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UBS Asset Management | Economic insights and asset class attractiveness

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Brexit: Are we there yet?

Highlights

– An historic weekend sitting of the UK parliament was expected to vote on and approve the deal that prime minister Boris Johnson had agreed with the European Union (EU) regarding the UK's withdrawal from the EU just two days earlier. Instead, UK Members of Parliament (MPs) voted to delay the decision.
– Importantly, the weekend vote is not a fundamental rejection of the deal that Johnson has negotiated and the delay request can be withdrawn if parliament subsequently approves the deal.
– Nonetheless, the mathematics of gaining parliamentary approval for the deal are challenging.
– A complex array of potential Brexit outcomes and a feverish political atmosphere in the UK have represented meaningful barriers to the efficient deployment of investor risk capital in UK assets.

The graffiti artist who memorably daubed "if you are not confused, you don't understand the situation" across a Belfast wall in the late 1970s, could not have expected his sardonic indictment of British and Irish politics to remain so relevant four decades later albeit in a different political context. The twists and turns of Brexit continue. An historic weekend sitting of the UK parliament was expected to vote on and approve the deal that prime minister Boris Johnson had agreed with the European Union (EU) regarding the UK's withdrawal from the EU just two days earlier. Instead, UK Members of Parliament (MPs) voted to delay the decision.

Under the terms of the controversial Benn Act, this delay forced Johnson to write to the European Council to ask for an extension to the current October 31 Brexit deadline until January 31. Johnson complied but did not sign the request. Instead he sent two accompanying letters outlining his strong opposition to any further delay to Brexit. Johnson's combative approach is likely to be subject to a legal challenge in the Scottish Courts in the coming days. And despite Johnson's opposition, EU leaders are likely to approve the UK's request in order to avoid a no-deal scenario. But they may help Johnson by running down the clock on granting that extension in order to put pressure on parliament.

Importantly, the weekend vote is not a fundamental rejection of the deal that Johnson has negotiated and the delay request can be withdrawn if parliament subsequently approves the deal. Johnson's government is therefore likely to bring his Withdrawal Agreement back to parliament for a vote in the coming days. Whether they do or not depends on a number of factors. These include whether MPs against Brexit formally propose material changes to Johnson's deal, such as remaining in the EU Customs Union or having a second referendum on EU membership. In these circumstances, the prime minister will likely abandon the vote in the short term and negotiate an extension, rather than risk the proposals being adopted.

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Either way, the mathematics of gaining parliamentary approval for the deal are challenging. Johnson's Conservative party does not have a majority of MPs. And in accepting a compromise solution for the complex issue of the Irish border that was acceptable to the EU, Johnson has alienated the Democratic Unionist Party (DUP) whose 10 MPs have previously voted with the government. Johnson has clearly gambled that he can persuade a sufficient number of Labour and independent MPs to support his deal to compensate for the DUP. But any vote is likely to be close and to depend on a handful of MPs.

Events of the past 48 hours are also likely to inspire Johnson to redouble his efforts to trigger a general election in order to achieve the parliamentary majority he currently lacks. Based on current polls, he will get it, but in the volatile world of British politics, that too is far from certain.

The bottom line

We do not believe that we are alone in generally steering clear of large active positions in UK risk assets in global multi asset portfolios for most of the period since June 2016's Referendum. A complex array of potential Brexit outcomes and a feverish political atmosphere in the UK have represented meaningful barriers to the efficient deployment of investor risk capital in UK assets.

But as we have drawn closer to the October 31 deadline, the risks have become more quantifiable and the investability of UK risk assets has improved sufficiently for us to consider what opportunities exist. In June we took the view that UK asset and forex prices were overly discounting the probability of a no-deal Brexit and introduced a long GBP position against the EUR. We also believed that there was materially greater upside in domestically-oriented UK stocks such as mid-cap housebuilders, financials and retailers relative to their international counterparts than there was downside in the case of a no-deal. We therefore introduced a tactical long in the more domestically-focused FTSE 250 midcap index against its large cap and more internationally exposed FTSE 100 counterpart at around the same time.

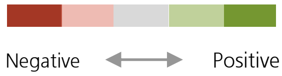
Finally, we believe there is likely to be upward pressure in most scenarios on nominal UK 10y gilt yields. Growth and inflation expectations are likely to rebound strongly if and when Johnson's Brexit deal passes parliament. In the unlikely event that the UK leaves the EU without a deal, we expect an aggressive fiscal expansion regardless of the outcome of any general election. We are therefore short UK duration in multi asset portfolios where gilts are a large part of the benchmark.

As ever with Brexit, the probabilities of various scenarios can change quickly and meaningfully. But our key takeaway of the most recent events is that the likelihood of no deal has reduced materially compared to earlier in the year. Since October 10, the upward spike in domestic UK equities, sterling and gilt yields likely reflect other investors repricing of no-deal risk. This has clearly been positive for all three trades, but the scale of the moves also reduces the scope for material further alpha and raises the question about what is now priced in relative to the risks. We will continue to monitor the risk/reward tradeoff carefully in the context of the Brexit news flow and each client's specific mandate.

At the margin, we believe that deal approval is also likely to be positive for UK and for European ex-UK equities in a relative context globally—with uncertainty over Brexit a driver of international investors' reluctance to invest in the region despite strong valuation attractions.

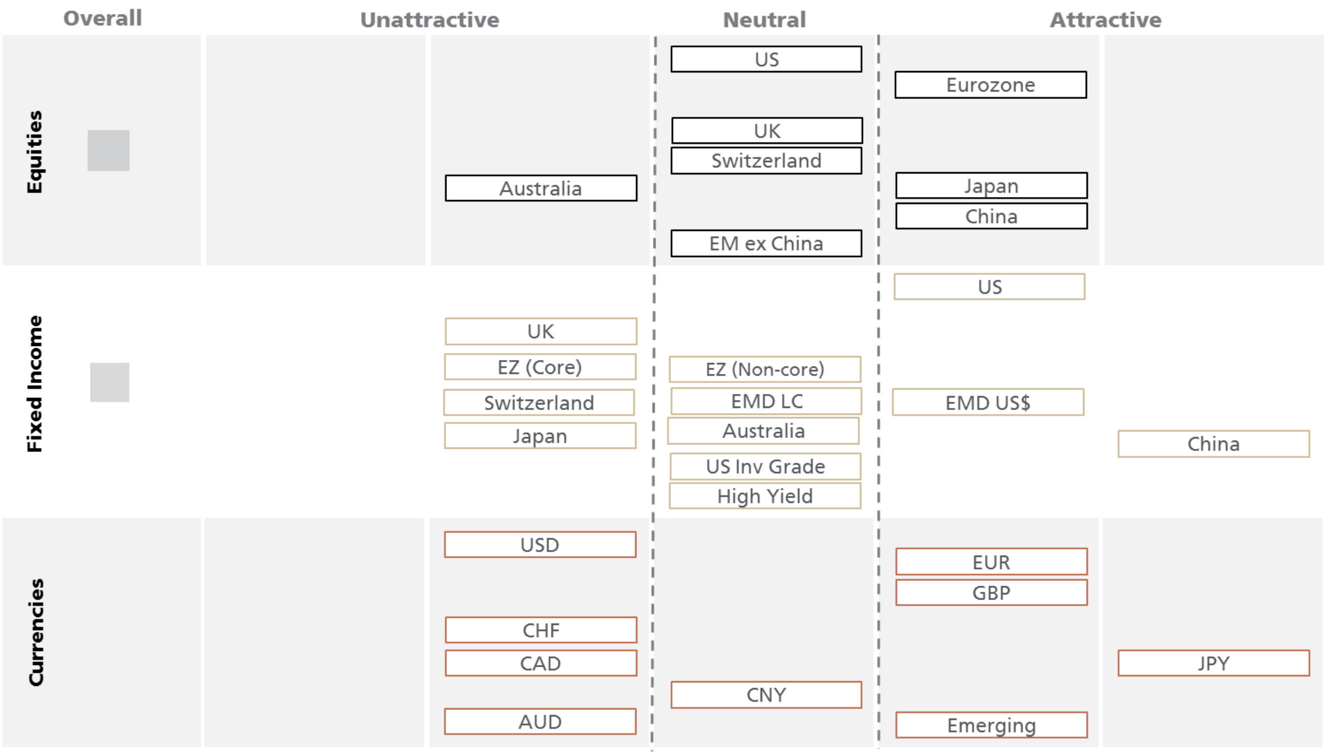
However, while uncertainty may be reducing it is not disappearing. The successful passing of the Withdrawal Agreement would represent a conclusion to only the first part of the Brexit process. What comes next are negotiations about exactly what kind of trading agreement the UK and EU will have going forward. The talks are likely to be protracted and complex.

The long first chapter appears close to an end, but the Brexit story is far from finished.



Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 18 October 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 18 October 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		– We maintain an overall neutral stance towards global equities after the sharp rebound in valuations year-to-date. On the positive side, we expect global growth to stabilize around its trend rate and do not anticipate a recession over the next 12 months. Meanwhile, monetary policymakers around the world have shifted to a clearly accommodative stance. Nevertheless, we see a lot of good news as priced in already, leaving the market vulnerable to surprises on trade policy, earnings expectations or less dovish tilts from central banks.
US Equities		– US equities benefit from a resilient domestic economy, a lower exposure to global growth factors compared to other major indices, and a more accommodative message from the Fed. However, we believe that the risk-reward compared to other markets has deteriorated as growth concerns begin to feed through to the US economy and risks to the technology sector as a result of geopolitics and regulation start to mount. US equities currently trade at a premium relative to other markets, suggesting they may underperform over coming quarters should global growth stabilize.
Ex-US Developed market Equities		– In Europe, recent economic data and business surveys have been disappointing but we expect the worst to be over and for data to start bottoming over the coming months. We expect European equities to anticipate this development. The European consumer remains resilient and services are holding up much better than in 2012. In September, the ECB delivered a comprehensive stimulus package which is growth supportive and the continued easing of central banks and governments around the world will likely put a bottom under the bleak external demand picture. This should gradually alleviate the main headwind to overall European demand growth. Furthermore, geopolitical headwinds have somewhat diminished in the region with Italy in a coalition government and the UK seemingly approaching a delayed Brexit deal. – We remain constructive on Japanese equities. There is clear valuation support. Meanwhile, fiscal measures taking effect in the aftermath of the tax hike should soften the spending slowdown. Furthermore, Tokyo business investment is likely to accelerate as we move closer to the 2020 Summer Olympics in the city.
Emerging Markets (EM) Equities		– Emerging market equities have performed in line with developed markets recently despite an ongoing deterioration in EM earnings. The partial trade truce between the US and China will likely support sentiment a bit longer and the steady rise in Chinese social financing bodes well for EM growth in time. However, given the continued earnings headwinds, we don't think EM looks attractive enough to overweight.
China Equities		– We remain positive on China as policy measures continue to provide a cushion to the economy. On balance we do not expect any escalation to the trade standoff in the short term. But the issue remains a major risk to Chinese growth. Should the standoff start to impact Chinese demand more significantly, the Chinese authorities have shown themselves willing and able to provide additional monetary, fiscal and regulatory support to help smooth ongoing developments. Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a re-rating. International capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
Global Duration		– Global central banks have almost universally moved in the direction of accommodation this year, contributing to much lower bond yields. Moreover, ongoing US-China trade tensions amid a still vulnerable global economy have driven a flight to safety in sovereign bonds. We believe that these heightened risks will continue to weigh on sovereign bond yields, but as long as the economy does not turn, credit and EM should continue to perform.
US Bonds		– We still expect the Fed to deliver some further accommodation although perhaps not as much as is currently priced. Hence, our assessment of the short end of the US curve is neutral. The scarcity of positive yielding safe assets should continue to drive flows into US Treasuries, keeping term premiums significantly negative. In our view, the long end of the US has more room to rally than other safe assets.

Negative ⟷ Positive

Ex-US Developed-market Bonds	Moderately negative	– In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and BoJ have committed to low rates for some time, limiting the attractiveness of these markets. We find Italian BTPs attractive on diminished political risks. – Elsewhere we were more positive on Australian duration on a relative basis. However, a 150bp rally in Australian bond yields since November 2018 makes us neutral on the current rates.
US Investment Grade (IG) Corporate Debt	Neutral	– Given the significant proportion of global fixed income that now has a negative yield, we believe that US IG is more attractive in relative terms. We do not have a recession as our base case and therefore believe that demand for IG will remain strong. – That said, we acknowledge high levels of corporate debt and the potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin.
US High Yield Bonds	Neutral	– Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop and accommodative Fed, we do not expect a material pickup in US defaults in the near term.
Emerging Markets Debt US dollar Local currency	 Moderately positive Neutral	– Spreads on EM debt, both hard currency and local currency, relative to US Treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, this year both hard currency and local currency EM yields have rallied together with Treasuries. The valuation case for EM rates is now much weaker than it was, particularly for the EM local currency debt. On the other hand, EM hard currency debt spreads have been around 350bp this year while the average since 2010 is 330bp. In a low yield environment we see this as attractive.
Chinese Bonds	Positive	– Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. We believe that slowing economic growth and inclusions in global bond market indices should continue to push yields down during the next 3-12 months.
Currency		– The USD has been stubbornly strong, but we see the next big move as lower. The USD is overvalued on a real trade-weighted basis. Meanwhile, US economic growth is moderating and the Fed is easing. Over time, we anticipate economies outside of the US will stabilize and investment capital will seek out opportunities in those countries, sending the dollar weaker. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.

Source: UBS Asset Management. As of 18 October 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

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