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Is it the right time to invest in the UK?

27th November, 2020

1. **Will UK investments retain their value post Brexit?**

Arlington Capital's assessment is that there still seems to be significant yield compression available in the UK market.

The UK remains one of the world's most desirable investment destinations for its stable and benign regulatory and tax environment, clarity of title, professional investment and services community, world leading research institutions, schools and universities, and for the many aspect of British life which continue to appeal to foreigners looking to settle and bring up their families. This has continued to be the case over the last few years leading up to Brexit and we do not expect this to change post January 1, 2021.

UBS says "A Brexit deal should remove any uncertainty which has been keeping international investors at bay, and thus we could see a return of flow to the UK equity index. UK assets are cheap, UBS have a preference for the UK equity market, given its 30% forward price-to-earnings discount to global equities and its 40% earnings growth forecast for 2021. Our June 2021 FTSE 100 price forecast is 7,000."

There are reasons to be optimistic about UK real estate prices. According to Longview Economics[1] a mini housing boom is underway in the UK. November has brought not one, but three working vaccines, meaning there are now two significant drivers of a return to consumer confidence over the next 6 months. Rising house prices, if history is any guide, will result in a strong wealth effect, rising confidence, stronger spending and a reversal of the dramatic upswing in the savings ratio should release pent up demand, along with some value returning to consumer credit. These factors in themselves would boost economic activity.

Two of the UK's largest commercial landlords have resumed shareholder payouts recently, reporting "robust" performance despite the impact of the pandemic.[2] Investment in UK real estate from foreign inbound investors and the major domestic buyers of assets continues to shore up real values, the former driven in part by a weak pound, the latter by market fundamentals. The City of London with its dependency on the financial service sector has

[1] Longview Economics, Global Macro Report, 9 October 2020 "UK Households: Cashed-Up"; and Global Macro Report, 15 October 2020 "UK Labour Market Adjustment – Well Advanced"

[2] "Property groups reinstate dividends despite pandemic hit" Financial Times, November 10 2020, https://www.ft.com/content/fb92ba44-54c9-4f36-89ac-efa5a54586d2

proved rather resilient and as few as 7,500 financial services sector jobs have left so far, compared to predictions [3] of a huge wave leaving for Frankfurt or Paris. More are likely to go as the ECB creates a regulatory burden on firms to establish more of their operations in Europe in order to be able to trade. However, UK financial services should remain robust as the UK will still host the most liquid financial markets in Europe, which is ultimately what counts. As former Bank of England Governor Mark Carney has pointed out the "City is too big to be a rule taker" and there is a complementary view that "moving away from a one-size-fits-all regime might help UK finance form new partnerships which would help to offset lost business with the EU, now just under 40 per cent of the UK's trade in financial services." [4]

If anything, we see the UK market and London especially as considerably more attractive than for example, the German real estate market. Germany's real estate market has experienced steep yield compression over the last years, and appears to be priced at the top of the cycle. International investors underweight the UK and London since 2016 are, we believe, going to see this imbalance reduce.

2. What will happen to sterling after Brexit?

Arlington's assessment is that there is some limited upside for sterling when the current Brexit uncertainties clear.

Sterling currently buys €1.12 and has traded around this mark with some volatility for over eighteen months now. Remember that sterling bought €1.30 on 23 June 2016 the day the Brexit referendum was held. Sterling had already depreciated significantly over 6 months prior to the vote so the current trading range is at an historic low. The market consensus suggests that risks associated with a hard Brexit, perhaps with a tiny trade deal attached, is largely priced in already.

Goldman Sachs Asset Management expects[5] that Britain and the European Union will strike a "thin" trade pact toward year-end, yet it maintains a "broadly neutral" position in the pound, gilts and the nation's corporate credit market regardless. The bank said that sterling, which at the time of the vote to leave the EU bought $1.30 or €1.10, remains held back by a perceived level of uncertainty that is "no longer warranted". Goldman said: "An orderly exit should persuade longer-term investors to reduce their UK underweights that have persisted since the referendum, as well as significantly reduce the risk that the Bank of England will introduce negative rates."

[3] "'Tens of thousands of jobs will go' in the City if UK leaves EU" https://www.ft.com/content/868345d8-1607-11e6-b197-a4af20d5575e

[4] "Brexit and the City: lost passport. A beggar-thy-neighbour battle for business will benefit Paris, Frankfurt and Dublin less than some EU politicians imagine" https://www.ft.com/content/b7ca7c6d-5753-4013-945a-55f2924269c1

[5] Goldman Sachs Economics Research 7 November 2020 "A (V)accine Shaped Recovery"

We agree with Goldman's expectations for a "thin" trade deal at best, and bearing in mind the market has this largely priced in already, should there be no deal we expect some volatility to perhaps even approaching parity[6]. We expect a quick recovery to follow above the €1.1 mark with further upside from an economic recovery as vaccination releases pent up demand in the economy, with the potential for a "rebound in UK assets" and the consequent release of pent-up demand for the pound likely also to assist the Bank of England in avoiding negative interest rates.[7]

The sterling interest rate Forward Swap Curve[8] implies a market consensus that rates will not rise much over the next five years. It is also the current policy of the Bank of England not to raise rates any time soon[9]. In fact, the BoE is adopting an inflationary policy and stated it won't raise rates until inflation has reached its target of 2%, which it expects to occur over the next 3 years. The impact a rise in interest rates would have on the government's cost of borrowing is a further brake in this direction, a condition which affects all major economy governments.

Rather, we see inflation as the risk. The Bank of England has a mild basic inflation target of 2% that may be "moderately" exceeded before the Bank takes any action, with the BoE likely to follow within the Fed policy here[10], so we expect some inflation to have a meaningful impact over the next five to ten years, but against what background?

To address the public finances, the UK is comparatively fiscally and monetarily conservative, standing favourably alongside comparable big economy borrowers, ensuring interest rates can stay low in the longer term, supporting the UK's longer and extending average maturity of government debt compared to other big economies[11]. The UK's current outstanding stock of gilts had an average maturity of nearly 16 years at the start of 2020, far longer than the world's other major bond markets, and though UK government debt has risen during COVID at a rate not seen for 300 years, the Treasury is able to borrow 6 year money at negative rates, and 30 year money is available at just 0.9%.[12] As a result a UK sovereign debt crisis is highly unlikely.

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[6] "Brexit crunch time? Traders say maybe later" https://www.ft.com/content/b58f2484-a741-4502-be49-90632e6d6202

[7] "Brexit crunch time? Traders say maybe later" https://www.ft.com/content/b58f2484-a741-4502-be49-90632e6d6202

[8] https://www.bankofengland.co.uk/statistics/yield-curves

[9] https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/september-2020.pdf

[10] "With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent." FOMC statement by Jerome Powell, September 16, 2020 https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916a.htm

[11] "UK long-term government bond yields sink below Japan's" https://www.ft.com/content/cfc3f73a-36e6-4b73-8387-168774ed958a

[12] "Why investors are not likely to cry out 'yikes' over UK debt" https://www.ft.com/content/767d81c6-726c-4d34-8b24-d9685a60ab1b

Within the current basket of macro-economic factors, particularly the forward guidance issued by the Bank of England, the Goldman's analysis above remains our central expectation. We see UK real estate as an excellent hedge against wider volatility, especially when market practice commands indexed tenancy agreements and asset backed ten-year fixed debt interest rates are low and demonstrably set to remain low, with inflation the main risk alongside upside risk for sterling against the euro. Each of these factors would provide upside for investors.

3. Do taxes for international investors in the UK change with Brexit?

Arlington does not provide tax advice.

We obtain individual tax opinions from leading professional services firms on behalf of our clients as part of the transaction structuring process, pre investment. [13]

The European Union (Withdrawal) Act 2018, although it repeals the European Communities Act 1972, actually ensures that EU legislation that applies directly to the UK is incorporated into UK law. It also ensures that UK legislation based upon other types of EU legislation, such as EU Directives, is preserved.

The principle applied is that the totality of UK law will be the same, both before and after, Exit Day. Legislation introduced in the Great Repeal Bill will in fact work exactly the same way post Brexit as it did pre-Brexit.

Further, to avoid double taxation the UK has negotiated treaties with over 100 countries so the potential for double taxation is neutralized, as well as the potential withholding taxes. There should be no changes to the tax treatment of UK investment for International-identity capital.[14]

UK legislation giving effect to the EU Interest and Royalties Directive (IRD) will still be effective and unamended from 1 January 2021.

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[13] Note: Arlington does not provide tax advice. Comments are subject to a tax opinion from a professional services firm.

[14] https://www.gov.uk/guidance/double-taxation-relief-for-companies

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