Macro Insight

Why do we like UK equities?

We believe pessimism on the UK economy has probably been overdone

Since early spring, our house view has been positive on UK equities. The rationale has been driven by our ongoing preference for risky asset classes, as well as our view that UK equities look attractive in their own right, from a valuation perspective.

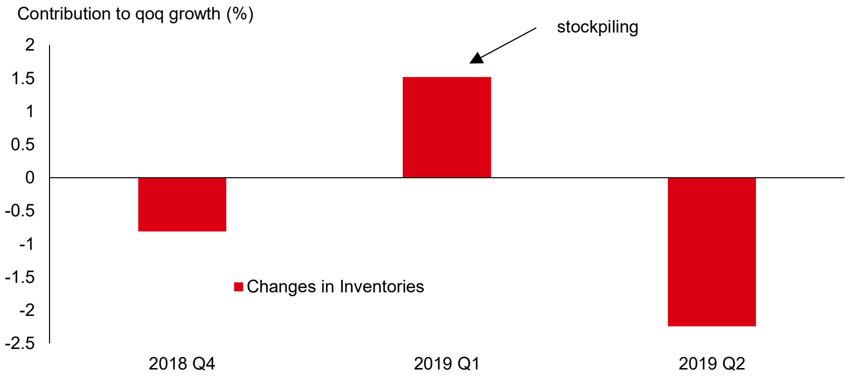
At this juncture it is worth asking if our view is challenged by evidence of a slowdown in the UK economy – including negative Q2 growth – and the risk of a "no-deal" Brexit in October.

UK growth: not as bad as it seems

The first estimate of UK Q2 GDP showed the first quarterly contraction since 2012 at -0.2% quarter-on-quarter (qoq). This has raised concerns in the media that the UK could be heading for a "Brexit recession". In our view, this pessimism is overdone, for three reasons:

1. Q1 growth was boosted by **stockpiling** ahead of the original Brexit date of 31 March. With the Brexit deadline extended to 31 October, many businesses unwound their inventories in Q2, weighing on growth (Figure 1). In Q3, we could see renewed stockpiling adding to growth again.

Figure 1: Contribution of changes in inventories to UK GDP growth



Source: UK Office for National Statistics, data as of 14 August 2019

2. Manufacturing sector output in Q2 saw a drag from **carmakers** bringing their annual summer shutdowns forward to April. Many car plants operating in August, when they would be usually closed, should support Q3 growth.
3. **Consumer spending growth** remained resilient in Q2. This is perhaps unsurprising in the context of a strong UK labour market. UK wage growth is edging up, closing in on 4% year-on-year (yoy), well above the rate of inflation.

We should also consider the global growth context. The industrial sector has been performing poorly this year, across many economies. Rising global uncertainty has weighed on firms' investment plans, of which Brexit is only one part of the story.

Our views

In a multi-asset portfolio context, we are still comfortable with our overweight view on UK equities.

The combination of expensive valuation and possible UK fiscal easing backs up our underweight view on UK gilts

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A "no-deal" Brexit is a key risk for the UK economy, but looser fiscal policy could mitigate some of the effects…

…while the Bank of England would also be likely to loosen monetary policy

What about a no-deal Brexit?

UK Prime Minister (PM) Boris Johnson has entertained the possibility of a no-deal Brexit. In our view, such an outcome is a downside risk to the UK economy as it may result in:

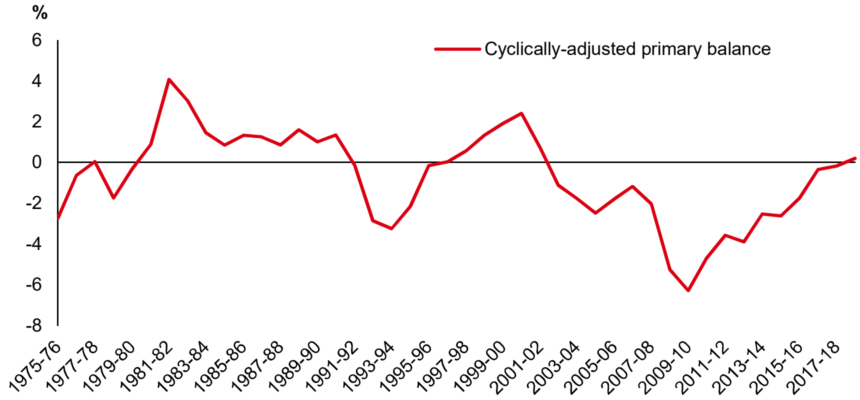
1. Trade disruption at the UK-EU border (e.g. customs and regulatory checks);
2. Confidence and uncertainty shocks to households and businesses;
3. Declines in the pound sterling, which could raise UK inflation and weigh on household disposable income and consumer spending.

However, there **remains much uncertainty on how political developments will play out between now and the current Brexit deadline of 31 October**.

In the event of a no-deal Brexit, we would expect policy measures to mitigate some of the impact on growth. PM Johnson has signalled a substantial package of fiscal easing measures made possible by the UK's significantly improved fiscal position (Figure 2).

Meanwhile, the Bank of England (BoE) would likely cut interest rates, with some BoE officials suggesting they could go down to 0% from 0.75% at present. The BoE could also potentially restart its programme of bond buying and offer cheap loans to banks.

Figure 2: UK fiscal position



Source: UK Office for Budget Responsibility, data as of 14 August 2019. This measure excludes interest payments and is adjusted for effects of the economic cycle

What does this mean for our UK asset class views?

Figure 3 summarises our latest views on UK assets in a multi-asset portfolio context.

Figure 3: UK asset class views

	Equities	Gilts (UK government bonds)
	Overweight	Underweight
Growth	Recent data appears to have been distorted by "Brexit stockpiling" and other one-off effects. The labour market remains a key support for growth	
Valuation	The UK equity risk premium (excess return over cash) remains comfortably above the equity risk premium for developed market (DM) equities	Our estimate of prospective risk-adjusted returns for gilts is extremely low
No-deal Brexit	A no-deal Brexit is likely to hit growth. But policy support – particularly fiscal – may offset some of the effects	The supply of gilts is likely to increase in the coming years
	Sterling (GBP) would probably decline. This may support the earnings performance of UK based multinationals with foreign currency revenues	A fall in GBP is likely to push up UK inflation, which could put downward pressure on bond prices

	Equities	Gilts (UK government bonds)
	Overweight	Underweight
Brexit with Withdrawal Agreement	A negotiated Brexit is likely to lift some uncertainty, supporting corporate investment. Higher UK growth may support domestically oriented stocks	Gilts would look vulnerable from less uncertainty and better growth (reduced "safe-haven" demand), and potentially more hawkish BoE policy
Risks to our view	A much more significant deterioration in UK growth and corporate fundamentals would be a major challenge for equities	A significant deterioration in UK growth could support gilts, as could Fed and ECB policy easing

Source: HSBC Global Asset Management, as of 13 August 2019 and subject to change.

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