

UK assets tread Brexit highwire

Pound's flash crash deepens concerns amid prospect of 'hard' departure from EU

MICHAEL HUNTER, ROGER BLITZ AND ELAINE MOORE

Theresa May and the UK financial markets are now walking the same Brexit highwire. They are trying to balance complex political expectations and an unforgiving economic reality.

Mrs May, the prime minister, has a long time to reach safety, with negotiations scheduled to last two years from the time she triggers the EU treaty's exit clause, now due by the end of March. But for financial markets, the unsteadiness is already affecting the pound, UK equities and prices for government debt, or gilts — and yesterday's "flash crash" risks tipping the scales into crisis.

Increasingly, recent talk of a "hard Brexit", or a clean break from the EU rather than a more limited withdrawal that maintains access to Europe's common market, has spooked markets, with the pound this week sinking to its lowest level since the June referendum result — which is also the weakest it has been against the dollar since 1985.

The mood has changed rapidly. A two-minute flash crash that sent the pound tumbling from \$1.26 against the dollar to a little more than \$1.18 in two minutes flat during early trading in Asia yesterday was triggered by tough talk over the UK leaving the EU from French president François Hollande.

Technical reasons for the huge fall, such as so-called fat-finger trading, will not suffice for some market commentators. To them, the Leave vote has put the deficit-riddled UK economy, with its high dependence on capital inflows, in jeopardy.

Yesterday's crash is more to do with "a deeper and higher volatility adjustment in sterling should longer-term foreign investors start to repatriate sterling exposure", says Paul Meggyesi, FX strategist at JPMorgan.

Market talk before this week's Conservative party conference was about the surprising resilience of the UK economy in the wake of the Brexit vote and the amount of short sterling positions in the market, says Goldman Sachs.

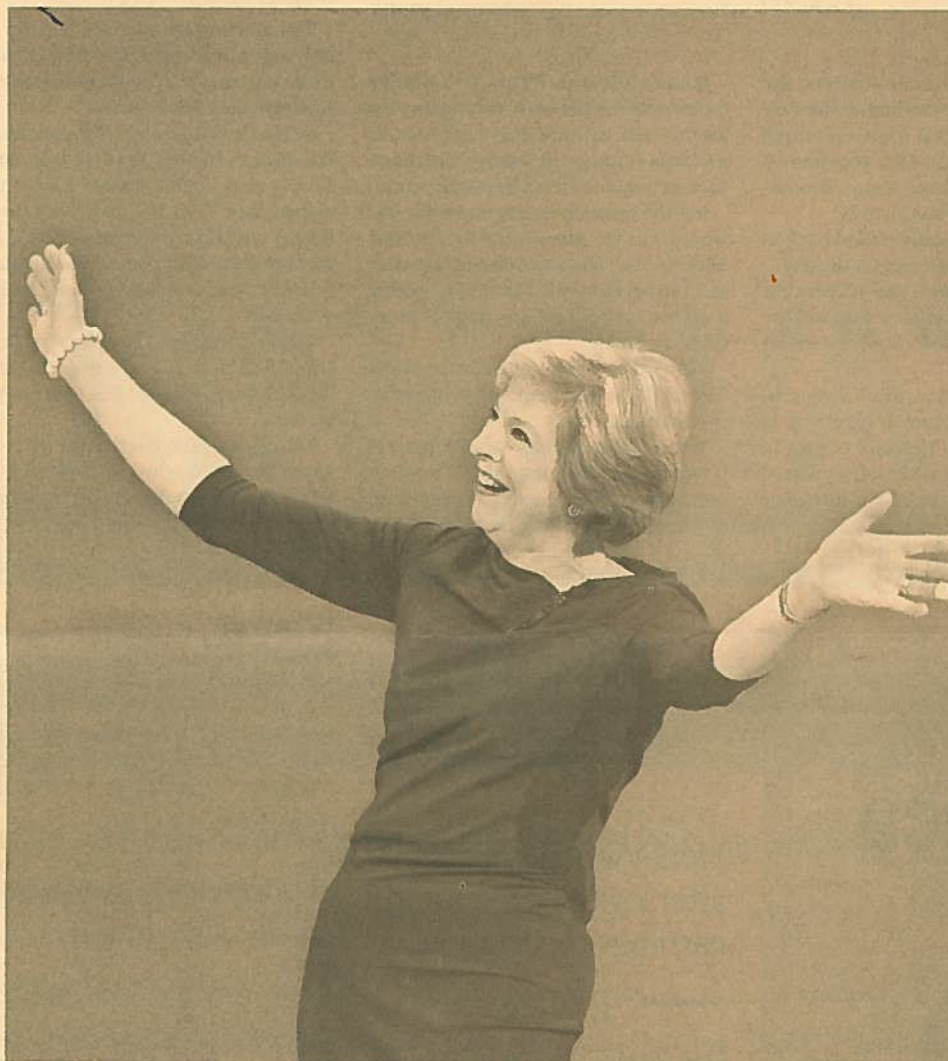
"In a sign of how times have changed... discussion has now switched to how much downside there potentially is in sterling," the bank adds.

A weak exchange rate has, until the start of the week, boosted UK equities, particularly for multinationals with significant revenues from overseas. Asset prices have also benefited from the Bank of England's resumption of bond purchases, which has suppressed borrowing costs.

This was all well and good while the market awaited political developments. So, when the prime minister used speeches at the party conference to set a deadline for triggering the EU's exit clause, the market took fright.

Not only that, Mrs May criticised monetary policy and the effect low interest rates and quantitative easing are having on wealth distribution. At the same time, a member of her policy board told the BBC that the government wanted to move away from reliance on monetary easing and planned to increase borrowing to invest in infrastructure.

For investors in the UK and out-



Waving or drowning: prime minister Theresa May's rhetoric over the UK's exit from the EU has done little to calm markets
Charlie Bibby

how long a pound close to freefall can act as a safety net for equities.

Oliver Harvey of Deutsche Bank says: "If the market was anticipating a relatively benign outcome from the UK's forthcoming renegotiation, political developments will have come as more of a shock."

"Hard Brexit has become a meaningful risk."

While there is widespread agreement that politics will be in the driving seat for the foreseeable future, some analysts argue that investors are better prepared than politicians were.

Though yesterday's crash in the pound takes the currency's fall against the dollar since the start of the year to more than 15 per cent, the general direction and extent of the move, if not its dizzying pace yesterday, has been a concern to investors for a while.

"I don't think markets found talk of hard Brexit as much of a surprise as the media did," says John Bilton, head of global multi-asset strategy at JPMorgan Asset Management. But as political negotiations continue, behind closed doors and with "many actors" involved, the risk of further "spasms" in prices will remain, he adds.

But there remains disagreement about how much further the pound will fall. Richard Bibbey, HSBC head of FX cash trading and risk management, argues that there have been three phases in sterling since the vote to leave the EU, the first driven by the outcome of the vote and the second during the summer when it consolidated because of crowded positioning and buoyant data.

"Now we are starting to see the third phase, which is a sustained move lower," he adds. How long will this one last? "That depends on the speed of the downward move. If momentum continues, we could see a sustained move lower."

FTSE 100 within touching distance of its record closing level — a milestone comfortably passed by the mid-cap FTSE 250 index.

London's second-tier index is often described as more representative of the domestic UK economy, and its constituents do generate a greater proportion of their revenue at home.

Its biggest fallers are mainly consumer goods groups, which are more exposed to the disruption facing the UK economy because of rising inflation and falling employment rates, both of which are expected to intensify as the UK withdraws from the EU.

Even though London's two main indices are trading at around record highs, there are signs that investors

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are seeking to reduce their exposure to UK equities. For overseas-based investors, who have not hedged the currency risk, UK equities are well in the red for the year.

Fund flow data from Markit show some \$423m left UK-tracking equity exchange traded funds during the third quarter of this year, the largest outflow in two years.

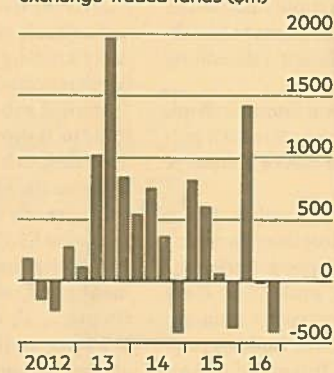
There are concerns that the boost to the FTSE 100 that has been provided by the pound's slide may have already run its course, with the index potentially constrained by the outlook for earnings in the year ahead.

A recent revision to UBS's fair value target for the FTSE 100 put it at 6,500 by the end of 2016, significantly below its current reading above 7,000 points.

"We struggle to get upside on the FTSE," says Nick Nelson, a strategist with the bank.

Investors go sour on UK equities

Quarterly flows into UK equity exchange-traded funds (\$m)



FTSE 250: overseas groups fly, UK plc plummets

% change since end-2015*



* NB - excludes Hochschild Mining, up 447% year to date

Sources: Markit; Thomson Reuters Datastream

roughly 10 per cent fall in the currency and 10 per cent rise in the oil price, or a different blend of those two moves."

He adds: "To get significantly further upside to 2017 EPS growth to, say, the 20-25 per cent range, we calculate we would need to see something like a 20 per cent rise in the oil price and 15 per cent fall in sterling."

With sterling at levels last seen in the 1980s, one potential bright spot is that dealmaking activity could increase as overseas companies receive a boost to their buying power. In her speech, Mrs May lauded the £24bn deal that Japan's SoftBank has sealed to buy Arm Holdings, the UK's biggest tech company.

For the government debt market, this week has been bruising with the 10-year gilt yield rising sharply and outpacing weakness seen among global sovereign debt rivals. According to Bank of England data, foreign investors have been persistent buyers of gilts throughout the summer, and further selling in the pound may well force a reappraisal of their holdings warn analysts.

While some argue that gilts will still find buyers in a world of ultra-low interest rates, the Autumn Statement and a much larger than anticipated fiscal stimulus package looms large. The prospect of a weaker pound spurring inflation also poses a threat to gilts.

A sustained rise in yields may well staunch the decline in the pound but also runs the risk of pressuring equity valuations.

Lower bond yields in the wake of the vote to leave the EU have bolstered share prices as the value of future cash flows of companies becomes more desirable.

Alastair George, chief strategist at Edison Investment Research, says that in light of Mrs May's remarks about QE, "the permanence of ultra-loose policy cannot be taken for