On the Minds of Investors

January 2020

Three reasons investors could return to UK stocks post Brexit

1) Brexit risk remains, but Corbyn risk has gone

In recent years, investors have faced two major sources of political risk when considering UK assets. The possibility of a hard Brexit and resulting damage to the UK economy was one. At least equally troubling for investors was the lingering possibility of a shift in power to a more radically left-leaning Labour government. Proposals put forward by Labour leader Jeremy Corbyn included renationalising key industries such as utilities, higher corporate and wealth taxes, and labour market policies that had the potential to exert considerable pressure on corporate profits.

The Conservative victory in the recent election has removed this Corbyn risk. A new election will not take place until 2024, leaving the Labour Party plenty of time to reflect, select a new leadership team, and decide whether it wants to reposition itself on the political spectrum.

Brexit risk has not been eliminated, but we continue to suspect a relatively benign end result. In the interim, however, the negotiations will generate negative headlines. The UK has just eleven months to agree on a future partnership with the EU. And ultimately, the problem that has plagued the discussions of the last three years is the seemingly impossible desire for the UK to maintain a close economic relationship with the EU, without agreeing to regulatory alignment. This is somewhat of a square peg/round hole situation, since regulatory alignment is always the foundation for a trade agreement, to prevent one country abusing standards (such as environmental or labour) to gain an unfair advantage. Boris Johnson will, in tandem, be hoping that a closer partnership with the US will at least replace some of the trade lost with the EU, though we doubt the UK is high on President Trump's priority list for this year.

As a result, talk and risk of a hard Brexit will persist to some degree, and may intensify by mid-year. However, investors will likely take comfort from the fact that, at the midnight hour, pragmatism has always prevailed. By the end of the year, we expect the UK to have made regulatory concessions in key sectors, such that it can leave with a skeleton free-trade agreement, allowing the finer details to be thrashed out in subsequent years.

AUTHOR

Karen Ward
Chief Market Strategist for EMEA

2) Domestic economy stable, but global pickup more important

The UK economy weakened notably into the December election. Business investment contracted through much of 2019, but is now beginning to recover. Investment spending is unlikely to bounce back vigorously given lingering uncertainty, but the main support to growth this year comes in the form of an almighty fiscal stimulus. The recent spending review committed to reverse the vast majority of the last decade's austerity, and more is likely to come in the March Budget. The Bank of England has indicated that it is also considering adding to stimulus by cutting the base rate of interest, though we see no obvious need for it to do so.

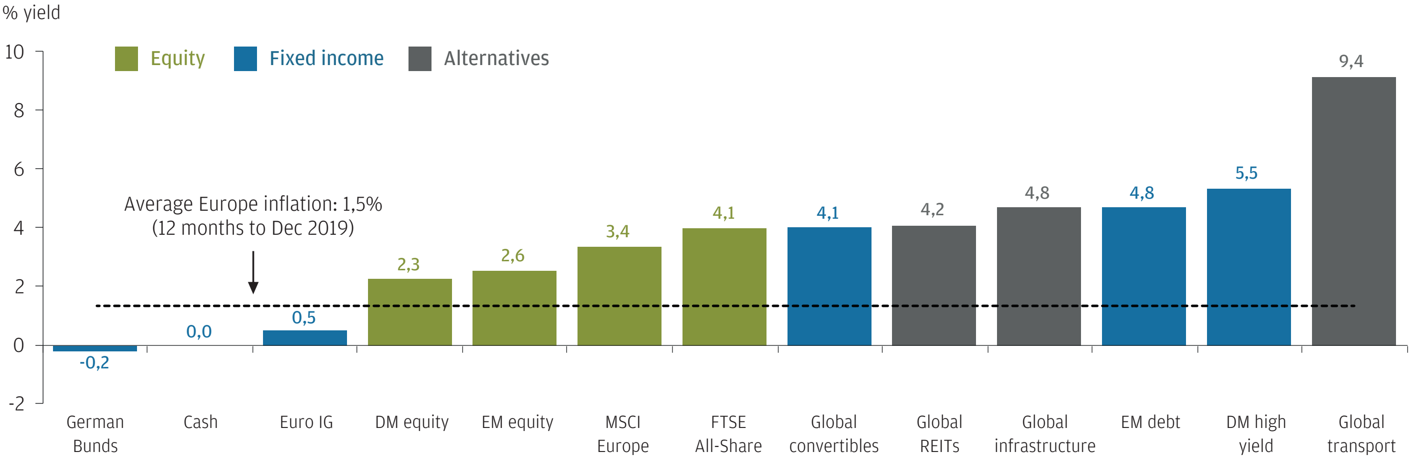
While the UK economy is likely to underperform its global counterparts, investors would be wise to remember that about 70% of the earnings of the FTSE All-share comes from overseas. What is happening elsewhere is more important. The easing in trade tensions and likely pickup in global activity should help to lift FTSE earnings. Uncertainty is also likely to keep sterling rangebound at around 1,30 against the dollar for the first half of the year, supporting the repatriated value of those earnings.

3) The UK market looks attractive in an environment in which investors are starved of yield

As political and economic risks subside, it is the attractive dividend yield offered by UK stocks that is likely to prove too tempting for international investors. Globally, investors are desperately searching for yield as central bank interventions have pushed down the income on offer in bond markets and forced income investors to turn to equity markets (see also our *On the Minds of Investors – A menu of options for income-hungry investors*).

With an overall dividend yield of 4,1%, the UK equity market is one of the highest dividend payers in the developed world (see **Exhibit 1**). Those who suspect, like us, that concessions will ultimately be made in the Brexit negotiations might also be tempted by the relatively attractive valuations of the UK market and the potential for currency uplift further down the line.

EXHIBIT 1: ASSET YIELD COMPARISON



Source: Bloomberg Barclays, BofA/Merrill Lynch, Clarkson, Drewry Maritime Consultants, FTSE, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Additional yield often comes with associated capital and/or liquidity risk. Global infrastructure and global transport yields are as of March 2019 and June 2019, respectively. Yields for the bond indices are yield to worst and dividend yields for the equity indices. Global transport levered yield is rental income minus operating expenses, debt amortisation and interest expenses, expressed as a percentage of equity value. Global convertibles: Bloomberg Barclays Global Convertibles; DM equity: MSCI World; EM equity: MSCI EM; German bunds: Germany 10-year yield; Euro IG: Bloomberg Barclays Euro Agg. – Corporates; Global REITs: FTSE NAREIT Index; DM high yield: BofA/Merrill Lynch Developed Markets High Yield Constrained; EM debt: J.P. Morgan EMBI Global; Global infrastructure: MSCI Global Infrastructure Asset Index – Low risk. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 December 2019.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

LV–JPM52573 | 01/20 | EU | 0903c02a827e468c

J.P.Morgan
Asset Management