Key Questions

Has the United Kingdom Really Left the European Union?

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Clarity is starting to emerge.

Three and one-half years, three formal extensions, and two general elections after the June 2016 United Kingdom (UK) referendum to exit the European Common Union, a mutually beneficial end is in sight in the first month of 2020. Over the past week, a withdrawal agreement has been signed by both UK legislators and members of the European Parliament (MEP), thus ratifying a withdrawal date of December 31, 2020.

Though separation talks have been contentious at times, the MEP sang Scottish poet Robert Burns' "Auld Lang Syne" after its watershed and landslide vote. Written in the old Scots language, the poem roughly translates into "For the sake of old times." Parts of the negotiation are expected to be agreed upon quickly, while others are expected to push against the year-end deadline. But through it all, the European community will acknowledge its intertwined roots.

The EU and the UK are in concert on the movement of goods across borders. Negotiations for services — including financial — and European marketplace access are expected to take a longer time to address. The most likely scenario is that Brexit will be accomplished in phases. Phase one will be the movement of goods, which should be completed by the end of the year. It is the necessary first piece for separation inasmuch as it deals directly with tariffs and import/export logistics. Phase two is a bit murkier and will probably require an extension to negotiations over issues of UK trade policy autonomy and immigration. This phase is expected to be completed in 2021.

As negotiation timelines solidify, economic conditions are changing within the UK. Companies that diverted assets into holding patterns because of Brexit uncertainty have begun to invest in new projects. These are expanding the scope of potential growth in the UK economy. Purchasing Managers' Index (PMI) surveys have begun to show positive momentum. Flash Manufacturing PMI increased 2.3 points to 49.8 while Flash Service PMI increased 2.9 points to 52.9. The PMI scale uses 50 as a baseline: Numbers above 50 show expansion and below 50 show contraction. Both numbers are significantly above estimates. In a related survey, strong growth was signaled in the New Orders and Future Output Indexes. Sentiment is trending positive.

On January 30, the Bank of England held short-term rates at 0.75%, leaving ammunition available in case the growth trend slows. Also, a new budget will be unveiled in March that is expected to loosen fiscal policy and further jump-start growth. These measures should boost what has been stagnant GDP growth since the referendum to leave the European Union.

Clarity is good news for investors. Uncertainty hurts. Legislation has been passed, the two sides of the negotiation have some aligned interests, and economic growth has positive momentum. Furthermore, valuations of UK equities are low compared with their own history and with the rest of the developed world. As price-to-equity multiples have expanded in this bull market, the UK has remained dormant. There is room for those multiples to expand and converge with the rest of the world. UK companies catering to UK consumers have been some of the hardest-hit companies since the referendum: They now have an improved economic backdrop to invest in new projects.

Accordingly, UK equity markets have more potential to outperform now that there is a clearer outcome to Brexit negotiations. At Key Private Bank, a recent Tactical Asset Allocation decision moved Developed ex-US Equity weights from Underweight to Neutral, partly to signify increased potential in the UK. As the Immortal Bard wrote, "Our doubts are traitors and make us lose the good we oft might win by fearing to attempt." The time is ripe to take a chance on UK equities.

For more information, please contact your Key Private Bank Advisor.

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