ISEQ offers more upside if a 'hard Brexit' can be avoided

Irish PLC profits decline by 10% in FY 2018! 2019 guidance much weaker than expected! These are the headlines you might expect to read over the next month as Irish companies report FY 2018 financial results post a 15% fall in the ISEQ over the last year.

The reality is that Irish listed shares have been caught up in the Brexit tsunami with investors pricing in a bad fallout for Ireland Inc, in the case of a 'hard no-deal' scenario. Given the constant news feed of what can only be described as a political shambles in Westminster, investors should be nimble. We think the ISEQ is currently assigning a much higher probability (c.50%) to a disorderly no-deal Brexit than we view the risk of such an event (c.30%).

While we do expect PLC management to talk up the potential impact of further Brexit uncertainty and indeed disruption, we believe such volatility around results will provide investors with opportunities to pick quality companies up cheaply on what should be conservative guidance.

Irish public companies are on course to report c.4.6% earnings growth in FY 2018 led by Smurfit Kappa. Ryanair & Paddy Power Betfair are weighing negatively on the average Irish company profit growth. A review of mid-cap Irish PLC earnings growth would imply an even stronger c.9.2% earnings growth for FY 2018.

We expect Irish public companies to deliver a stronger c.6.5% earnings growth in FY 2019. A lower €/$ rate, as seen in the second half of 2018, should help support the H1 2019 profit growth outlook for Irish public companies with significant overseas revenue. We expect modest revenue growth and relatively stable profit margins in 2019 as price increases offset higher input costs.

Despite the sell-off in shares through year end, we do not view the financial stability of Irish public companies as a concern for investors. The Irish banks are well capitalised and the average public company free cash flow yield is running at c.6% in 2019, the highest in five years.

While a 'no-deal' hard Brexit is very much a real risk, we believe the probability of such is fairly reflected in current share prices. Investors are reluctant to invest based on a successful outcome, in which case a UK recession would likely be avoided. A "managed no-deal", a fudged draft agreement or "Bremain" would support the growth outlook for the UK and reduce the risk of an Irish company earnings recession in 2019.

In the event of a no-deal Brexit and/or a general election leading to a Labour government, the ISEQ could fall c.10% from current levels (5,725). Worst case could see earnings fall 10-15% in FY 2019 but in our view, Irish shares are already discounting a 15% decline in earnings at current levels. There is no-doubt that a disorderly 'hard Brexit' would be bad for the UK, Ireland & Europe and it is for that reason we are hopeful that measures would be taken to support economic growth in the short term. In December, we have already seen the EU & UK adapt a framework to help protect the economy against the worst-case outcome.

At a domestic political level, extension of the confidence and supply arrangement and securing EU backing for resistance to a hard border could both be considered as economic wins, as it reduces uncertainty for businesses. Economically, 4.9% GDP growth in 2019 remains plausible.

As we begin the year, with global growth forecasts revised down and investors hugely de-risked we see potential for economic growth to the upside in H2 2019.

With inflation contained, monetary policy could remain supportive. Fiscal policy could be ramped up to support growth after a long period of austerity.

The longer "Brexit" and the US/China trade war are unresolved, the greater the risk that uncertainty starts to weigh on business investment, that earnings are revised down and that investor sentiment weighs. With the UK Parliament now voting down an amendment to extend Article 50, businesses and investors should have more clarity on the situation come April easing uncertainty.

Now that the UK Parliament has voted against leaving the EU with "no-deal", are in support of an alternative arrangement to the backstop to avoid a hard border on the Island of Ireland and wish to conclude the Article 50 process by 29th March we view the likelihood of an EU/UK compromise being more likely over the next month. With Jeremy Corbyn now willing to talk to Theresa May, it is more likely that they can find some common ground to get the Labour party's support for a deal. Furthermore, with the clock running down on Britain leaving the EU with no-deal, it is likely that the EU will compromise by fudging the text provided that a hard border can be avoided.

With regards to the US/China trade war, President Xi seems committed to agreeing a deal with Trump on trade with the latest speculation that China will look to reduce the trade deficit to zero over six years. Trump wants the reduction to occur over a smaller two-year period. Given growing concerns about a slow-down in China leading to unemployment and social unrest, we are quietly confident a deal will be done. If China were to boost demand for US goods by $200bn per annum over 4 years, that would be equivalent to a 1%

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Darren McKinley, Senior Equity Analyst, Cantor Fitzgerald Ireland

per annum boost to US GDP. A win of this magnitude for Trump could seal his re-election and curb him from picking more fights in the mean-time. A robust US is good for global growth! Hence based on the premise of an orderly Brexit and China stimulus plan, we would view short term uncertainty as an opportunity to pick up our preferred Irish stocks with a 12-month view. Longer term, we are mindful that the US economy has performed exceptionally well for several years and that the economic cycle is closer the end than it is to the start – as indicated by its current unemployment rate of 3.9%.

As we entered 2019, we were tactically bullish on Irish Plc share price performance in 2019 (see Cantor Fitzgerald's January Investment Journal), with an expected return of 16% (-10% in worst case (no-deal), +30% in best case ("Bremain")). We expect the ISEQ to base in Q1, as we get certainty on the terms of Brexit, before rallying over the course of the year. Year to date, the ISEQ has already rallied by 5% but given the heavy defeat in Parliament for the Withdrawal Agreement, we expect some consolidation until we get certainty that a messy no-deal can be avoided...

As of January, our preferred Irish stocks for the year ahead were CRH, AIB Group, Smurfit Kappa, Dalata Hotel Group, Total Produce, Cairn Homes and Applegreen. In sterling, our preferred Irish company is Grafton Group.

Cantor Fitzgerald Top Irish Picks (1st January 2019)

Cantor Irish 2019 Top picks	Portfolio Weight	2019 P/E	2019 DY	2019 EPS growth	Entry Price (31/12/2019)	Target Price	Upside
CRH	4%	10.5	3.2%	10%	23.10	30.00	30%
Smurfit Kappa	4%	8	4.4%	3%	22.58	28.00	24%
AIB Group	4%	10	5.5%	-10%	4.07	4.93	21%
Grafton Group	3%	10.5	2.7%	10%	7.13	8.20	15%
Dalata Hotel Group	3%	10.2	2.5%	12%	4.52	5.75	27%
Total Produce	3%	11.5	2.7%	15%	1.41	1.80	28%
Cairn Homes	3%	15	3.0%	50%	1.18	1.65	40%
Applegreen	3%	16.8	0.4%	27%	5.44	6.70	23%
Total Irish Allocation	27%	13.2	3.5%	17%		N/A	30%