Upgrading UK equities to overweight

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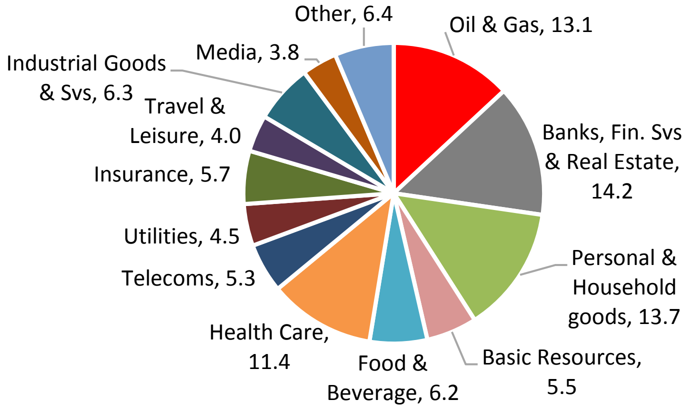
- **Within our asset allocation we have a long-standing underweight recommendation on equities. However, within the equity asset class, we upgrade UK large cap equities to overweight from underweight**
- **FTSE100 companies derive c70% of their revenues from overseas, meaning that prolonged (and further) GBP weakness will support earnings for a large array of the global heavyweights which dominate the FTSE100 index**
- **Key reasons to expect further GBP weakness are:**
  - **Continued easy monetary policy as the Bank of England attempts to cushion the economy from the Brexit-induced slowdown…**
  - **…as well as the UK's sizeable external vulnerability; currency weakness supports capital inflows required to fund the current account deficit**
- **Our preferred way to play this theme is via a dollar-hedged FTSE100 ETF (small caps have lower overseas revenues and therefore benefit much less from GBP weakness)**

Further currency weakness and loose monetary policy key supports

Large cap UK equities (FTSE100) have been among the best performing stocks globally since the June 23rd Brexit referendum, rising 9% in local currency. The reasons for this relate mostly to pound sterling weakness as well as Bank of England policy reaction to the Brexit vote. To a large extent these two factors are intertwined given that easier monetary policy leads to currency weakness. However, the UK's slowing economic growth and sizeable external vulnerabilities also call for a weaker currency. Despite the 14% depreciation in sterling against the US dollar already, we expect further pressure on the currency, not least because a cheaper GBP is required to maintain capital inflows in order to fund the 6% current account deficit.

GBP weakness will continue to boost earnings for UK large cap stocks; c70% of FTSE 100 companies' revenues are derived overseas. UK listed global heavyweights such as Burberry, BHP Billiton, Rio Tinto, BP, Shell, GlaxoSmithKline, to name a few, generate only a small share of their profits in the UK. Repatriating their euro and dollar profits from abroad therefore translates into higher GBP-denominated earnings. Sectors likely to be negatively impacted by Brexit and/or GBP weakness are banks (due to uncertainty over so-called EU passporting rights), real estate (as weaker domestic property demand will likely more than offset higher foreign demand) as well as companies relying on imported goods or raw materials. Looking at the FTSE100's sector composition (chart below) shows that banks and real estate are a relatively small share of the market. On the other hand, the share of defensive sectors (health care, staples, telecoms, utilities) and overseas revenue generators (resources, consumer discretionary) is very high. This is supportive of further outperformance in what remains a challenging environment for risk assets.

FTSE100 Supersector Breakdown (August 31, 2016)



Source: FTSE Russell

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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