Equity Research; Brexit “stabilisers” ahead

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

Report Date

22nd August 2019

Analyst

Ravi Lockyer MSc Llb ASCI

Collins Sarri Statham Investments Ltd

Key Risks to Price Target

Not applicable

Please note the risk warnings and disclaimers on the last page of this document.

“Brexit” “what if” scenarios in the run-up

With 31st October 2019 fast approaching we are compelled to conclude a “no-deal” Brexit is more likely than not. Why is this?

i) Lesson learned: Parliament is basically dysfunctional. The former PM failed three times to obtain parliamentary approval for the EU Withdrawal Bill. The new PM is unlikely to repeat any action that is dependent on a Parliamentary vote given the current 1 seat majority.

ii) EU unity. There is no sign of any shift in Brussel’s stance on the Irish backstop, the “divorce bill” or even UK demands for a renegotiation. The EU is open to changing the wording of the political declaration only. The UK remains hemmed in by its approach of appealing to heads of state, a method that has failed to undermine the EU’s chief negotiator Michel Barnier.

iii) Lack of time. The summer recess ends on the 2nd September 2019 providing little time for the requisite talks. A cross-party group of c.100 MPs has urged the PM to recall Parliament and let it sit until the UK leaves the EU. However the PM rejected this course of action on 20th August.

iv) PM Boris Johnson’s repeated “do or die” commitment to the 31st October implies the default is his preferred option. The new PM is aware that his 1 seat majority is unsustainable and there will need to be a General Election very soon – his task is to get past Brexit and to that election before a no-confidence vote.

v) Lack of good alternatives? a) another time extension (boosting the Brexit party and wrecking Johnson’s credibility) b) revoking Article 50 (no mandate for this) c) a Brexit “deal” – still possible but unlikely given the UK’s pre-conditions on the Irish backstop.

Johnson handouts effectively end austerity

The new government has embarked on high publicity spending commitments and making grandiose tax cut promises. These variously include:-

*Brexit “No Deal” preparations, border & customs, medical supplies, supporting UK nationals in EU: c.£2.1bn

*NHS £1.8bn cash injection (c. £1bn immediately available)

*Hiring 20k new police officers by 2022 - c. £1.1bn

*Creating 10k new prison places in England & Wales – c. £2.5bn- £2.8bn

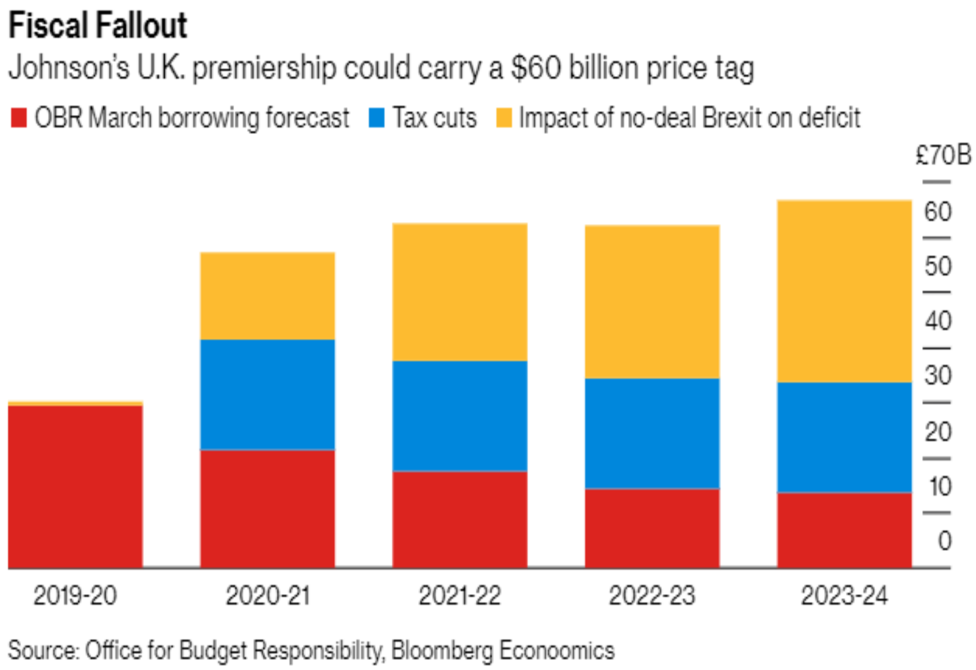
*"Level up" per pupil funding to at least £5,000 and reversing previous school spending cuts c. £4.65bn

*Full Fibre Rollout – the rollout of full fibre optic cable replacing the copper "trunk" network is estimated to cost c. £30bn though it is not clear the level of contribution from the private sector.

*Raise the higher income tax (40%) band from £50k to £80k – c. £10bn p.a.

*Cutting corporation tax from 19% in 2019 to 17% in 2020 – c. £6.2bn cost.

If delivered, these measures amount to a stimulus package of tax cuts and spending increases. All of these items might not get to the final cut, but we believe Johnson will lift government spending as part of a re-election campaign.



UK debt to GDP (ex. BoE's debt holdings) stood at 74.1% of GDP in July 2019. The UK budget deficit fell to £23.6bn in FY19 but will hit £29.3bn in FY20 due to Brexit. We see Johnson as a spender with little incentive for budget restraint.

UK monetary stimulus also likely

The decline in 10YR gilt yields over 2019 (1.3% to 0.47%) and in 2 year yields (0.42%) suggest a rate cut soon. A cut in Base rate to 0.5% in 2019 is likely.

source: www.fixedincomeinvestments.com

An expected 0.25% reduction in the base rate will boost the UK consumer in Q3/Q4 2019 and cushion a "no deal" Brexit and/or combat a trend towards slowing GDP (-0.2%).

But whether a base rate cut helps capital markets is moot. The main critique of the 2019 monetary easing cycle is that rate cuts are far less effective and will achieve a fraction of the 2008/ 2009 impact. Central bank easing is a blunt tool that carries the full gamut of disproportionate impacts and societal problems. These are better understood than in 2008/ 2009.

In 2019/ 2020, central banks must guard against increasing the stock of negative yield government debt (c.$15trn), which is deflationary, reduces investment returns and represents a time bomb for the banking sector. It is a likely cause of the next crisis. If the response to slowing GDP growth is conventional rate cuts, then can only be employed very sparingly.

Four countries, Denmark, Germany, Netherlands and Finland have negative government bond yields across the yield curve spectrum. The extreme pricing of bonds brings the risk of a crisis when the trend reverses. Central banks might have to reverse QE i.e. turn sellers of their debt for yield curve normalization.

We conclude UK markets are largely pricing in both lower rates and a bad "no deal" Brexit

The August global re-pricing – a reaction to evidence of slowing GDP growth, the ongoing Sino-US trade dispute, and disappointing Federal Reserve monetary guidance was hard on UK/ EU capital markets with July peak to August trough losses (-8.1%/ - 11%) underperforming global (-6%)and US indices (-6.8%).

Index	July 2019 peak	August 2019 trough	1MTH **Δ** (%)
US30	27,349.19	25,479.62	-6.8

US500	3,025.86	2,844.74	-6.0
UK100	7,686.61	7,067.01	-8.1
UK250	20,849.24	18,565.71	-11.0
DAX30	12,629.90	11,412.67	-9.6
CAC40	5,618.16	5,236.93	-6.8
Nikkei	21,756.55	20,405.65	-6.2
Hang Seng	28,594.30	25,281.30	-11.6
World Index	530.48	498.63	-6.0

In the re-pricing, investors ignored the higher chance of lower rates and no deal Brexit. The PM has increased the conviction that October 31st 2019 is firm and increased "no-deal" odds to c. 13/10 (www.oddschecker.com).

We see a hard Brexit as c.50% priced in with c. 1.5%-2.5% downside if it occurs. "No deal" is one of a host of risks, some with a greater downside magnitude (i.e. change of government). A UK rally is possible if i) global equities bounce or ii) a EU deal materializes that preserves UK/EU free trade or iii) Sino-US trade deal.

If the government survives, a hard Brexit followed by a General Election is the likely trajectory with a soft Brexit followed by a General Election a lower probability. H2 2019 will be eventful but is starting with low expectations, usually a good thing.

Collins Sarri Statham Investments Ltd

ANALYST CERTIFICATION:

The report's author certifies that this research report accurately states his personal views about the subject securities, which is reflected in the ratings as well as the substance of the reports.

RECOMMENDATIONS:

Collins Sarri Statham Investments Ltd (CSS) does not in any of its publications take into account any particular recipient's investment objectives, financial situation, and specific needs and demands. Therefore, all CSS publications are, unless otherwise specifically stated, intended for informational and/or marketing purposes only.CSS shall not be responsible for any loss arising from any investment based on a perceived recommendation.

No publication (including recommendations) shall be construed as a representation or warranty that the recipient will profit, nor avoid sustaining losses, from trading in accordance with a trading strategy set forth in a publication.

This research is non-independent and is classified as a Marketing Communication under FCA rules detailed in their Conduct of Business Rulebook (COBS). As such it has not been prepared in accordance with legal requirements designed to promote independence of investment research and it is not subject to the prohibition of dealing ahead of the dissemination of investment research outlined in COBS 12.2.18.

RISK WARNING:

Trading in the products and services offered by Collins Sarri Statham Investments Ltd (CSS) may, result in losses as well as profits as the value of investments may go down as well as up. You may not get back the full amount you have invested. Any reference to past performance should not be viewed as an indication of any future performance. Investments held in overseas markets are subject to the effects of changes in exchange rates which will impact on the value of the underlying investment. Leveraged products such as Contracts for Difference (CFDs), derivatives, commodities & Foreign Exchange (FX), carry a higher risk to your capital. They can lose their value rapidly and you may lose substantially more than your initial investment.

SPECULATIVE TRADING IS NOT SUITABLE FOR ALL INVESTORS.

The information contained herein is based on materials and sources that we believe to be reliable however we make no representation or warranty, either express or implied, in relation to the accuracy, completeness or reliability of the information contained herein. Please note that the figures shown may, in some instances, be rounded to the nearest penny. Prices can move sharply from those quoted in this document. Current prices can be verified by calling one of our brokers. CSS is under no obligation to update the information contained herein. Neither CSS, nor its affiliates, nor its employees shall have any liability whatsoever for any indirect or consequential loss or damage arising from the use of this document.