Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY July 6, 2021

How Has Brexit Impacted the U.K. Economy?

Britain voted to leave the European Union (EU) in the famed Brexit vote on June 23, 2016. That means it's been just over five years since voters decided to end 47 years of U.K. membership in the EU. This was a huge decision, with far-reaching economic and investment implications that are still being processed.[1]

Our research looks at trends not only in the U.S., but also across the global economy. We live in an increasingly globalized world – more than 50% of all reported foreign taxable income (for all companies, globally) is earned in Europe and Asia. In 2019, S&P 500 companies derived almost 30% of their revenues from outside the U.S. Investors may not realize it, but by owning large cap U.S. stocks, you are actually gaining international exposure.[2]

Today and going forward, understanding where multinationals derive revenue – and understanding the macroeconomic pictures in those regions and countries – are key components of thorough earnings analysis.

That's what makes the U.K., which was the 6th largest economy in the world in 2020, so important. It also makes it worth analyzing the Brexit decision closely, to understand how the U.K. has performed since the decision – and what the future may hold.

So far, it has not been so good. Here are a few key data points worth noting:

- In the five years from June 23, 2016, to June 23, 2021, the MSCI All-Country World Index rose +80.65%, but the MSCI UK Index is only up 8.13% (price returns). The underperformance here is quite significant;
- Britain's international trade has declined 14% since 2018, while total world trade declined a lesser 8% over the same period;
- Out of 10 major global currencies tracked since the Brexit referendum on June 23, 2016, the pound sterling (GBP) has weakened the most;
- Business investment in Britain stalled in the years following the vote, and took a big hit during the pandemic;
- London has been slowly losing its status as the financial capital of Europe, with banks continuing to shift employees to other European cities;

- And, most recently, Britain has been facing labor shortages similar to what we are seeing here in the U.S., without the ability of EU workers to enter the country and fill jobs.

Brexit has not been an unmitigated disaster for the U.K., but it has certainly not been a triumph, either. The upshot is that the U.K. may implement some pro-growth policies going forward, which could reopen an investment thesis for British stocks.

The government is currently planning a "super deduction" tax break, which will allow businesses to deduct 130% of new equipment and plant spending. If a business buys a $100,000 machine in 2021, it can deduct $130,000 from revenue when filing taxes in 2022. This tax break could spur new investment.

Financial services make up 7% of Britain's economy, and 40% of its financial services exports go to the EU. But Brexit has muddied London's standing as the financial hub of Europe, with cities like Amsterdam, Frankfurt, and Paris vying to take its place. On the working first day of 2021, trading in European shares showed a marked shift from venues in London to venues on the European continent. Many expect the trend to continue.

Once again, the government is attempting a pro-business response, by overhauling rulings on listings and loosening regulations. Part of this effort involves allowing SPACs into the markets and setting up a fast-track visa process for fintech workers who want to move to Britain. Fintech is another area where regulators are being asked to step back to let start-ups experiment.

Bottom Line for Investors

The five years since Brexit have been largely rough going for the U.K. economy and equity markets. Stock market returns have been muted, growth has been uninspiring, trade has fallen, and business investment has stalled. There have not been many reasons to be excited about investing there.

The picture could look different going forward, however, as the government seeks to goose the economy with lower taxes, less regulation, and other incentives like fast-tracked visas for tech workers. All developed economies are likely to see a strong bounce back in the months and quarters following the worst of the pandemic. The question for the U.K. and global investors, however, is whether Britain can return to its pre-Brexit might.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Bloomberg. June 23, 2021. https://www.bloomberg.com/opinion/articles/2021-06-23/brexit-five-years-after-referendum-shows-no-gain-just-pain

[2] S&P Market Intelligence, June 18, 2020. https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/s-p-500-companies-non-us-revenue-share-hits-10-year-low-8211-goldman-sachs-59094991

IN FOCUS THIS WEEK

- Consumer purchases shifting
- Business investment soars to new highs
- U.S. banks remain in strong shape

Consumer Spending Remains Strong, But Purchases are Shifting

American household spending was flat in May from the previous month, but a closer look at the data shows that U.S. consumers increasingly eschewed larger ticket items in favor of spending on travel, restaurants, and other everyday services. During the pandemic, Americans stepped up purchases of big-ticket items like cars, homes, and home improvement projects, while spending far less on services. In May, households were seen doing the opposite – spending on leisure and discretionary services rose 0.7% while spending on furniture and cars fell by -2.8%. Even still, strong spending throughout 2021 has started to show signs of easing, as households dig into the accumulated savings of the past year. The personal saving rate fell to 12.4% in May from 14.5% in April, as spending stabilized (see chart on the right). Consumers are eating into savings a bit, but remain confident about economic prospects looking ahead – the consumer confidence index rose to 127.3 in June, and has been fast approaching the pre-pandemic high of 132.6 reached in February.[1]

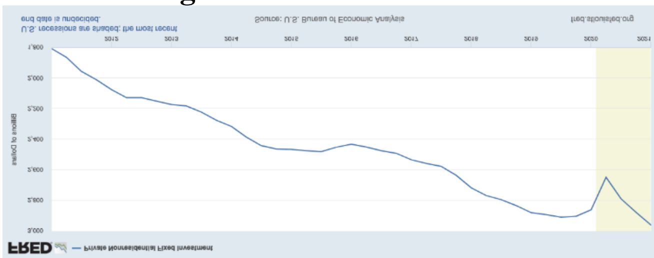
U.S. Consumer Spending

Source: Federal Reserve Bank of St. Louis[2]

Business Investment Soars Past Pre-Pandemic High

Many market-watchers have long awaited a return of the business investment cycle, which was largely absent during the economic recovery following the 2008-2009 Global Financial Crisis. Following the "Great Recession," businesses were more reluctant to invest in capital and equipment, and labor was cheap. Instead of investing in new plants, companies just hired more workers. In the current economic recovery/expansion, the labor market is tight, and workers are demanding higher wages. This setup has spurred businesses to increase spending on computers, equipment, technology infrastructure, and software to drive productivity. Nonresidential private fixed investment, which is a proxy for business investment, increased at a seasonally adjusted annual rate of 11.7% in Q1, following double-digit increases in Q3 and Q4 of last year (see chart below). It makes sense that the biggest outlays in spending came in software and tech equipment, as businesses position for the realities of less customer contact (think delivery everything) and a "hybrid" work model where employees work in some combination of home and office.[3]

Business Investment Climbs Above Pre-Pandemic High



Source: Federal Reserve Bank of St. Louis[4]

U.S. Banks, Largely Unfazed by the Pandemic, Remain in Strong Shape

Remember the Fed's "stress tests," a legacy of the 2008 Financial Crisis where the Fed would check banks' capital levels and readiness for an economic crisis regularly? The stress tests are still happening, but they barely make the news anymore because banks keep passing them easily. A fairly major shift happened this week, with the Fed saying it would now end limits on dividend payments and share buybacks for the biggest U.S. banks. In the news, many major banks announced plans to do both – raise dividends and buy back shares.[5]

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[1] Wall Street Journal. June 25, 2021. https://www.wsj.com/articles/consumer-spending-personal-income-inflation-may-2021-11624563378

[2] Fred Economic Data. June 25, 2021. https://fred.stlouisfed.org/series/PCE#0

[3] Wall Street Journal. June 27, 2021. https://www.wsj.com/articles/capital-spending-surge-further-lifts-economic-recovery-11624798800

[4] Fred Economic Data. June 24, 2021. https://fred.stlouisfed.org/series/PNFI

[5] Wall Street Journal. June 24, 2021. https://www.wsj.com/articles/fed-gives-big-banks-clean-bill-of-health-in-latest-stress-test-11624566662

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The MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries. With 2,986 constituents, the index covers approximately 85% of the global investable equity opportunity set. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The MSCI UK All Cap Index captures large, mid, small and micro cap representation of the UK market. With 819 constituents, the index is comprehensive, covering approximately 99% of the UK equity universe. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

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