

Brexit update – a pension investment perspective

» In brief

- The market has been pricing in the possibility of a no-deal Brexit with notable deterioration in market prices since last summer
- The political outlook is highly uncertain and scope for a no-deal could cause further investment challenges
- However, a good Brexit deal also has scope to cause issues for investors
- A resilient long term investment strategy should be positioned to withstand either scenario

» Next steps

- Consider if there is scope for your scheme to benefit from the tabled actions

The negotiation on the UK's exit from the EU has taken many turns since the vote to leave in June 2016, and is climaxing with a highly uncertain political impasse as we approach the deadline of 11pm on 29 March 2019.

This paper sets out a summary of how things have progressed since we last wrote on the subject and revisits what the future could hold for pension scheme investments.

Background

In August 2018 XPS Investment highlighted the wide range of possible outcomes we faced with Brexit on the horizon, but noted the considerable uncertainty that a no-deal Brexit might create. We considered the possible impact of a no-deal Brexit on a range of relevant economic measures and how this could impact pension schemes – financially and operationally. We also highlighted the actions that pension schemes could take in preparing for this uncertainty in the run up to the deadline.

These mitigations included:

- Limiting risk exposures;
- Increasing interest rate and inflation hedging;
- Avoiding transition activity in early 2019; and
- Thinking ahead to cash requirements.

Whilst Brexit has not yet occurred, over the past 5 months the risk of a no-deal Brexit (or a hard Brexit) resulting in World Trade Organisation (WTO) rules on trade has seemed increasingly likely. It is generally considered that the market has been pricing in the greater probability of a no-deal Brexit.

In our previous analysis we set out a straw man of what a no-deal Brexit could look like. Whilst this was not intended to be a prediction for the following 5 months, the market returns that have unfolded have borne more than a passing resemblance to our no-deal scenario.



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The table below sets out the August no-deal scenario and what has since materialised.

Asset class	August paper	What's happened (31 August 2018 to 18 January 2019)
UK equities	-15.0%	-5.8%
Global ex UK equities (currency hedged)	-3.0%	-6.8%
UK credit spreads	+0.75%	+0.3%
Long dated gilt yields	-0.5%	+0.1%
UK commercial property	-10.0%	-6.7%
Long term inflation expectations	+0.5%	+0.1%
Sterling currency	-15.0%	0.0%

It would appear that in the summer the currency markets had already been pricing in a notable probability of a no-deal given that currency is close to where it was in the summer.

Latest developments

The political developments are changing on a daily basis and this note seeks to summarise the key short and medium strategic issues for pension schemes to consider, rather than detailing a blow by blow account of recent events.

The area of current political focus isn't on the UK's trade terms with the EU, but rather the "transition agreement" that will create sufficient time and space for an appropriate trade deal to be agreed. From the perspective of investment markets the primary role of Theresa May's transition deal, which was voted against by Parliament on 15 January 2019, was to extend and define the period over which the trade deal with the EU would be reached. This was intended to stretch out to December 2020 within May's proposed plan, with the UK/EU continuing to trade under current terms for that period or until a trade deal was reached. There are a number of other highly contentious and important areas covered by the now defunct transition agreement but these were less directly relevant to markets and so are not covered in this note.

How we could stumble over the no-deal cliff edge

In the absence of any other agreement with the EU, the UK has to leave the EU on the 29 March 2019. This would precipitate a 'no-deal Brexit' and World Trade Organisation tariffs and rules would apply.

Over the last few months the Government has issued a range of technical papers on how different markets would be supported if a no-deal scenario were to occur. These provide reassurance on a number of aspects, not least from a finance and banking perspective the Temporary Recognition Regime and Temporary Permissions Regime which provide passporting rights for banks to continue to operate cross borders for up to 3 years after exit. This is of fundamental importance and reassures on the scope to realise foreign investment for cash as you would expect in the normal course of business.

Despite this, a no-deal scenario is generally considered an undesirable outcome due to the confusion that is likely to result, in particular introducing delay in imports/exports and disruption to key services such as healthcare.

Looking ahead

There are an array of possible outcomes from the current negotiations ranging from:

- a forced no-deal because time has run out
- an extension of Article 50
- a general election
- a referendum known as the "people's vote", or
- a successfully renegotiated withdrawal agreement addressing the greatest concerns

As pension scheme investors it is important to focus on strategic decisions rather than getting drawn into tactical or speculative trades. But it can still be powerful to think of different possible scenarios as a way of gauging if risk levels remain appropriate and to test if alternative approaches could increase a portfolio's resilience.

We have set out two scenarios: 'no-deal' or 'good deal'. This doesn't seek to define what a good deal is but reflects the view that if a deal is made at all it will be on the basis that Parliament or possibly the population of the UK believe it is preferable to no-deal and vote in favour.

Our scenarios factor in our assessment of current markets, and that the market is already pricing in a meaningful probability that a no-deal Brexit might occur. Contrast this to 2016 where the markets did not factor in any meaningful likelihood of the referendum voting to Leave.

However, we do not consider that a no-deal is fully priced in, ie the market isn't pricing on the basis it will definitely happen, simply that it might happen.

The table below sets out plausible scenarios that portray the impact for both a 'no-deal' situation and a 'good deal' situation on different investment markets.

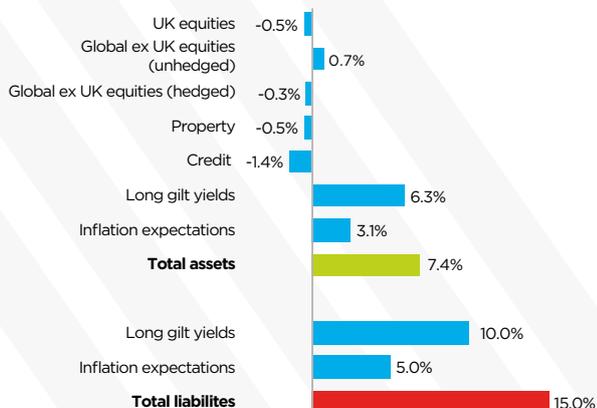
Asset class	Brexit no deal	Explanation	Brexit good deal	Explanation
UK equities	-10%	Confusion over tariffs and trade materially disrupt UK businesses	+5%	Some of the pessimism already built in evaporates but currency appreciation takes the edge off the improvements
Global ex UK equities (currency hedged)	-3%	Unanticipated negative impact on Europe detracts from equity market returns	0%	Global markets largely unaffected with more pressing matters driving returns, such as US monetary tightening
UK credit spreads	0.5%	Dip in the perception of the creditworthiness of UK businesses	-0.5%	Rebound in confidence of UK businesses
Long dated gilt yields	-0.5%	Flight to quality leads to a fall in yields. BoE reduces rates or raises more slowly to support economy	0.5%	Economy shifts towards expectation of continuing rate rises, albeit cautiously implemented
UK commercial property	-10%	Further falls off the back of reduced foreign investment and struggling high street	+5%	Recent losses rebound but longer standing issues around retail constrain upside
Long term inflation expectations	0.5%	Currency depreciation leads to a rise in prices	-0.25%	Future expectations normalise, given that near term inflation has been falling and currently expectations reflect a probability of no-deal
Sterling currency	-10%	Reduced trade and investment in the UK drives sterling down	+10%	Spike in sterling given that the market is currently pricing in the potential of no-deal

Impact on assets and liabilities

No-deal

Comment:

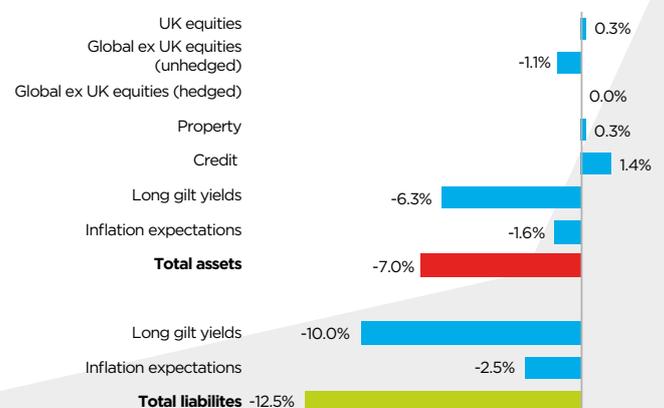
- Typical scheme assets rise by 7.4%
- Typical scheme liabilities rise by 15.0%
- Overall funding level falls by 5.3%
- Gilt yield falls most significant for most



Good deal

Comment:

- Typical scheme assets fall by 7.0%
- Typical scheme liabilities fall by 12.5%
- Overall funding level increases by 5.0%
- It is important to note that a good deal Brexit scenario has scope to have a sting in the tail for investors that have substantial unhedged overseas holdings



What action can you take?

For pension schemes that do not yet feel they have prepared themselves for the uncertainty surrounding Brexit going in either direction, time is running short but there is still scope to take action.

We note that uncertainty applies in both directions and so protecting against the impact of a good Brexit is as important as protecting against a no-deal Brexit – depending on your scheme's specific vulnerabilities.

Schemes can consider their overall risk exposure and where this is judged to be too great consider taking the following possible actions:

- Increase Liability Driven Investment hedging but aiming to avoid trading around the time of key political announcements
- Reduce overall equity exposure – to reduce overall risk
- Introduce or increase extent of currency hedging to protect against a good deal Brexit
- Reduce any overweight to the UK equities – diversifying to currency hedged global equities



The market is on a knife edge – pricing in potential for a no-deal Brexit.

Strategies should not be positioned one way or the other. Instead the key is to be resilient to both.

To discuss any of the issues covered in this edition, please get in touch with Simeon Willis:



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Typical scheme example has assumed asset allocation of 5% UK equities, 11% Currency hedged global ex UK equities, 11% Unhedged global ex UK equities, 5% Property, 29% credit and 39% in gilts/cash/Liability Driven Investment (LDI) with LDI overlay providing a total of 50% hedge on inflation and interest rates. This example scheme was 80% funded.

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