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Brexit: Are UK stocks really that hot?

New KPMG indices reveal underlying sentiment towards UK economy

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At a glance:

- New KPMG UK50 index filters out currency impact to reveal investor sentiment about UK economy
- Both domestic and globally geared companies have underperformed global benchmark since vote
- £40 billion wiped off value of KPMG UK50 since referendum

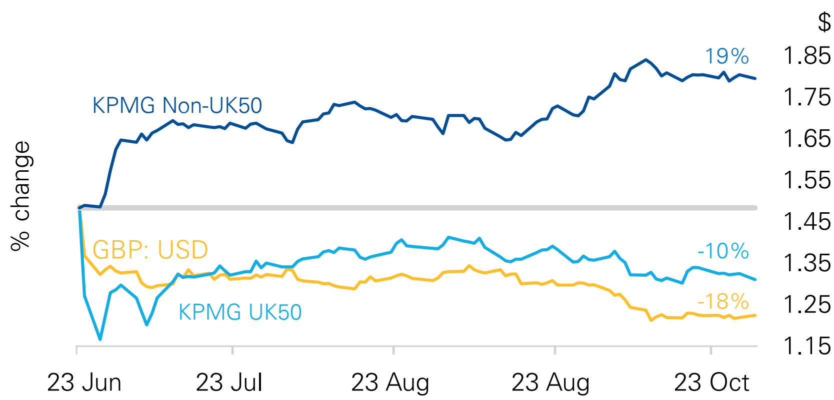
Defying the pre-vote predictions, the major UK stocks indices have surged since the EU referendum. Yet few attribute its performance to a groundswell of optimism about the broader UK economy. Most market watchers and participants agree that gains in the FTSE 100 in particular are thanks to the pound's 18% fall since 23 June because many of its constituents generate a significant portion of their revenues in dollars (which now buy more pounds). The fact that 40% of FTSE 100 companies declare dividends in dollars has also attracted investors.

But while the performance of the FTSE 100 (and to a lesser extent the FTSE 250) is good news for investors and savers, it is little use as a barometer of sentiment towards the UK economy. To gauge investors' appetite for UK exposure, KPMG has developed two stock indices that strip away the international effect.

The KPMG Non-UK50 is made up of the UK's largest listed firms that derive more than 70% of revenues from abroad. The KPMG UK50 includes the largest listed firms from the FTSE 100 and 250 that derive more than 70% of their revenues from the UK.

Plotting their performance since 23 June reveals just how sharply their fortunes have diverged. While the KPMG Non-UK50 is up 19%, the KPMG UK50 is down 10%. Put in pounds and pence, that equates to a £211 billion rise in the value of the KPMG Non-UK50 and a £40 billion loss for their domestic equivalent.

Chart 1: Performance of KPMG indices since Brexit vote



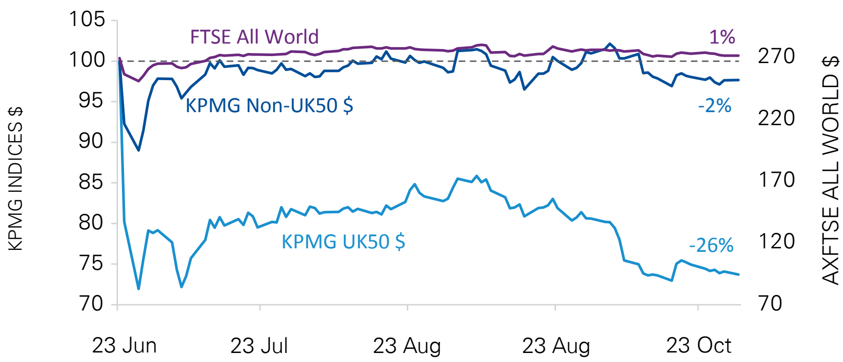
Graph sources: KPMG analysis, Bloomberg, Capital IQ and Thomson Reuters Datastream

Is this just a currency story? Certainly, the fact that the gap between the two continues to widen as the pound has depreciated further suggests that may be the case, as does the performance of the KPMG Non-UK50 almost perfectly mirroring sterling.

That said, uncertainty over the future of the UK economy inevitably plays a role. Although preliminary figures for third quarter GDP beat expectations, we still expect growth to halve next year to 1% as investment spending falls and consumer confidence wanes in the face of rising prices and uncertainty. Without the benefit of the weaker pound acting as a shock absorber to the share price, these macro factors are likely to be uppermost in investors' minds.

Putting both indices in a global context and rebasing them in dollars, takes even more of the sheen off the performance of UK stocks – whether geared to domestic or global earnings. In dollar terms, the KPMG Non-UK50 is down by 2% and the KPMG UK50 index of domestic stocks is down 26%. By comparison, the FTSE all world $ Price Index has risen 1% in that time. It is clear that global investor sentiment towards the UK market in general remains bearish.

Chart 2: Performance of KPMG indices since vote, rebased in dollars



Graph sources: KPMG analysis, Bloomberg, Capital IQ and Thomson Reuters Datastream

Right now, the FTSE 100 may therefore be moving more on fluctuations in the value of the pound, than on the underlying concerns about the prospects for the UK economy, although the two are invariably linked. This trend is likely to remain intact until well into next year, when we may learn more around the UK's exit strategy after Article 50 is triggered and get more information on how the real economy is adjusting to the Brexit related uncertainties. Until then, these two KPMG indices should filter some of the market noise and help analyse the underlying impact of Brexit on UK companies, and sentiment towards them.

"Rebasing the indices in dollars takes even more of the sheen off the performance of UK stocks – both domestically and globally focused."

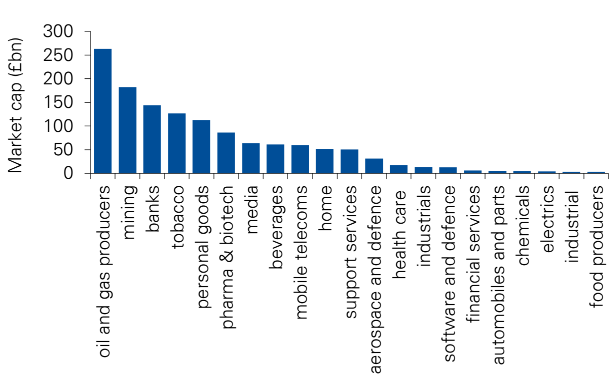
How we created the new indices

KPMG analysed the annual accounts of every company in the FTSE 100 and FTSE 250 to calculate the proportion of their revenues originating in and outside the UK. Companies that earned over 70% of their revenues inside Britain were classified as ‘UK companies’, while those that derived less than 30% were deemed ‘non-UK’.

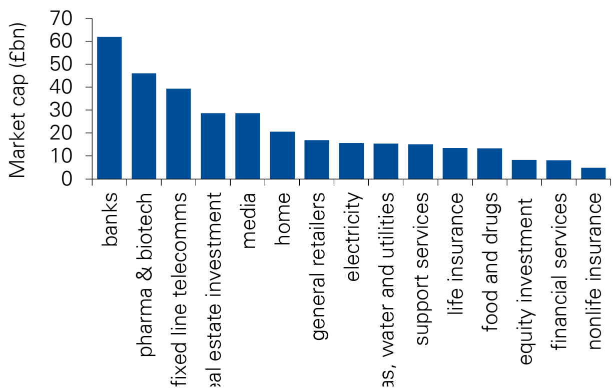
These companies were then ranked by market capitalisation (as of 23 June) and the 50 largest companies included in each index. The indices were weighted by market cap and calculated using the change in market cap of each company over the period from 23 June to 31 October 2016. Both indices were rebaselined to 100 on the date of the referendum, in line with the FTSE 100 calculation methodology.

The number of companies selected for each index took into consideration the range of sectors that are included in each index.

KPMG Non-UK 50 – sector weighting by market cap



KPMG UK 50 – sector weighting by market cap



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