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Equity markets after Brexit

An M&G Investments institutional briefing

July 2016

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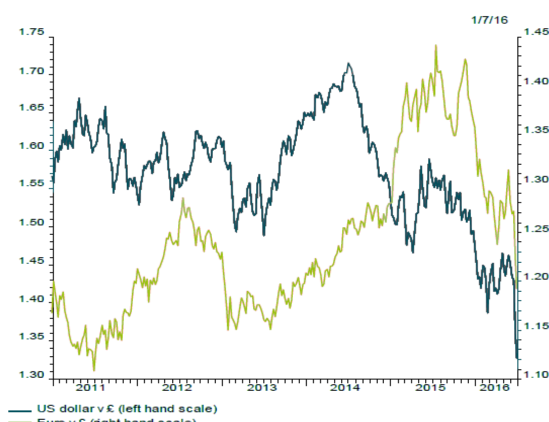
Sentiment in financial markets is expected to be driven by political events in the coming months following the shock UK referendum outcome in favour of Brexit. In equity markets, huge divergences in share price movements are creating numerous investment opportunities for stock-pickers such as M&G that can offer attractive valuations for investors willing to take on equity risk.

Global financial markets have been dominated by the largely unexpected result of the UK's EU referendum. The surprise vote to leave the EU sent equity markets into a tailspin as investors grappled with the implications, with an immediate sell-off in those stocks with revenue exposure to the UK and Europe. US equities also fell sharply on the news, but have since pared back the losses to stay in the black for the year-to-date (8 July), while Asia excluding Japan equities suffered minimal impact from the fallout.

Risk-off sentiment has fuelled a flight to 'safe haven' assets



Source: Datastream

Volatility also spiked following the vote as investors rushed to defensive 'safe havens'. The biggest movements occurred in currency markets, where the Pound fell versus the US Dollar to lows not seen since 1985. Sterling subsequently staged a comeback in response to broader market recovery, only to slump back close to 31-year lows on 7 July.

The winners in this risk-off environment have been the safe-haven Japanese Yen and the US Dollar. The Yen rallied on the back of fund flows into the currency, despite a material risk of intervention from the Bank of Japan and the strong possibility of further easing later in July.

In commodities, oil and gold have been the strongest performers. The oil price has benefited from continued improvement in the balance of supply and demand and was resilient in the immediate aftermath of the Brexit vote. It appears oil - and indeed energy more broadly - has been viewed as defensive in the current environment.

Brexit has ignited a period of uncertainty and triggered high risk aversion in stock markets, particularly among UK corporates and banks. The UK’s mid-cap and small-cap stocks were the most vulnerable to the outcome, with the FTSE 250 and the FTSE Small Cap indices both battered in the sell-off. In fact, over half of the underperformance of UK indices in the year to date came in the last week of June following the EU vote.

At a global sector level, financials and consumer discretionary were the weakest sectors over the first half of the year and again, the Brexit effect accounted for half of that. In June, the more defensive sectors - utilities and telcos - were the winners. The rush towards less risky assets was also reflected in style performance, with value largely underperforming and quality back in favour.

Meanwhile, banking stocks continue to suffer, along with property and insurance companies, general retailers and travel and leisure stocks.

In focus: UK banks

Banking stocks have come under pressure since the vote on 23 June as investors have fretted about the likely impact of Brexit on interest rates, economic growth and access to the European market – all of which can affect banks' earnings. Banks are already experiencing challenges in the current low interest rate environment, which means mortgage rates are low and they cannot make money from depositors. Brexit heightens the risk of further rate cuts in the UK – negative for the banking sector.

Equally, a weaker economic outlook with higher recession risk could result in an increase in provisions against bad loans. Finally, there is greater uncertainty over the banks' likely outcome regarding passporting rules and trade agreements after Article 50 is invoked – although feedback from bank managements is that they are comfortable with their exposure to Europe and believe they have good enough links with the EU to cope with Brexit.

Read our global banks analyst Ed Booth's blog, **'Brexit pressure weighs on UK banks'**, on *The Equities Forum* . http://www.equitiesforum.com/

Brexit risk varies across the market-cap spectrum

What could Brexit mean for UK shares? Although all indices dropped sharply immediately after the referendum result, the FTSE 100 rebounded quickly. Companies in the index earn the majority of their revenues overseas - many in US dollars - have benefited from the sharp fall in sterling. More broadly, at a sector level, pharma and energy are the most defensive sectors when gilt yields are low and PMIs and sterling weaken.

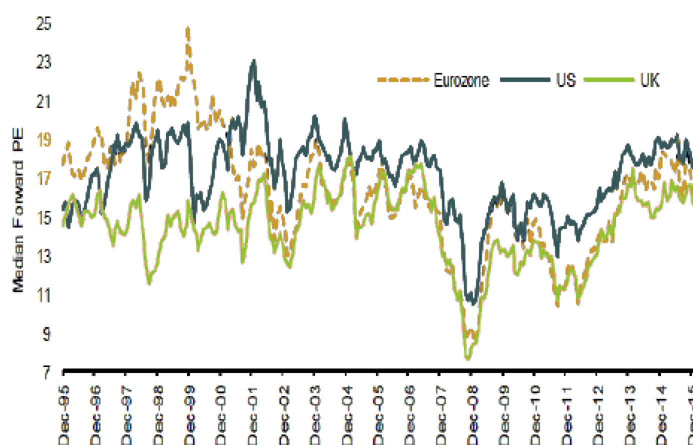
On the other hand, mid- and small-cap stocks tend to underperform as PMI or sterling fall. They have triple the domestic exposure of large-caps and greater cyclical exposure.

But while mid- and small-cap indices were battered hard in the Brexit storm, not all companies in these indices are domestically focused. Many have international earnings and a global client base. They have good financials and sound business models. The importance of good stock picking in those segments can therefore not be underestimated.

The outlook

So what is the outlook for UK equities more broadly in the short term? The recent weakness in performance means that while not cheap, the average UK stock is certainly less expensive than it was and against US equities in particular.

Median P/E ratios for the eurozone, UK and US



Source: SG Cross Asset Research 1 July 2016

In the short term, EPS momentum should be supported by positive currency translation effects. Given this, and the fact that US EPS momentum is deteriorating quite rapidly, UK equities on a selective basis are now a more attractive proposition for overseas investors than they were.

This could also prompt a rise in merger and acquisition activity from foreign buyers as cheaper valuations coupled with a weaker sterling make UK companies more attractive.

The one thing we can be certain of is that there will be continued uncertainty in the months to come. Now is the time for calm heads to prevail over knee-jerk reactions. For long-term investors, the current volatility can present selective opportunities for those willing to take advantage of attractive valuations.

In focus: Housebuilders

Although UK housebuilders have (as of 8 July) staged a recovery from their 30% fall in the week after the referendum, they remain under pressure from concerns over potential house price deflation and declines in house sale volumes. However, this is a different property cycle to 2007-08: land prices have been much more reasonable, housebuilders are much more returns-focused rather than relying on rising house prices, and there has not been a drive to bid-up land. To put the recent setback in context, the housebuilders' index had risen by around 800% from its 2008 trough to just before the Brexit result announcement.

What's more, a number of structural drivers are in place to protect against negative outcomes from Brexit including buy-to-let, record low mortgage rates incentivising people to own houses, and housebuilding falling short of the government's target to build 200,000 houses a year. In addition, housebuilders now generally hold large land banks and the majority are operating with a net cash position, rather than the significant leverage they used in the past, while home affordability is at mid-cycle levels and not the highs of 2007.

For further analysis, see the blog by our global industrials analyst Chris Youl**, 'This time it might be different for UK homebuilders'**, on *The Equities Forum*.

About the author

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Ritu Vohora joined M&G in May 2005. She has worked in M&G Equities for the past seven years and currently heads up client communications on Portfolio Construction and Risk and markets, focusing on the analysis and interpretation of portfolio construction, investment risk, and positioning of equity funds for clients and fund managers.

Ritu graduated from Warwick Business School with a BSc (honours) degree in accounting and finance in 2003 and subsequently gained an MSc in management and regulation of risk at the London School of Economics in 2004.

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