roadblocks along the way.

Investment implications

Don't expect sterling to strengthen significantly any time soon, even if there isn't too much more downside from current levels. All asset markets currently seem to have priced in the Brexit news; however, we expect volatility as the negotiations get underway. The euro's biggest test in the coming months will come from national elections, but it may also be susceptible to weakness if the Brexit discussions reveal differences among member states.

Given the potential for the UK to leave the EU without transition arrangements or a new trade deal in place, investors would be wise to stay on the alert.

Be cautious of sectors and companies with significant exposures to the UK market

Consider more carefully the value chain of manufacturers or supplier – in particular their dependence on UK-EU trade and their scope to protect themselves from the risk of tariffs

Prepare for recognition of "equivalence" of standards and regulations to be strained by the negotiation process

Use actively managed investment strategies to benefit from any undue weakness in sterling by investing in attractive, longer-term UK assets or infrastructure