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The workplace pensions experts

BBS investment update

Update on Brexit and Possible Investment Implications

Summary

- With Theresa May's deal being comprehensively rejected by Parliament, the direction of the Brexit process remains uncertain.
- This investment update considers the possible impact on markets that affect the value of pension scheme assets and liabilities.
- For many schemes, a key consideration will also be the impact of Brexit on the sponsor, with a potential weakening in covenant for employers that rely on trading relationships with and via the European Union.
- In recent years, trustees of pension schemes have increasingly developed investment strategies expected to be appropriately resilient through a range of economic scenarios, taking account of their specific position. However, please discuss any concerns you might have with your usual BBS consultant.

1. Introduction

Following Theresa May's record Parliamentary defeat on her 'Plan A' withdrawal agreement, the outcome of Brexit remains very uncertain at the time of writing. Mrs May's Government survived a vote of no-confidence immediately after this defeat and has met with MPs across the political spectrum to try to find a way forward. However, obtaining any consensus appears to be very difficult.

There are a number of possible outcomes:

- An amended 'Plan B' deal is voted through by Parliament prior to the 29 March 2019 deadline.
- The UK leaves the European Union (EU) on 29 March 2019 with no deal.
- Brexit is delayed while a withdrawal deal is negotiated.
- There is a second referendum on the form of withdrawal and whether to leave at all.
- Something else happens!

This update provides a brief reminder of some of the possible investment implications of the main potential outcomes of the Brexit process.

2. Market Reaction

No-deal Brexit

The markets are likely to view a 'no-deal' Brexit on 29 March 2019 as the worst possible scenario. Markets would be concerned about both short-term disruption and the longer-term impact on the UK economy associated with an uncertain future trade relationship with the EU.

Sterling would be the most obvious target for investors seeking to express a negative view on the UK, and one might expected a further fall in its value. The resulting higher cost of imports might be expected to lead to higher price inflation, although this may be offset to some extent through reduced consumer and business confidence. Sentiment towards domestically-focused UK equities may turn more negative, although the shares of larger FTSE-listed companies receiving significant levels of Dollar and Euro-based revenue may receive a revenue boost from a weaker Sterling. European assets could generally struggle if global investors' sentiment turns negative on the region as a whole.

Whilst higher inflation might be expected to require an increase in interest rates, the opposite may be true in practice. In particular, the Bank of England may be required to keep rates 'lower for longer' to stimulate economic activity, putting downward pressure on long-term gilt yields and increasing pension scheme liabilities. Gilts may also be regarded as an attractive safe-haven investment by UK investors. Again, upwards pressure on gilt pricing will be subject to the competing offset of overseas investors reducing Sterling exposure by selling their UK assets.

Similar to the period immediately after the EU referendum in 2016, UK commercial property may suffer adverse sentiment, with potential for restrictions to be placed on redemptions from pooled property funds.

Brexit with a withdrawal agreement in place

If the UK were to leave the EU with a deal along the lines of that proposed by Mrs May, then this would be likely to be seen positively by markets, with less chance of short-term disruption and an assumption that a favourable future trading relationship is more likely.

Under this scenario, Sterling might be expected to rise, whilst there would also be improved sentiment towards UK assets such as equities and property. The Bank of England is likely to be more comfortable continuing its process of 'interest rate normalisation', which could reduce pressure on longer-term gilt yields and pension liability valuations. The threat to inflation caused by a weaker Sterling would also be reduced.

Delay to Brexit

A delay would tend to be viewed positively by markets, as it would be considered more likely to result in a 'softer' form of Brexit, with less disruption to existing trading terms or potentially a second referendum resulting in the UK staying in the EU.

3. Brexit and UK Assets aren't Everything!

The above illustrations of the possible implications of different Brexit outcomes are very much on an 'other things being equal' basis and do not consider other global economic events and non-UK assets. For instance, a 'softer' Brexit outcome may lead to losses on overseas assets if overseas currency exposure is not hedged. Similarly, the fate of global markets is, ultimately, more likely to be affected by the direction of the US economy and its interest rates rather than the course taken with Brexit negotiations.

4. Defined Benefit Scheme Liability Values

As discussed above, broadly speaking, the increased likelihood of reduced economic activity associated with an uncertain trading relationship with the EU (i.e. a 'no deal' Brexit), is more likely to put upwards pressure on pension scheme liability values.

The extent to which a defined benefit pension scheme will be affected by this will depend upon their level of liability hedging – those schemes with low levels of hedging will be more exposed to adverse changes in long-term interest rates.

5. Multi-asset Holdings

Schemes invested in multi-asset strategies have delegated asset allocation decisions to their managers. The managers will be factoring the potential implications of the Brexit process into their portfolio management decisions and should be prepared to act quickly, irrespective of the outcome. The events of the past few years have shown how difficult it is to predict political events and the investment implications of such events – however, one of the advantages of multi-asset approaches is the speed with which a manager can respond to events.

6. Impact on Employer Covenant

One of the biggest implications of the form of Brexit will be the extent to which it affects sponsoring employers. This will vary significantly from scheme to scheme, and trustees need to keep a watching brief on the position. For instance, if a 'no-deal' Brexit would materially weaken the employer covenant for a scheme, and that scenario becomes increasingly likely over forthcoming weeks, then consideration ought to be given as to whether the level of investment risk should be reduced, e.g. through increasing the level of hedging against interest rate risk.

7. Conclusions

This summary is intended to provide a brief reminder of the main investment implications of different outcomes for the Brexit process, which remain difficult to predict. BBS clients will typically have considered the risks to their own scheme's position associated with a range of economic scenarios, inclusive of the type of outcomes discussed in this update.

However, please contact your usual BBS consultant if you wish to discuss your scheme's specific situation in more detail.

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