Despite Brexit...
Can UK Equities and Bonds Have a Great 2018?

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"Public sentiment is everything. With public sentiment, nothing can fail. Without it, nothing can succeed" Abraham Lincoln

No matter what your starting point, if you are thinking or talking about the British economy or prospects for the UK financial markets, it does not take long for the issue of Brexit to come up. There are multifarious influences on any economy or financial market but, unsurprisingly for a deeply internationally integrated country like the UK, the status of trade legislation and diplomacy with its geographically most proximate - and integrated - economic ally materially matters.

The Brexit word was never far from the lips of commentators appraising the latest economic projections for the UK economy, released by the Office for Budgetary Responsibility in late November. Muted growth, a shabby progression in productivity gains and a persistent budget deficit were all at least associated with the Brexit debate and the economic reality impact of the ongoing negotiations on consumer and business confidence and decision-making.

However, the UK's most-quoted stock market index ended 2017 at an all-time high and, while interest rates did edge up near the end of the year for the first time in a decade, borrowing costs - and gilt yields - remain strikingly low. UK investors in both asset classes had a reason to raise a toast to the gods of the financial markets during the festive season.

So what comes next? Well, in terms of the Brexit debate, 2018 is going to be an important year as 2017's preliminary discussions shift to a second and more detailed phase with an aim to have a sufficiently outlined deal by October, to allow ratification by any Parliament that wishes to do this before the end of the decade. However, timetables are starting to become blurred, with at least a 'transitional arrangement' period of eighteen months after the end of March 2019 sanctioned by European Union negotiators to allow legislation, required changes and preparations to be finalised. Fear then of a sharp 'cliff edge' in trade legislation, which could cause widespread economic disruption early next year, have abated.

> Hope of less short-term economic uncertainty has the potential to buoy sectors and companies which are more UK or pan-European oriented

The best gauge for this improving tone has been the rising value of the Pound during the last year against international peers such as the Dollar and the Yen. A rising Pound always has the potential to shift preferences within a stock market such as the UK where a significant proportion of corporate revenues and earnings are generated internationally, and this could well occur in 2018. Hope of less short-term economic uncertainty - even if the UK's economic performance remains relatively dull - has the potential to buoy sectors and companies which are more UK or pan-European oriented, versus even more internationally focused areas which have tended to outperform in the last couple of years. This correctly should be viewed as opportunistic for UK stock market investors - especially those who are prepared to pick and choose their investments. The current very low level of positive sentiment generally reported in global investor surveys towards the UK equity market only adds to this potential.

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Bond investors have some different headwinds. Many equities are still offering a pick-up yield premium versus even medium or longer duration bonds, and any notion of an improving backdrop due to less Brexit uncertainty is likely to encourage further shifts into equities. However, there appears to be little justification at the moment for radical shifts in either Bank of England stimulus or interest rate policy, meaning that bond markets - where yields are already very low versus historical norms - are likely to be dull at best.

So while active equity stockpickers should have reason to hope that Brexit compromises can lead to opportunities, much rests on the hard-to-measure tone of the ongoing discussions between the UK government and the European Union. Brexit is not everything but it will continue to matter for the UK financial markets in 2018.

KEY TAKEAWAYS:

- Brexit timetables are starting to become blurred
- Low levels of positive sentiment towards the UK equity market means there is potential
- Bond markets are likely to be dull at best
- Much rests on the hard-to-measure tone of the ongoing Brexit discussions

The Brexit Year Ahead

January **Transition talks start** **29** Meeting of EU affairs ministers to sign off start of talks	**February** **23 Summit**	**March** **Trade talks start** **22-23 Summit**	**April**
May **17 Summit**	**June** **28-29 Summit**	**July**	**August**
September **20-3 Oct** **Conservative party conference**	**October** An outline deal is to be wrapped up to give EU parliament time to ratify **18-19 Summit**	**November**	**December** **13-14 Summit**

Source: Bloomberg

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