
EUROPEAN MACRO OUTLOOK: UK

Wisdomtree EU
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Structural weakness in sterling underpins pressures on economy and gilts

Expectations of a hard Brexit that triggered a marked devaluation of sterling last year have effectively reversed since a now markedly weakened PM in charge of a minority government must lead the exit negotiations with diminished political capital/leverage. Britain looks ready to make more concessions to the EU than previously envisioned. Philip Hammond, UK's finance minister, has already stated that the vote to leave the EU was not a vote for Britain to become insecure or poorer, thus prioritising the economy over anything else. We believe the stance by taken by the Treasury Department will help to stabilise the sterling in the short term.

Looking ahead, the EU will prioritise cementing stability within the EU membership itself as two years of negotiations start on a new trade relationship between the UK and the EU. Depriving the UK of some - and potentially major - economic benefits it enjoyed as an EU member is therefore on the cards. Affecting the pound potentially the most will be the loss of EU passporting rights that allow banks and insurance companies to sell financial services into the EU freely and without having to set up a local presence. Financial services are the UK's largest contributor to the trade surplus. Losing these benefits means those trade surpluses are set to weaken, unless offset by improved export conditions in goods as sterling weakens. As an overwhelmingly service based economy however, the net effect points towards a widening, not shrinkage, of UK's trade deficits with the EU.

UK's overreliance on foreign capital to not just fund the trade deficit but also fund deficit spending and sustain confidence in an already propped up housing market underpins sterling's structural weaknesses. It leaves monetary policy of the Bank of England (BoE) largely on hold to dovish. The import-cost induced inflationary pressures following the marked devaluation in sterling means consumers' debt-fuelled spending power looks significantly weakened over the remainder of 2017 amidst indications of wage rises remaining absent. Therefore, any tightening by the BoE will likely come in a delayed fashion, as the weakening of energy and food prices will ease inflationary pressures further out. The muted long-term inflation expectations suggest gilts are unlikely to succumb to significant pressure, as even when inflation adjusted, UK's long-dated gilt yields are negative. However, bigger pressures await gilts if sterling continues to weaken or succumbs to increased volatility. We see foreign investors' enthusiasm in gilts, which in the period from 2010 to date amounted to GBP 237 billion of net purchases (even as UK investors redeemed GBP 116 billion in the same period) wane as a primary concern for gilts longer term.

Across UK asset classes, we see UK equities overall the least affected. Large-caps are likely to absorb the 2 years and probably more of soft Brexit negotiations, along with the rising structural imbalance caused by UK's twin deficits, better than mid and small-

caps. A potentially higher and volatile inflationary backdrop would also favour high dividend yielding equities as income strategies.

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