Outlook & Commentary

Conservative majority brings some certainty to the UK – for now

13/12/2019

Summary

Victory for Prime Minister Boris Johnson's Conservative party in the UK general election is likely to be welcomed by markets and potentially boosts prospects for the UK economy. It doesn't, however, end the Brexit uncertainty overnight – and the UK continues to be vulnerable to a late-cycle global environment.

Key takeaways

- The Conservative party's outright majority in the UK general election should signal a way forward on Brexit, restoring some confidence to UK markets
- As a result of the general election outcome, we expect the UK to leave the EU on 31 January 2020, although the UK's long-term relationship with the EU on trade and other matters remains unresolved
- The British pound sterling, which has gained 10 cents against the US dollar since August, surged immediately following the result, and should continue its recovery
- UK mid-cap stocks may be best positioned to benefit from a "relief rally" in markets, but the picture for large-caps is less clear given their higher proportion of overseas earnings
- Pent-up demand will drive UK recovery but it may prove difficult to sustain against a late-cycle global economy, and the possibility of the UK leaving the EU without a deal has not gone away entirely

The Conservative party's emphatic victory in the UK general election will likely bring an end to the parliamentary impasse on Brexit. This should reassure investors who have been spooked by Brexit uncertainty and the prospect of a Labour government.

Certainly, the near-term plan for Brexit is clearer now that the Conservatives have won an outright majority in Parliament. With Prime Minister Boris Johnson leading his party, his European Union (EU) withdrawal deal should get the green light – potentially even before Christmas.

This would likely pave the way for the UK to leave the EU on 31 January and allow both parties to start negotiating the terms of their future trading relationship. We also anticipate that the UK will move quickly to secure trade deals with Australia, New Zealand and others, and begin working towards a much-debated trade deal with the US.

However, it's possible that a satisfactory UK-EU trading relationship will not be negotiated before the transition period ends in December 2020. This so-called "no-deal" exit would likely proceed according to the World Trade Organization's terms. Clearly, many questions remain about the UK's future relationship with its largest trading partner, the EU. If trade friction increases, we expect to see an economic impact for both sides.

We expect sterling to rally further

Immediately before the election, the British pound sterling was trading at around USD 1.30. Following confirmation of the Conservative victory, the currency rallied by more than 2% against the dollar, achieving its highest rate since May 2018.

Sterling could strengthen further in the coming months if there is certainty around the timing and terms of a post-Brexit trade deal. Conversely, if a no-deal exit re-emerges as a possibility – however unlikely – this outcome could be priced back into rates and temper any recovery.

UK equities could see a "relief rally"

The release of pent-up demand from global investors – who previously stayed away from the UK due to uncertainty around Brexit – could represent another fillip for the UK economy.

We expect UK small- and mid-cap stocks to be the chief beneficiaries of this so-called "relief rally". Since Mr Johnson became prime minister in July, UK mid-caps have already outperformed their European counterparts by around 6%, and we think another 10% is possible.

While large-cap performance will be affected by stronger sterling – given that a higher proportion of these companies' revenues tend to be in overseas currencies – we think parts of the UK large-cap universe could bounce back, even if they do not lead markets. Banks, property, tobacco and pharmaceuticals may do well as these sectors appear cheaper than their international peers, with some companies offering high dividends.

Some investors will also be reassured by the defeat of Jeremy Corbyn's Labour party. Mr Corbyn's policy agenda had spooked markets with the prospect of increased corporate taxes and his proposed renationalisation of key utilities and the railways.

Could UK rates turn negative?

It is not yet clear what the election result will mean for UK interest rates. Mark Carney is due to step down as Bank of England governor in January, and the BoE's policy outlook will be shaped by his successor. We anticipate one rate cut during 2020. Three more rate cuts would put UK rates into negative territory – something Mr Carney always resisted – but the new governor may be more open to negative rates.

Long-term prospects for the UK

Overall, markets should welcome an election outcome that many regard as an end to uncertainty. While there is much to be resolved on Brexit – and the path of UK fiscal policy is still unclear – the foundations are set for an environment that could prove positive for sterling, good for equities and other risk assets, and neutral for UK government bonds.

It remains to be seen, however, how long this "halo effect" will last. The UK has traditionally been a defensive safe haven amid weak global fundamentals, and investors' attention may focus again on the UK as a place of stability. But it's impossible to ignore that the global economy remains late in the economic cycle, closer to recession than expansion, and this broadly negative global outlook makes a longer-term rally in the UK unlikely.

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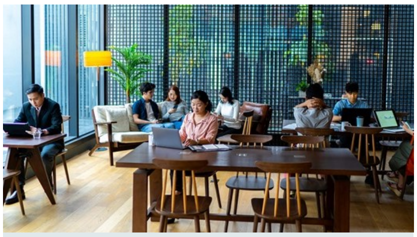

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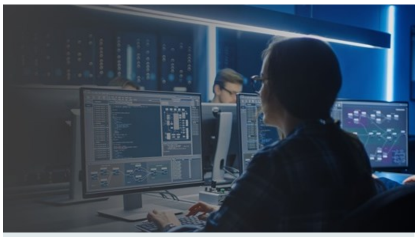

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by Neil Dwane | 16/01/2020

Summary

The financial markets are signalling that the situation in the Middle East won't get out of hand, but US-Iran friction could continue for some time. The defence industry and oil and gas-related sectors could remain well-supported, but overall we believe investors should be cautious yet patient. Look to higher-quality stocks with lower correlations to the broader market and "hunt for income" if headline volatility is a risk you wish to avoid.

Key takeaways

- Despite a slight cooling of tensions in the Middle East, there remains potential for further escalation in the region
- Oil prices have been relatively stable, but any further disruption in the Middle East will push them higher, acting as a headwind to global growth
- Investors should look to investing in higher quality stocks and bonds with lower correlation to markets

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