NEUBERGER | BERMAN

Brexit Means Brexit: But What Could That Mean for Portfolios?

Disruptive Forces in Investing

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Martin Steward: Back in 2016, with 52 percent of the popular vote, the U.K. voted to withdraw for the European Union. As of the 31st of January 2020, Brexit went into effect, beginning a year-long transition period, during which the U.K. effectively remained within the E.U. while negotiating its future trading relationship with the E.U. and other countries around the world. That year is now in its fourth quarter, and we still don't have a trade agreement between the U.K. and the E.U. as we're recording this podcast. As if that weren't enough to be thinking about, we have the added uncertainty of coronavirus, currently undergoing something of a resurgence throughout Europe and North America. So where does that leave us with respect to the economic and financial market impact of Brexit and the implications for investors? On this episode of "Disruptive Forces," I'm joined by Joe McDonnell, head of Portfolio Solutions in EMEA, who is going to offer our take on these questions. Joe, thanks for joining us.

Joe McDonnell: Thanks, Martin. Great to be here.

Martin Steward: So, incredibly, it's been four long years, and we still haven't reached the end point of Brexit; or maybe it's wrongheaded to think of Brexit as having an end point at all. Joe, why don't you start by giving us a quick roundup of where we are now, how we got here, and what might happen next in terms of the basic mechanics of Brexit?

Joe McDonnell: So yes, Martin, a lot of people are somewhat frustrated it's taken 4-1/2 years, to get to this point as we are today, on the verge of a free-trade agreement. So the Brexit process has taken a long time. But you know, people should also be aware, it, it took an awful long time to get into the European Union. Indeed, it applied for membership both in 1963 and 1967, and, and we're, uh, that membership was rejected, uh and actually only joined in 1973. So entrance took 10 years, exit 4-1/2 years. In terms of the free-trade agreement, the next 65 days are crucial. The first of January 2021 is the deadline for an agreement. Neither side will accept a continuation from here; so this is really everything for both sides. A workable free-trade agreement is in sight. There are a couple of key sticking points. Uh, you know, um, fishing access is very important, the commitment to a level playing field, so ensuring that there is state aid for certain sectors or industries. Um, but it looks like both sides are willing to, uh, uh, get to a point of agreement on those two issues. So a thin trade deal is more than likely to take place at some point over the next couple of months. This is hugely important for the U.K. A lot of people have talked about, well, what happens if that doesn't, if that isn't achieved. Well, if that doesn't – if, if we don't have a free-trade agreement, then we'll default to, uh, World Trade Organization terms, which would cost something between one and two percent of, of GDP. So the option of not achieving an agreement is, is an incredibly high cost, both politically and economically.

Martin Steward: Okay, so let's assume that we do get the, as you describe it, thin trading agreement between the U.K. and the E.U. and the fishing rights issues and the level playing field issues are resolved, let's turn our focus to what that means for markets when we get to January the 1st. Um, let's focus on U.K. markets first and, and equity markets specifically. Should this make a difference to how people view the U.K. equity market?

Joe McDonnell: Well, I think, I think it's really very important for investors to try and disentangle, uh, the impact of COVID, uh, and the impact of Brexit, obviously, uh, two different timeframes. If we go back over the last 4-1/2 years, U.K. equity markets, both the FTSE 100 and the FTSE 250 have performed very badly, on an absolute and relative basis. Indeed, the FTSE is down over, since, um, since 2016, down about one percent, versus the S&P, which is cumulative up over 70 percent.

So it has massively underperformed other developed-market equity indices. So that's, that's very important for, for an investor to think about. Well, it's, it's underperformed for a reason. Uh, and you could say, well, that reason is Brexit; but that's not, that's not all of the truth. The, the reality is that the, the FTSE 100 index, uh, actually has, uh, very different characteristics to, say, the S&P 500. It has, uh, very noticeable sector biases within it, so it's dominated by materials, banks, pharma. If you like the value factor, which has clearly underperformed for quite some time, is really embedded, you know, in the FTSE 100. So today it has the lowest PE and the highest dividend yield of any developed-market equity index.

So, yes, it's performed very badly for a protracted period of time. Some of it is because of, you know, no, no doubt because of a concern around Brexit. Some of it more focused on the underlying attributes, if you like, of that index. Now, if you're talking about the local PLC index, which would be the FTSE 250, that has done badly as well, uh, and has lagged other U.S. mid- and small-cap equivalents. So really they're both – you know, the two main indices in the U.K., 100 and 250, have performed badly since the end of 2016 and year to date. So when investors look at those, those markets, they'll be thinking, well, if there is a resolution around Brexit and the free-trade agreement, at least that will be moving one characteristic, or one, one problem, if you like, that, that essentially weighed on those specific markets, which is not the case in other equity markets. So, you know that's a positive outcome, if you like, of achieving that agreement.

Martin Steward: Yeah, it's interesting, isn't it? Because if you think about the next, uh, three to four months, I guess, there's a potential for a lot of uncertainty to be lifted, uh, not just about Brexit, but potentially about coronavirus and, of course, around U.S. politics. And when some of that uncertainty is lifted, investors can start to look with a slightly clearer eye at the, at the factor exposures they get from U.K. equity markets, and maybe start to see some of the value in those factors. That's a really interesting point. Let's turn onto the gilt market. This is interesting because, very unlike the equity market, there is no valuation buffer in the gilt markets. It's very low yield. It's very flat curve, and on the inflation question, Brexit could be, well U.K.'s inflation has always been more volatile than other developed nations' inflation. The Brexit arrangements could make that even more volatile. I wonder what the view is on U.K. gilts and how investors should approach that.

Joe McDonnell: Well, in, in terms of U.K. gilts, you're absolutely right. You know, we're in a, we're in a zero-rate environment in – well, actually base rates in the U.K. are 10 basis points. So they're likely to even drop from there, and maybe go to, to a negative-rate situation here in the U.K. But, but really, that's not symptomatic of Brexit. That is basically what we've seen since March. We've had a zero-rate environment in most developed markets across, across the world. Now, it is the case that, that the yield curve in the U.K. is particularly flat. So even extending to 30 years, you're getting, you know, 72 basis points of yield. So when investors look at the U.K. bond market, you know, the historical reasons why you invest in, in U.K. bonds, yield and diversification; well, yield doesn't really exist today, which means – the absence of yield means the diversification benefit may exist, but the opportunity cost of investing in U.K. bonds is extremely high. So investors, increasingly, are thinking about, well, what can I do. You know, are there certain strategies that are available to potentially, you know, enhance the yield but still maintain that diversification or downside protection that comes with gilt investing? So we anticipate, over the coming couple of years, we're going to see more emphasis around gilt-replacement strategies. So ways and means of allocating in bond markets to enhance yield but still maintain that diversification benefit, should there be, you know, a further equity-market correction. So, that seems to be a logical area for investors to focus on, um, given the fact that we are where we are. But to be absolutely clear, I don't think that where we are with the gilt market is driven, necessarily, by Brexit. Now, you mentioned inflation. You know, 10-year break-even today is about 1.73 percent, so that's kind of fair value. You know, U.K. linkers, uh, you know, they were certainly attractive earlier in the year. There were much, much lower break-evens, but today, closer to fair value. Um, it is the case that U.K. inflation can be quite volatile, but in the, in the general, um, you know, global deflationary environment, I don't think investors are, in the short term, that focused on, on inflation management. I think in the medium to long run, there will be, uh, interest in real assets. But, um, I don't think necessarily that investors need to focus on, on, um, you know, switching from, from nominal bonds to inflation-linked bonds in the U.K. I think that the, the bigger issue here is just the, the absolute, you know, miniscule yields that are available. Maybe, maybe they will fall from here but investors need to think about what kind of replacement strategies are available to them.

Martin Steward: What can you tell us about Neuberger's view on the pound, which has obviously been very volatile over the last four years since the Brexit vote, but, you know, when you look at it against the U.S. dollar, it's interesting that we're pretty much back to where it was on the day after the vote.

Joe McDonnell: Yeah. Well, if you – the, the night of the vote, actually sterling, strengthened, I think, close to kind of 155, you know, right up until the returns started coming in. We saw, you know, constituencies in the north of England started voting for Brexit, and then, you know, sterling plummeted, and plummeted, you know, right down, I think, to the low 120s. So today, at 129, 130, it's reflecting the impact, if you like, on Brexit as being weaker sterling. On an interest-rate differential basis, you would expect sterling to be modestly, firmer, and stronger against, against the dollar. Neuberger Berman's view is that we should see some strength on the back of a free-trade agreement, particularly, uh, in sterling. But, you know, we're not going to go back, if you like, to where we were with people anticipating. You know, much stronger levels of sterling would require very strong relative GDP growth, which is, which is unlikely. We still have, uh, you know, we have a, we have a very significant unemployment problem in the U.K. Um, you know, we, we obviously have, um, a, a resurgence of COVID. So it's, it's difficult to kind of think, at least in the short term, that there's going to be significant, uh, performance improvements in the

U.K. relative to other economies. So yes, some strength in sterling could be, could be, uh, a short-term result of the free-trade agreement; but, uh, beyond that there's, there's more questions.

Martin Steward: Uh, I thought it was really interesting that, you know, this is nominally, a podcast about Brexit; but you opened your comments at the top, talking about coronavirus. And, you know, it just brings it home that coronavirus really does put everything into perspective. So kind of brings me to my final question, which is a really simple one. As far as investors are concerned, is Brexit really important in the grand scheme of things?

Joe McDonnell: Well, I mean, you know, it's a surprise that it isn't the biggest issue here in the U.K. I mean, as you say, COVID is so unique. It's the biggest growth shock in 50 years, uh, and, you know, Brexit's been around, you know, for 4-1/2 years. Implementation is around the corner, at least in terms of the free-trade agreement, which is positive. So it's a huge issue for Britain. Uh, as I said, the absence of a deal would have a very significant impact on GDP in the U.K., would have a negative impact as well in France and Germany and other parts of the European Union. So arriving at a deal is very, very important from a U.K. and for a European perspective. It's not as big an issue, obviously, you know, outside of those countries, or the region more generally. So, you know, it moves down the pecking order. I think people are more, you know, in the next two weeks, more focused on the U.S. election outcome and the implications for that. We're obviously focused on the vaccine, whether that comes in Q1 or Q2, and you know, the effects of that. So, it's moved down the pecking order, but nevertheless, I think you'll see, over the next 65 days, which is the time left in which to [have] this deal to be completed, that, that there will be a fair amount of emphasis, as well.

Martin Steward: Okay, and what do you think this whole process means for the European Union more widely? Some people say that the unofficial motto of the European Union is, don't let a good crisis go to waste. Are we seeing that with the Brexit process?

Joe McDonnell: Yes, I think – well, yes and no. I think what we should say is that there's plenty of examples in history where the European Union has had, had to face significant challenges; and the response to that has been ever closer, you know, to expansion and unification. So, and what we've seen this year in response to COVID, is a €750 billion recovery effort, and wider fiscal and monetary support over €2 trillion, as a whole; we've seen, actually, more solidarity from a monetary and fiscal perspective across the European Union. So, in many ways, Brexit, you know, there were – a few years ago, people were talking about Brexit being the first step for, for fragmentation of the European Union. But in actual fact, where we are today, with COVID as well, we're seeing greater integration in the European Union. So Brexit still remains, and will most likely do for a number of years, kind of a standalone event, in terms of, you know, relationship with European Union.

Martin Steward: Yeah, it's a really fascinating dynamic and, yeah, another one to add to the very complex mix today. Thank you so much, Joe, for your insights. It's, uh, it's going to be an interesting year ahead, for sure. We're all looking forward to, uh, seeing what happens.

Joe McDonnell: Thanks, Martin. It's been great to have the opportunity to talk about Brexit.

Martin Steward: Thank you, and of course thanks finally to our listeners. As always, you can subscribe to "Disruptive Forces" by Apple podcast, Google podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and our offerings.