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Brexit and the long-term real estate investment picture in the UK

In an interim 2-3 months of likely continued political uncertainty, off-market deals are offering those with longer-term investment horizons rarely available value in both core real estate markets and value add.

An ArCap view of the current picture

1) "No deal" – we anticipate cable (GBP/USD) will be pushed as far as 1.1 then to recover fairly quickly from the "shock", but stay undervalued until the political fallout has calmed, and the economy evidences a return to growth; gradual return of investor confidence to follow as the heavens do not fall. However, as the CBI and others have commented, there will be significant business disruptions.

- A WTO rules ("No deal") Brexit cannot be discounted entirely as a possibility, but it will be by accident rather than design.
- Both main parties may split under no deal (as well as Remain).
- Evidence shows the UK's major trading partner countries rapidly preparing "business as usual" trading arrangements for "No deal"
- Thus the unlikely "worst case" impact of "No deal" is likely to be short-term disruption, some of which will be painful, but with all sides incentivised to resolve the situation quickly.

2) Deal – May's deal, maybe with some tweaks, or an adjusted customs union like deal. Pound rebounds (though arguably this is somewhat priced in), a lot of investment "dry powder" comes back into the market.

- According to our sources inside Parliament the current general direction of political momentum is towards a softer Brexit.
- The EU Council, Germany and President Tusk leading, is resisting a hard approach to the UK as outwardly can appear threatened by the French. The French have to look tough to try to placate current domestic riots, but in reality there has been little to no interest in Macron's recent manifesto for stronger EU integration, much of which is highly unrealistic, for example the EU defence force. Angela Merkel has argued hard for an approach which is more accommodative.
- A lengthy delay in Brexit offers the Council significant downside as Brexit will become a major issue in the European parliamentary elections this spring, and is being seen as a gift for populist parties on the continent and in the UK. Farage has already announced a "Brexit Party" covering left and right in politics, making sure the issue will again be a battle in constituencies all over the UK. Plus a "No Deal" Brexit implies no Brexit payment from the UK, leaving a large hole in the EU budget to fill. The Council is certainly trying to come to some kind of deal to avoid this outcome.
- Thus a short-term extension of Article 50 has been granted to May 22, with a central objective of achieving an "orderly Brexit", with a further plan for a deal if May's deal is not approved by Parliament by April 12th – the last date the UK parliament can approve participation in European Elections.
- Parliament may get to give indicative votes on its preferred outcome, if not "May's Deal" but either outcome is positive for investment.

3) No Brexit/Revocation of Article 50. Immediate positive impact and a surge in cable up to 1.4 and possibly beyond. Strongly positive for investment and growth, but with the possibility of ongoing political turmoil.

- A petition to revoke Article 50 has reached 3 million signatures within days. There is a Remain march planned for the weekend that is expected to draw significant support.
- However, continued political turmoil could ensue, as under a "no deal" scenario.
- An election becomes possible if May's deal or a deal becomes impossible to achieve.
- The Labour party will struggle to win an election if fighting for anything other than Brexit, and its Northern heartland constituencies will be a central target for Farage's new party if it does.
- The Conservatives can win only if they remain Brexit focused, and Farage will target constituencies of Remain MPs. Both main parties have threatened to purge Remainer MPs which could lead to a split of both parties.

The ArCap longer view

The UK has shown economic growth ahead of all but a handful of developed economies in a century of near uninterrupted crisis between the UK and Europe. With a 300 history of stable government and growth to rest on, it seeks to move away from what in historical terms is a comparatively brief experiment (45 years) within the European Union.

Democracy can sometimes be untidy, especially when it is working at its best. Against a picture of apparent crisis, an investor with a long-term perspective may observe that, despite the heat of debate, there are no riots, protestors aren't getting arrested or beaten, and no property is being destroyed, as is the case on a day-to-day basis in France as we write. Instead, political discord, of which there has been much, is absorbed and processed in the solid foundations upon which the UK's democracy is based. In our Brexit process journalists have been reaching back hundreds of years for precedents in our system. Those with long-term-views and who admire constitutional government can find this reassuring, Quixotically so, to those with shorter-term views. Therein we believe, lies the opportunity for long-term defensive investment.

The discord with the EU derives at its highest level, and as the noted scholar Professor Vernon Bogdanor among many others has observed, from comparatively different national political psyches. Over its post war history, the UK has tended, while recognising huge advances in social welfare brought in by Labour, to a more conservative, liberal and free trading, pragmatic and less ideological outlook than the EU, deriving from the reinforcement of its wartime success, not being invaded, not being a victim of nationalism. The EU is, by contrast, more driven by its vision for the European project, driven post war by the need, perforce, to rethink constitutions and orders and to constrain disastrous nationalist tendencies within European structures in which these terrible forces could be sublimated.

The UK psyche sees inherent risks in visions, for example the UK rejected the Euro project, and avoided getting involved in bailing out the Southern European nations and the banking union. It was the great German Chancellor Helmut Schmidt who observed in 1971 that politicians who had visions should go see a doctor. He might have been British. The UK as a whole has consequently never "bought" the European vision of unification and has consistently fought against it, yet since 1961 seeking the trading opportunity provided by the platform. From this long-term perspective we can observe, not much has changed.

Nor has much changed in domestic UK politics. All 5 previous Conservative prime ministers have been riven by the European debate, with even Margaret Thatcher being forced to resign over the issue. Conservatives are internally divided over the issue, but have historically been united in their determination to govern, and for the UK to trade. Plus ca change, c'est la meme chose.

The Labour party is equally riven and again, nothing much has changed. Ideologically, the left views European corporatism with deep-rooted suspicion, and the party split in 1981 over Europe, when it ran on a manifesto to leave the EU without a referendum, leading to the formation of the SDLP. In 2019 another small group of Labour MPs have again left the party to form the Independent Group. The right of the Labour party (Tony Blair and Peter Mandelson considered the Blair project fundamentally Thatcherite in substance) who were leading during Labour's sole extended period in power in the 45 years the UK has been in the EU, opened up the UK to the European migration. It is this migration that resulted in resentment in Labour heartland constituencies in the north, and now threatens them again. So Labour too will likely continue to be riven should Brexit be delayed or cancelled. And it is near impossible to imagine Labour being elected to govern the UK in such a circumstance, such would be the swing to other parties in these Labour/Leave constituencies. Their one hope would be to see the Conservatives lose Remain constituencies such as Kensington and Chelsea, which elected a Labour MP in 2017. However, the gamble to credibly propose a Remain agenda to attract such votes again, after having betrayed Remainer voters so far, is a big stretch for a Labour Leadership who are, at heart, Leavers.

Even could Labour win, with either an adjusted deal, or remain, it is hard to imagine these long term forces not continuing to shape a constructive and pragmatic trading arrangement between the UK and Europe, alongside continuing grumbles over the direction of travel over EU visions, many of which, as we have noted, are fundamentally unrealistic and not widely supported in Europe. Business leaders, union bosses, electors, all across Europe are petitioning their leaders to simply get over the current uncertainties in order that they can plan, invest, work and move forward. The force of these EU wide constraints, upon leaders of the left, the right and the EU visionaries is such that it will continue with increasing force to compel the entire region towards business, trade, growth, the rule of law, and certainty in the end.

Conclusion

The long-term structural underpinnings supporting investment in the UK remain unchanged by short-term political uncertainties. The long term growth of the UK, its central position in the world time clock, language, climate, culture, world leading education systems and world leading centres of innovation, excellent free health care, the rule of law and surety of title, consistent and moderate taxation and regulation, stable and moderate employment law, a professional civil service, all combine to make the UK the 5th largest economy in the world, and a comparatively fast growing developed nation. One might summarise the current debate "it may not be pretty, but it's working" and we would argue it's working ineluctably to a positive conclusion.

Short-term uncertainties provide a buying opportunity, and where some short-term investors hesitate, they put value on the table for long-term investors seeking defensive yield. UK pension funds, for example, continue to invest heavily in UK real estate looking for higher yields than they can find in the bond market, and in our segment of the market, with bond comparable risk profiles.

International investors who are prepared to engage in this period of uncertainty can look forward to doing good deals with higher yield profiles now, or being well prepared in the market when the political picture clears, as it will surely do, and "business as usual" returns.

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