THE DRIVE YOU DEMAND

SPOTLIGHT: UK ELECTIONS

Political challenges continue

The disappointing outcome for UK Prime Minister Theresa May's Conservative Party suggests a fragile political backdrop as the British government enters negotiations about its exit from the European Union. We expect a weak British pound to shoulder much of the policy burden in cushioning the UK economy from Brexit. UK fixed-income investors should be cautious, given low real yields and tight corporate spreads. Although sterling-referenced equity investors may benefit from globally-exposed, large-cap UK equities, we continue to prefer continental European equities to their UK counterparts.

June 2017 | Global Investment Committee

UBP
Union Bancaire Privée

Key points

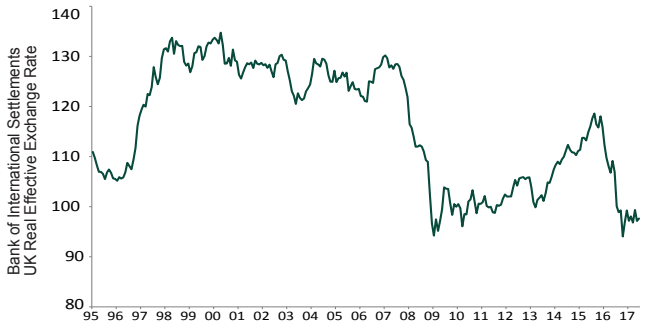
- *Even in coalition with the Democratic Unionist Party (DUP), the standing of the Conservative Party in Brexit negotiations will be challenged*
- *We expect sterling to shoulder a disproportionate share of the burden in helping the UK economy adjust to a post-Brexit world*
- *Low real interest rates and tight spreads suggest modest fixed-income returns for UK fixed-income investors*
- *Although UK equity investors should benefit from globally oriented, large-cap exposures, we continue to prefer continental European equities to UK corporates*

With only one seat left to declare in the UK general election, it has been confirmed that Theresa May's Conservative Party has lost its parliamentary majority. While a coalition with the Democratic Unionist Party (DUP) would be enough to keep the Conservatives in power, the apparent outcome of Thursday's election serves to weaken rather than strengthen the negotiating position of the UK government as they enter into Brexit talks with the European Union. Indeed, the chance of uncertain support from her own party, combined with the potential for a weak and unstable coalition, leaves open the prospect that the UK will be spending a sizeable part of the first year of Brexit negotiations in a state of political limbo.

With the UK's political engine sputtering, the chance of significant support for the UK economy to help ease the transition out of the European Union appears to be a growing headwind. While the US was able to turn to monetary policymakers for economic support during their period of political gridlock in the post-2008 era, the Bank of England today faces the unenviable challenge of high inflation and already negative policy against a backdrop of an external shock to growth (i.e. Brexit).

In light of this, we expect sterling to continue to shoulder a disproportionate share of the burden in helping the UK economy adjust in the coming years. Despite its rally from the June 2016 lows, the pound remains historically weak in real terms. However, just as was seen after the post-2008 shock (see chart hereafter), this period of weakness could persist for an extended period, thus allowing the domestic economy to transform itself to compete in the post-Brexit world.

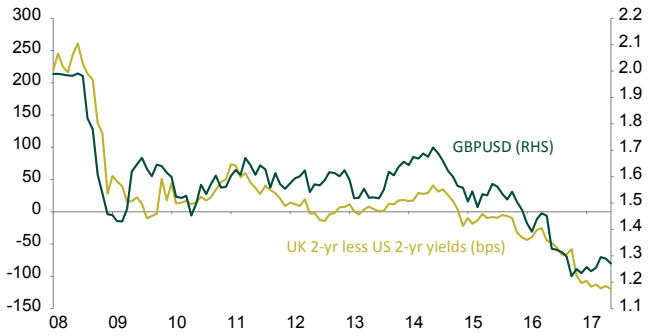
Sterling set to remain weak to help the UK economy adjust post-Brexit



Source: Bank of International Settlements

More tactically, sterling appears to be properly priced against the current interest rate backdrop, when compared with US rates (see chart hereafter). However, it is pricing in little in the way of risk premia should there be an unfavourable outcome to the Brexit negotiations and/or continued instability of political leadership in the UK. Should the UK currency seek to price risk premia in in a similar way to that seen in the wake of the Brexit referendum in June 2016 (even assuming little change in US or UK interest rates), risks to sterling could see it move towards 1.15-1.20 against the USD.

Sterling fails to price in UK political uncertainty

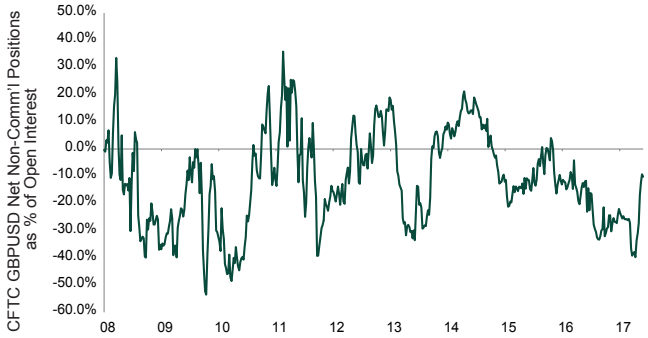


Source: Bloomberg Finance L.P.

More tactically, in the wake of Prime Minister May's announcement of the snap election in April 2017, sterling rallied sharply and, equally importantly, short positions in futures markets which had been near the multi-decade highs (see chart hereafter), closed rapidly to just shy of flat. As when looking at the UK currency through an interest rate differential lens, positioning suggests that investors are not overly well placed for the uncertainty and risk surrounding Brexit negotiations in the months ahead.

Indeed, options markets (risk reversals) were relatively well behaved in the hours following the election results being declared – unlike the period immediately after the Brexit referendum. Prices have only returned to the levels seen in April, when Theresa May called the election.

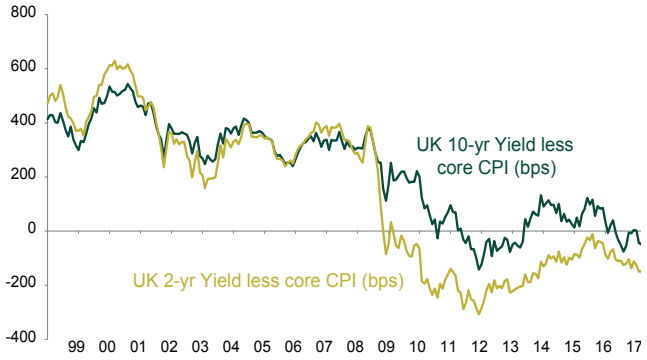
Speculators are no longer short on the British pound



Source: Bloomberg Finance L.P.

With real UK government bond yields already deeply negative and nearing levels last seen during the height of the eurozone crisis in 2011-2012 (see chart hereafter), we do not expect rallies in UK gilts to be sustained, given that UK inflation is already above its target range. With spreads already tight, sterling bond investors should be cautious about total return prospects, looking ahead.

Deeply negative real interest rates suggest fixed-income return expectations should be modest



Source: Bloomberg Finance L.P.

Though many might suspect that such political uncertainty would be an obstacle for UK equities, as seen in the post-Brexit-referendum period, the prospect of currency weakness should benefit UK large caps which generate substantial non-GBP revenue and earnings. In spite of this, we prefer continental European equities, where political risk has abated in recent months and where the strength and sustainability of economic growth appears to be more promising.

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

Norman Villamin
Chief Investment Officer (CIO)
Private Banking

norman.villamin@ubp.ch

Patrice Gautry
Chief Economist

patrice.gautry@ubp.ch

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1, Switzerland
ubp@ubp.com | www.ubp.com