FIXED INCOME

Brexit: Not the Beginning of the End, But the End of the Beginning?

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Against the odds, Boris Johnson's UK government appears to have agreed to a deal in principle with the European Union (EU) which could see the United Kingdom leave the EU on October 31 in an orderly way. But David Zahn, our Head of European Fixed Income, cautions against popping the champagne corks too prematurely. There's still a lot of work to be done, and financial market volatility is likely to remain heightened, he says.

Winston Churchill's famous aphorism: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Seems very apt today.

Against the odds, the European Union (EU) appears to have accepted the UK government's revised Brexit proposals.

There remains a big question mark over whether UK Prime Minister Boris Johnson can secure Parliamentary approval for his new agreement. If he can edge a victory in the House of Commons, Johnson could be on course to deliver on his promise of taking the United Kingdom out of the EU on October 31.

But in Churchill's words—appropriately delivered almost exactly 77 years ago—this is not the end. Consideration now shifts to how the two sides can negotiate a trade agreement over the next two years.

Financial Market Reaction

As active investors, we'll be keeping a close eye on the financial market reaction. In the short term, we expect sterling should likely rally and gilt yields rise.

But markets are likely to remain very volatile. The ability to adjust portfolios quickly to react to changes in the market is likely to be important for active investors.

For example, if there were to be a 50 basis-point[1] rise in yields on the 10-year gilt, some investors might consider that an attractive buying opportunity.

Some of these potential moves in gilt yields might be very short term. However, we should remember that global growth is slowing; growth in the United Kingdom has slowed and growth in Europe has also slowed down considerably. This development is unlikely to change that.

So, if there were to be a significant rise in gilt yields, some investors might spy a chance to lengthen duration[2] in their portfolios.

Currency considerations are likely something investors are paying attention to. We think the pound is already undervalued. Once you remove the uncertainty of a possible hard Brexit, we'd expect to see a resumption of inward investment into the United Kingdom, which could have a positive influence on sterling. But prudent investors will likely want to see what any trade agreement looks like before making decisions.

Impact on Corporate Bonds

Another area this development is likely to bring focus on is corporate bonds—not just those denominated in sterling, but also in euros.

UK corporate bonds have underperformed in recent quarters. We'd now expect to see a potential snapback quite quickly, with yields likely heading down toward the levels of European counterparts.

Away from the United Kingdom, we reckon this tentative agreement should have a positive impact on German assets. Germany was set to be one of the biggest losers if the United Kingdom were to leave without a deal—particularly the German auto sector.

This won't necessarily turn around the fortunes of a struggling Germany, but it might take some of the pressure off. There's still likely to be a lot of uncertainty over the coming months as the practical arrangements of this deal in principle play out.

The Relationship between the United Kingdom and EU

We think a lot of investors have been waiting for some sign of a resolution to Brexit before they return to investing in the United Kingdom. Taking the major risk of a no-deal Brexit out of the European economy should act to bolster confidence somewhat.

But while this agreement reduces the chances of one unknown—the possibility of a Hard Brexit—there remain many other unknowns to be dealt with. As a result, we expect volatility to continue, at least in the short term.

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Actively managed strategies could experience losses if the investment manager's judgement about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results.

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1. A basis point is a unit of measurement. One basis point is equal to 0.01%.

2. Duration is a measure of the sensitivity of a bond or a fund to changes in interest rates. It is typically expressed in years.