

UK: New Prime Minister, But Old Problems Still Loom Large

- **New UK Prime Minister.** Boris Johnson takes over from Theresa May today as UK PM.
- **Strong party mandate.** With two-thirds of Conservative members backing him over rival Jeremy Hunt, Mr Johnson has a convincing mandate from his party for personnel changes and a new approach to Brexit.
- **Weak parliamentary hand.** The new PM inherits a parliamentary working majority of only two MPs.
- **Little room for manoeuvre.** The UK parliament is opposed to leaving the European Union EU on 31 October without a deal.
- **Successful Brexit deal renegotiation challenging.** We see a high probability that the new PM won't reach agreement with the EU to reset the terms of an orderly Brexit.
- **Autumn general election risk.** If the EU cannot be successfully renegotiated and the UK parliament blocks leaving without a deal, a UK general election becomes likely.
- **Electoral uncertainty.** Given the polarization and fragmentation over Brexit, the result of any election could hinge on whether PM Johnson can secure support from the hardline anti-EU Brexit Party.
- **Economy weakening.** Cyclical pressures could be exacerbated by a 'no deal exit' and by weakening confidence due to ongoing domestic political uncertainty.
- **Stay cautious for now.** The risks of a 'no deal' Brexit and of a Labour-led coalition winning a UK general election are likely to restrain UK assets this summer. We also highlight three developments that could lead to early upside surprise.
 - **Selective short-term opportunities only.** While UK currency and equities are inexpensive, reflecting political uncertainty, we see only selective equity opportunities for the moment.
 - **Wait until the outlook becomes clearer.** We think the UK leaving the EU with a deal would be very positive for UK assets. Such an outcome would likely also keep the business-friendly Conservative Party in government. A 'no deal' exit followed by a Conservative-led coalition would be initially negative due to the economic impact, then recovery. The worst-case for UK assets would be a 'no deal exit' followed by a Labour-led coalition.

The new PM's early priorities

PM Johnson's early days in power will focus on areas he can control without the need for UK parliamentary approval nor EU negotiation:

1. His new Cabinet will likely contain more Brexiters. If he appoints too many, though, it would raise fears of a 'no deal' Brexit. He will likely give key roles to former adversaries.
2. Plans for 'no deal' will be stepped-up. This is not the new PM's preferred route. However, greater preparedness for 'no deal' may strengthen his hand for upcoming negotiations with the EU.
3. His new finance minister – probably Sajid Javid – will likely produce a fiscal expansion plan equating to around 1.5% of GDP.
4. The PM will visit regional UK leaders in Scotland and Northern Ireland, as well as the Republic of Ireland's leadership. His government continues to rely on support from Northern Irish unionist MPs. A compromise on the Irish border issue would be very helpful in subsequent Brussels negotiations. He also needs to dissuade Scottish nationalists from another referendum to leave the United Kingdom.

5. An early meeting with President Trump is possible. Hints of a future US trade deal could strengthen the PM's hand with the EU. If the PM appoints the hardline Brexit Party leader Nigel Farage as next US ambassador, it would remove an important opponent at home and build bridges between the Conservatives and the Brexit Party.

UK's polarized and fragmented political landscape

The traditionally dominant Conservative and Labour parties suffered massive losses of support in May's EU parliamentary elections. The ruling Conservatives lost support to the insurgent Brexit Party because of the Conservative government's failure to deliver Brexit three years after the EU referendum. The opposition Labour Party lost support to the pro-EU Liberal Democrats owing to the former's ambiguous stance on Brexit and the latter's clear opposition to it. The fragmentation is reflected in recent YouGov polling, showing all four parties each gaining 18-24% of the vote if a vote were held today – **figure 1**.

PM Johnson was elected by his party members because he convinced Conservative parliamentarians and party activists that he can win supporters back from the Brexit Party. This was helped by his campaign promise to deliver Brexit with or without a deal by the deadline of 31st October. To fulfil this promise, he needs to win EU concessions for a deal, or may have to prorogue – or temporarily suspend – the UK parliament ahead of 31st October so that MPs cannot vote down 'no deal'. The latter would be highly controversial and we consider it unlikely. We thus consider below the possibility of the EU making concessions.

Challenging UK-EU negotiations to come

Over the last two weeks, six or seven of the EU27 countries have reportedly approached Johnson's team to discuss possible compromises. In addition, the European economic outlook has darkened significantly over the spring, raising the possibility of a compromise. Finally, both sides have been exploring the potential for new technologies to help resolve the Irish border issue (that could address the contentious Irish backstop within the Withdrawal Agreement). Despite this, the EU Chief Negotiator Michel Barnier continues to be publicly intransigent over changing the Withdrawal Agreement. At this stage, therefore, the best that might be agreed is further wording changes within the Brexit Political Agreement, aiming to give more confidence that the Irish backstop might never be triggered.

This might not be sufficient to drive the existing exit deal through the UK parliament. Hardline Brexiter MPs might vote against. With the UK House of Commons already having indicated its opposition to a 'no deal' exit, a fresh crisis could ensue. PM Johnson would be unable to implement Brexit. The PM could then seek a snap general election to break the impasse or face – and probably lose – a parliamentary vote of confidence, also leading to a snap general election.

The economic risks posed by the Labor party

Were there to be a snap general election, it would be fought over the issue of Brexit. A Labour victory is possible and would pose additional economic risks. The party's socialist programme could include increases in both corporate and personal taxes, as well as nationalization across several sectors, including the national electricity grid, water companies, the postal service, and the railways. It might also include an 'Investment Transformation Fund' to invest £250 billion over a decade in energy, communications, scientific research, and housing. They might also seek to grant 10% ownership of many UK blue chip companies to employees. That said, Labour might well fail to win an outright parliamentary majority, forcing it into coalition with more moderate partners that would water down its economic policies. Even so, a Labour victory would at the very least cause a slowdown in foreign direct and portfolio investment, as well as prompting further falls in domestic business confidence – **figure 2**.

UK economy already facing cyclical pressures

There have been meaningful signs of further UK economic deterioration in recent months. Most notably, PMIs have turned lower, especially within the construction sector, which has fallen deep into contraction territory at 43.1 – **figure 3**. UK factory orders have also continued to contract at their fastest pace in a decade, as Brexit uncertainty weighs upon UK manufacturing. Stock-piling activities – which drove activity in the first quarter – have also declined sharply, which is further evidenced by manufacturing investment intentions falling to 10-year lows, as businesses put investment plans on hold amid Brexit uncertainty. Against this backdrop, second quarter GDP growth is expected to be negative, despite a marginal pick-up in May.

The rising risk of a 'no deal' Brexit therefore comes at a bad time. Citi Research forecasts a negative impact upon GDP of 5% over the next two to three years in the event of a 'no deal' Brexit. That would be consistent with a GDP growth rate of 0-0.5% over the same period. The National Institute of Economic and Social Research went further earlier this week, forecasting an overall 2% economic contraction, a 5% impact upon output, a 10% fall in Sterling 10% to \$1.12, and a spike in inflation to 4%. The IMF has also warned this week that a 'no deal' Brexit poses a severe threat to the world economy, as significant as global trade concerns.

The bearish economic forecasts and possible 'no deal' impacts also put the subsequent policy response from the Bank of England in focus. Markets are currently pricing in a 10% probability of a rate cut ahead of the 31st October EU exit deadline, rising to 50% probability by the end of 2019.

Unexpected developments could change the outlook to positive sooner than expected

There is some chance that unexpected developments could materially change the outlook for the UK.

One such development would be if PM Johnson manages to secure more concessions from the EU than currently seems possible. These could include wording in the Brexit political agreement that gave greater comfort that the Irish backstop would never be used (possibly including independent arbitration on whether the EU is using "best endeavours" to ensure that the backstop is never used), as well as a firm timetable for EU trade discussions. If these transpired, the UK parliament might narrowly approve the exit deal. However, this is highly speculative at this stage.

Another surprise could come from PM Johnson's visit to the Irish Republic. Irish willingness to compromise on the Northern Irish border issue could pave the way to a smoother Brexit on 31st October. Once again, this issue is highly unpredictable.

Were Nigel Farage, the leader of the Brexit Party, appointed to be the UK's ambassador to Washington, President Trump might make further overtures about a US-UK trade deal. This might also lessen the general election risk.

If any one of these three developments occurred, it could lessen and perhaps even negate the two key UK risks of a 'no deal' Brexit and a general election resulting in a Labour-led government.

Conclusions:

Three years after the EU referendum, this summer will be pivotal for Brexit. The new UK PM is committed to exiting the EU, which in the medium-term will determine the UK's economic direction. In turn, that could give the clarity needed to encourage investors. However, the short-term path in achieving exit is hazardous, as 'no deal' is now a higher probability than the cancellation of Brexit, while the risk of an unpredictable general election is also rising.

Sterling: As the main barometer of Brexit, we expect Sterling to be capped at \$1.25 over the summer. Firmer signs of 'no deal' or of a snap general election would probably take the currency lower. The cheap real exchange rate is only a secondary consideration until the UK political backdrop stabilizes.

Gilts: In the short-term, prices could rally further (and thus yields fall), in line with the global sovereign bond rally. However, in the medium-term we expect yields to rise. The Conservative Party are likely to announce fiscal expansion, and if this is later followed by a Labour government then the fiscal deficit could rise very significantly.

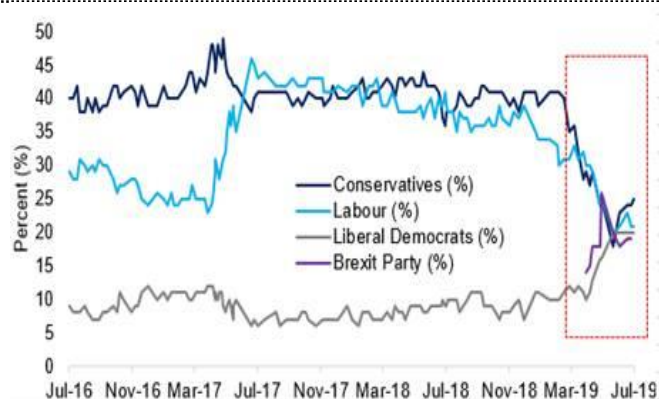
Equities: The average UK price/earnings multiple of 12X and dividend yield of 4.9% look attractive. However, we don't advise buying the market following the 14% rally YTD as uncertainties over Brexit and domestic politics immediately ahead could cap inflows and further index upside.

Instead, in the short-term, we advise a selective equity buying approach, essentially seeking alpha not beta, within these attractive areas:

- **High dividend yielders**, where we see the potential for the dividend pay-outs to be maintained.
- **Liquid blue chips rather than small- and mid-caps**, in line with our global recommendation to raise portfolio quality.
- **Overseas earners**, which are benefiting from the 16% fall in Sterling since the EU referendum.

- **Value stocks.** Growth has meaningfully outperformed value by 6% YTD, driven specifically by the outperformance of IT – **figure 4**. While we still see opportunities in growth sectors such as IT and healthcare, longer-term value in historically cheap sectors such as energy and financials with high dividend yields (5.8% and 5.1% respectively) look attractive.

Figure 1: YouGov Polling on next UK general election



Source: YouGov as of 24th July 2019

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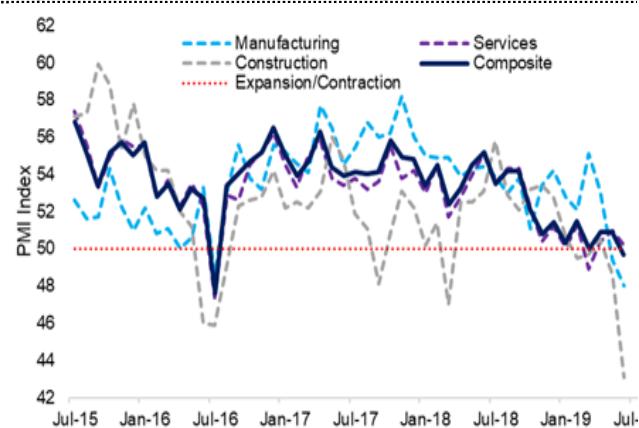
Figure 2: UK consumer confidence crumbles



Source: Bloomberg as of 24th July 2019

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Figure 3: UK Construction falling sharply



Source: Bloomberg as of 24th July 2019

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Figure 4: UK Equity Performance and Valuations

Sector	YTD Return (%)	1 Year Return (%)	Trailing 12M P/E (x)	Fwd 12M P/E (x)	Price / Book (x)	DVD Yield (%)
UK	14.2	2.5	17.9	13.0	1.8	4.8
Communication Services	-5.8	-8.8	172.4	12.7	1.1	5.6
Consumer Discretionary	17.0	1.6	17.9	15.1	2.7	4.0
Consumer Staples	18.4	1.0	24.1	15.0	2.5	3.9
Energy	11.7	-0.3	12.6	12.0	1.4	5.8
Financials	14.2	-0.4	13.5	10.3	1.0	5.1
Healthcare	12.8	14.2	28.3	18.0	11.1	3.8
Industrials	17.1	-1.9	55.1	18.4	4.7	2.3
Information Technology	39.5	43.0	50.6	19.1	3.0	9.0
Materials	22.1	18.9	11.4	10.4	1.9	6.8
Utilities	6.7	-2.0	14.8	13.6	1.9	6.8
Value	12.2	-0.8	14.8	10.9	1.3	6.1
Growth	18.4	9.3	30.0	20.8	4.7	2.4
Value / Growth	-6.2	-10.1				
UK Mid-Cap	15.4	-1.2	22.1	15.3	2.1	4.4

Source: Bloomberg as of 11th June 2019

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