



Countdown to Brexit

KPMG Investment Advisory

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Countdown to Brexit

We spend a great deal of our time carefully mapping out with our clients potential catalysts for a sea change or a sudden repricing of assets in markets. More often than not these catalysts, and the risks and opportunities which go with them, are uncertain in timing and vary in their probability of occurring.

Political events are different in an important respect. We know something is definitely going to happen, and we often have certainty on when 'it' is going to happen, we just don't know what the outcome of 'it' entails. Usually 'it' is an election with one of two, or maybe three, results. But on 29 March 2019 'it' is the UK's formal departure from the European Union, with a myriad of possible outcomes depending on the shape of any deal negotiated (or not).

It is rather like having a staycation for the British summer unwittingly booked for you. You know when and where you are going – the dates of annual leave are blocked out in your work calendar, and the B&B on the Dorset coast is reserved. But if the weather will be sun-kissed or stormy is near unknowable.

Whilst the good news is that a relatively known timeline allows pension schemes to do some forward planning, the challenge is, with so many outcomes possible over the next five months, how to plan effectively.

Know where you will be affected

Planning effectively for Brexit first means knowing which areas or decisions are likely to be affected. For pension schemes these are threefold:



Sponsor covenant

Lots of businesses, many of whom may be pension scheme sponsors, face potential disruption after 29 March and/or could see significant changes to their operating environment in the longer-term.



Investment portfolio

Sterling, European and UK equity and credit markets, UK gilts and property markets will all respond as political events unfold.



Liability management exercises

Significant moves in long-term interest rates, credit spreads and market pricing of inflation may impact either the terms offered to members or the degree of cost-neutrality of those offers.

Understand the possible political and market scenarios

Whilst the political outcome remains unclear, from a practical planning perspective for pension schemes, we believe the political scenarios can be classified into 3 categories:



Deal

The withdrawal agreement which has been negotiated (or another amended version) is ratified by the UK and European Parliaments. A transition period begins and both sides work towards a permanent future arrangement before December 2020. Disruption for businesses will be minimal due to transition, but some unexpected consequences remain possible.



Inconclusive

The negotiating parties cannot break the stalemate on a future arrangement but find a form of words which contains enough ambiguity to be acceptable. A withdrawal agreement of some form is signed, but the medium term future is uncertain.



No deal, "accidental cliff edge"

No deal is reached, or the withdrawal deal on the table is voted down by the UK parliament. The Brexit deadline passes and the UK implements its no deal planning. The UK falls back on WTO rules for global trade, with businesses operating in the UK across many sectors having little time to enact contingency plans leading to significant short term disruption.

It is worth remembering that asset prices can react to particular political scenarios very differently than even the most seasoned observers of markets can anticipate. Many foretold of gloom and volatility for equities in the immediate aftermath of 2016's "Leave" vote and Trump's US presidential victory. Whilst volatility did materialise, it was skewed to the upside. Markets rebounded strongly after an initial dip in early trading, and proved resilient over the following months. Therefore, understanding different market scenarios which may result under the same political outcome is just as important.



Develop a contingency plan

Businesses across all sectors of the UK economy are putting in place contingency plans for Brexit, and so we believe pension schemes should too.

A robust contingency plan should:

1. Identify where your 'risk hotspots' lie.
2. Ensure your portfolio is built to weather the range of political and market scenarios.
3. Include preparation to be nimble to capture potential upside.

Our 'Brexit checklist' can help you evaluate whether your contingency plan is fit for purpose or if there are areas where you might benefit from additional preparation.

Where are your investment risk 'hot spots'?

Currency

Most likely the asset class expected to have the maximum volatility. A significant repricing of Sterling in the event of a disorderly exit or last minute deal is a strong possibility.

Inflation

UK price inflation may in part respond to exchange rates movements, but also in part to wage growth. Wages themselves will depend on the extent to which tightness in the labour market is (or is not) offset by pressure on company margins in a post Brexit landscape.

Interest rates

Short-term interest rates will be dictated by the policy response from the Bank of England. The reaction of long-term interest rates will depend on the extent to which gilts continue to be seen as a "safe haven" asset by investors and the demand by UK institutional investors.

Sponsor covenant

Whilst important to identify financial risks within the portfolio, the overall level of risk in investment strategy rests on the strength of the sponsor covenant. This could be a scheme's single largest risk exposure.

Equities

Reaction in equity markets is likely to be localised in the UK and Europe. Smaller UK companies, who often have a more domestic focus, represent a closer barometer of the health of the UK economy than large-cap companies comprising the FTSE100 Index.

Credit

Similar to equity, the impact is likely to be limited to UK credit and to a certain extent European credit. However, we do not expect any of the outcomes to significantly impact the default outlook for UK investment grade credit.

UK property

Capital values are likely to be vulnerable if the UK domestic economy suffers a shock. However, prices may be supported by overseas investors taking advantage of a weak pound to purchase assets at bargain prices.

Liability management

Schemes considering PIE or FRO exercises should be wary of what the impact of Brexit might be? If volatility spikes in currency and implied inflation, PIE exercises may become viewed as less attractive by members.

Possible political and market scenarios

How might each of the investment exposures, or 'hot spots', we have highlighted respond under our central political scenarios? This provides a conceptual framework in which to consider how your current portfolio and funding position may be affected.

	Deal	Inconclusive	No deal, "accidental cliff edge"
 Rates	<p>The Bank of England has charted a course of gradual tightening of monetary policy and is likely to pursue this. The impact on long dated gilts is difficult to analyse due to the persistent demand from liability aware investors.</p> <p style="text-align: right;">↑</p>	<p>Status quo scenario where rates react to gradual tightening of monetary policy, and modest growth keeps inflation stable.</p>	<p>Gilts act as a "safe haven": risk off sentiment where rates tumble as investors seek the safety of gilts. ↓</p> <p>Gilts sell-off: investors lose confidence in the UK debt, with potential rating downgrades. ↑</p>
 Inflation	<p>While wage growth may put pressure on prices, a stronger pound would ease the cost on imports, keeping inflation stable and potentially lower.</p> <p style="text-align: right;">↔</p>	<p>Sterling and UK property to struggle from lack of clarity and expected to be slightly weakened.</p> <p>UK and European equity and credit markets are likely to move range bound with no significant moves one way or the other.</p>	<p>Price inflation kicks in as import prices rise following significant Sterling fall. ↑</p>
 Currency	<p>Sterling is likely to be the beneficiary with the expectation of strengthening versus the Euro and US Dollar.</p> <p style="text-align: right;">↑</p>	↔	<p>A further fall in Sterling likely. ↓</p>
 Equity	<p>UK and European equity markets most likely would respond positively, especially small cap companies. For UK large caps, good news may be tempered by the degree to which Sterling strengthens.</p> <p style="text-align: right;">↑</p>		<p>Elevated uncertainty and potential for contractual disputes is priced into UK and European equities. But, conversely to a "deal" scenario, weaker Sterling helps in supporting large caps and exporters. Risks associated with active management may be exacerbated. ↔</p>
 Credit	<p>Most likely to see the UK & European credit spreads tighten, but not significantly.</p> <p style="text-align: right;">↔</p>		<p>Spreads most likely to be pushed out especially in below investment grade UK & European credit. ↓</p>
 Property	<p>Modest capital appreciation in response to resumed capex by businesses.</p> <p style="text-align: right;">↔</p>		<p>Property prices in the retail and central London office sectors are impacted, the former in response to weaker consumer demand and the latter in response to financial services relocating operations to EU-hubs. ↓</p>

Mapping your Brexit contingency plan

Our recommendation is to have a “Brexit Plan” ready and prepare your portfolios to weather a range of possible outcomes.

As a first step, our ‘Brexit checklist’ can help you evaluate whether your plan is fit for purpose or if there are areas where you might benefit from additional preparation.

Your Brexit checklist



Have you evaluated the potential impact on sponsor covenant?



Have you identified the investment risk ‘hotspots’ and do you understand how your portfolio is likely to respond to a range of Brexit scenarios?



Have you identified what levers are available to you to either manage risk or capture opportunities?



Do you have a governance framework and operational plan in place to take action swiftly if necessary?



Do you have any significant projects in the pipeline which may need revisiting and re-evaluating? Planned liability management exercises, asset transitions, fund commitments?

Whilst planning should focus on how best to manage risk and protect your scheme's funding position, for those that can be nimble this could also incorporate ways to capture opportunity should markets present them.



Rates and Inflation

Risk management

Revisiting hedging policy: Unless the Sponsor or Trustee has strong views on the direction of rates, our recommendation would be to hedge as much as possible to reduce downside risk. Clients may want to think about phasing the hedge increase over multiple trades given the expected volatility in markets.

Schemes should ensure they have sufficient liquidity if LDI portfolios require additional collateral.

Opportunity

Clients with sophisticated governance structures could install trigger mechanisms for your LDI manager to capture any upside from volatility.



Currency

Re-visiting hedging policy: Hedging currency exposure provides greater certainty of outcomes, but the policy should also consider the potential for USD to act as a safe haven currency during times of distress.

Similar to rates, Brexit could provide attractive opportunities to re-adjust your currency hedge.



Equity and Credit

A geographically diversified portfolio mitigates the risks a no deal Brexit may represent. Potentially reduce any significant overweight to UK exposures.



Property

Review your allocation and understand the sector exposures in more detail. If you have any significant concerns, managers may be able to provide opportunities to reduce exposure at reasonable prices.

Our consultants are happy to help you assess your Brexit plan and conduct bespoke analysis to demonstrate how robust your portfolio is under each of the scenarios. We can work with you to take the next steps necessary to improve your Brexit readiness.



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