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INVESTMENT TALKS

Brexit: Where do we stand and what should investors expect?

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- ***Where we stand and possible scenarios ahead:*** *After the EU approval of Brexit deal, we are going to pass through some tough times until the UK parliamentary vote on Brexit Withdrawal Agreement in December. UK Parliamentary ratification of the deal will be very difficult and will likely bring new episodes of market stress, but we think the* ***most likely scenario is that the deal will ultimately be ratified*** *(but probably not on the first attempt on 10th December). Whatever happens, uncertainty is likely to remain until the end-March Brexit date.*
- ***UK Economy:*** *Even though Brexit-related uncertainty is weighing on confidence, we assume that in the event of a Brexit deal (our base case scenario) the UK economy should experience a slight acceleration in 2019 and 2020. Furthermore, the labour market is in good shape and real wages, which are positive again, should support consumption.*
- ***Investment implications:*** *In the* ***fixed income market****, we have a relatively neutral view on Gilts (government bonds), becoming more constructive in case of a no-deal and more bearish in the other case. In the* ***equity market*** *we remain cautious on UK-listed equities, especially on UK stocks exposed to domestic growth. We look with more favour to more internationally-focused stocks and sectors with a majority of their earnings abroad or which report in a currency other than sterling.* ***On currency:*** *developments and trading in British Pound (GBP) are becoming increasingly binary: our base case scenario is that there will ultimately be a Brexit deal with the potential for the GBP to appreciate, but we expect the currency to show a very erratic pattern though. So, the sizing of position and risk management for investors willing to take GBP exposure will be of utmost importance.*

Where do we stand in the Brexit process?

DB/TP: The Brexit-related news flow has become very intense, with the announcement of the agreement of EU and UK officials on a final draft of the UK withdrawal deal, the approval of the deal by British PM Theresa May's cabinet, the resignation of several members of this cabinet on the day following the Brexit agreement (including the Brexit secretary, Dominic Raab), and the decision by Tory Eurosceptic Members of Parliament (MPs) to initiate the process to call for a motion of no-confidence in Theresa May. Moreover, Brexiteer ministers who have not yet resigned, announced that they would seek to amend the deal, in a clear move of disrespect towards Theresa May's authority, although the majority of them should nonetheless remain in the government. As of today, Theresa May should remain as UK prime minister as the threshold of 48 Conservative MPs – required to call for a no-confidence vote – has not been reached yet. And even if it were reached, there would be a majority among the 315 Conservative MPs to oust her. If she were to survive a no-confidence motion, then there could not be another vote of no-confidence for another year.

The main reason why hard Brexiteers have rejected the deal is its "backstop plan", aimed to guarantee in advance that there will be no hard border in Ireland whatever the outcome of the trade negotiations. Under this backstop plan, the UK would remain in the customs union with the EU until another solution is agreed, with no possibility of exiting this customs union unilaterally (there will be a review process by an independent panel). Moreover, Northern Ireland would remain bound to the regulation of the EU single market for most goods and some services. From the EU point of view, granting the UK the possibility of staying in the customs union was already a major concession and there is no will to make any further concessions.

"We believe that ultimately a deal will likely be reached, but it is a path full of pitfalls going forward".

What scenarios ahead of the Parliament vote on the negotiated Withdrawal Agreement?

DB/TP: UK Parliamentary ratification of the deal will be very difficult and will likely bring new episodes of market stress, but we think the most likely scenario is that the deal will ultimately be ratified (but probably not on the first attempt on 10th December).

At the time of writing, we maintain our **70% probability of a deal**'s outcome where an agreement is ratified and the UK enters a transition period until the end of 2020 with possible extensions. Importantly, this probability takes into account a rocky path with scare tactics, new negotiations, political crises, new elections and short term extensions of deadlines. The EU is likely to grant a short-term extension of Article 50 (that requires a unanimous vote among the EU27) if this is necessary to organize new elections and to confirm the deal with a new UK government. The real deadline is rather the European election of May 2019.

The **probability of a no-deal is 20%,** in our view, noting that mitigation measures (despite the difficulty of negotiating them both bilaterally and with the WTO) would probably prevent an outright fall into a raw WTO regime, while negotiations carry on over a comprehensive new trade framework. The search would also continue for a solution to avoid the building of a border in Ireland against the will of the UK (that could refuse to cooperate should the EU attempt to build one), of the Irish Republic (where this issue could become conflictual with the rest of the EU) and of the local population on both sides of the border.

We believe there is a **10% probability of a second referendum** (itself leading to various outcomes, depending on the question asked and the result, meaning that a Brexit reversal scenario carries a much lower, single-digit probability). Nonetheless, it would probably require a new general election and the victory of opposition parties beforehand (and a short term extension of Art 50, granted by the EU conditionally on the precise question asked, which could be seen as problematic interference).

Finally, other minor scenarios could occur, such as a unilateral repeal by a new UK government of the Art. 50 invocation (the European Court of Justice has been consulted on this possibility and should rule on it in January) to give itself time to rethink the entire issue, or a short term EEA (European Economic Area) member status for the UK while negotiations continue (although with no Irish backstop agreed, this would not resolve the issue of the financial settlement).

"In the event of a deal, UK growth should re-accelerate despite political uncertainty".

What is your view on the UK from a macro perspective?

TP: So far, even though the Brexit-related uncertainty (and inflation due to the sterling depreciation) has weighed on confidence, the damage has been less than what was feared just after the June 2016 referendum. UK GDP has increased 3.8% since June 2016, which is only a moderate underperformance vs. the 4.9% in the Eurozone. However, this has not prevented the output gap to close since potential growth has slowed at the same time: indeed, net migration from the EU has declined sharply since mid-2016, resulting in lower labour force and employment growth. Conditional on a Brexit deal scenario, there should be a slight rebound in the UK economy in 2019 and 2020. The labour market is in good shape and real wages, which are positive again after a period of high inflation, should support consumption. However the growth cycle is very mature, which pleads for a gradual Bank of England (BoE) tightening and limits the upside potential. Our UK GDP forecasts are 1.5% for 2019 and 1.6% in 2020 (and in line with potential growth at around 1.5%). Longer term, we expect that the lesser degree of access to the EU market will be slightly negative for trend growth. In the case of a no deal Brexit, we would expect the UK economy to be severely negatively impacted in 2019, with the extent of the damage depending on the mitigation measures that can be agreed, for which there is little visibility at this stage.

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“We have a relatively neutral view on Gilts. We expect to turn more constructive in case of a no-deal and more bearish in the other case”.

What’s your view on UK fixed income market amid different Brexit scenarios?

CM: For the time being, we have a relatively neutral view on Gilts. Growth is on the weak side, inflation appears to have peaked and is coming down faster than anticipated, and flows appear to be solid. It is worth remembering that the UK has large pensions and insurance markets that helped to maintain support for Gilts, especially at the long end. Global reserve managers also appear to have stuck with Gilts, despite the large current account deficit and Brexit uncertainty. Of course, things will change as we approach the key Brexit dates. If there appears to be a rising chance of a no-deal Brexit, we will likely become more constructive on Gilts, as the rate hikes that have been priced in by the market are likely to be priced out, and some may even anticipate a renewed Quantitative Easing process[1]. However, it will be important not to chase this trend: the BoE has underscored how difficult it will be to assess the correct monetary stance if we get a no-deal Brexit or a very hard version of an agreement. Both supply and demand sides of the economy will be at play, and the likely re-weakening of the currency may put upward pressure on imported prices. The BoE will want to ‘look through’ the impact of the currency depreciation, but will have to be mindful of any second-round impact on wages amid what will likely be a shrinking labour supply at that time.

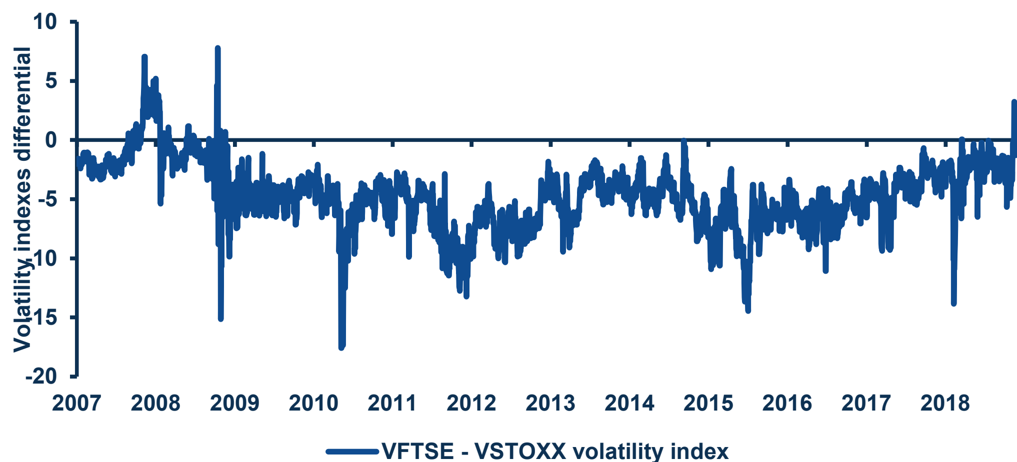
If, more positively, we get a favourable agreement, we will become bearish on Gilts, especially at the short end. The market has priced in a very modest pace of hiking at present, and the BoE has made it clear they are inclined to go faster than the market has priced in, so long as the Brexit outcomes are within the range that they consider tolerable. Once again, it will be important not to be too aggressive. Inflows have been very solid in recent years, and growth is still weak, even if it is less weak than under the more negative Brexit scenarios. If sterling strengthens as no-deal Brexit becomes less of a risk, then this too will be keeping downward pressure on prices.

“We are cautious on UK-listed equities while looking with favour at more internationally-focused sectors”.

What’s your view on UK equities?

AA: We are cautious on UK-listed equities within the overall context of the European market. From a pure stock picking perspective, we believe that more attractive investment cases on balance can be found in other markets. We acknowledge ongoing uncertainty associated with Brexit which is weighing on potential growth and profitability for many UK businesses at this point.

UK equity volatility at the highest levels in a decade vs Eurostoxx volatility



Source: Bloomberg, data as of 23 November 2018. VFTSE=FTSE100 volatility index; VSTOXX= volatility index on Eurostoxx50.

[1] Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

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The UK market breaks down into more domestic sectors (like banks, retailing and utilities) and more internationally focused sectors (such as energy, consumer staples and healthcare) where the constituent companies are listed in the UK, but where the country typically represents only a relatively small contribution of their overall revenues and earnings. Overall, we believe that investors should prefer equities of the latter category of international business models. They could benefit in earnings terms in an environment of GBP weakness by translating their revenues and cash flows from other regions of the world back into sterling. Conversely, we prefer to maintain a neutral stance towards the more domestic UK economy-centric companies.

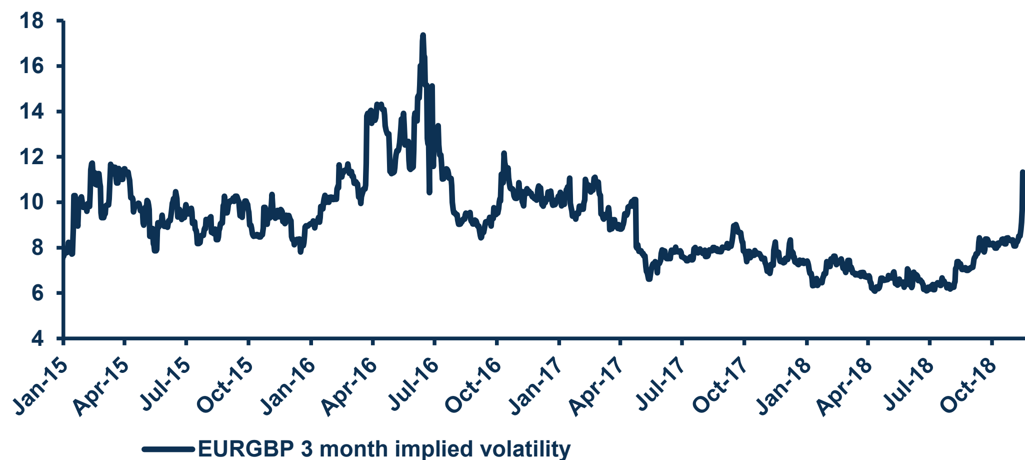
"In case of a Brexit deal, GBP has potential to appreciate".

Where do you see the GBP headed in the foreseeable future?

AK: Developments and trading in GBP are becoming increasingly binary. At this point in time, things are evolving so quickly that it is very difficult, if not impossible, to have a knowledge advantage. So, we believe that an investment decision in such uncertain and unstable environment should be based on either managing (ie. reducing or removing) the existing GBP or UK exposure, or seeing the developments as a chance to extract yield in the FX market. We are aware that different policy outcomes will lead to different impacts on GBP in either direction, though we think that in the case of a "no-deal" a downward movement in GBP would be faster and more aggressive than the other way round.

Our base case scenario is that there will ultimately be a Brexit deal with the potential for the GBP to appreciate, albeit with a very erratic pattern before the final agreement. So, the sizing of position and risk management will be of utmost importance. In the event of the agreement not passing parliament on the first attempt, there will be a limited negative reaction of approximately 1.0-1.5% only, as it will not be necessarily the final attempt. In the end, we expect an agreement to pass. A "no-deal" Brexit would have a significant impact on GBP, with a potential down movement of approx. 10% to around perhaps breaking through 2016 levels (around 1.20).

Currency volatility spike



Source: Bloomberg, as of 23 November 2018.

In conclusion, how should investors adapt their portfolios in the event of a possible hard or soft Brexit?

CM: A hard Brexit, and, in particular, a no-deal Brexit, is likely to put sterling under pressure. We can expect a re-run of the depreciation we saw after the Referendum result. We can also

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"Investors should be positioned for the central scenario but be ready to adapt quickly in case alternative scenarios (hard Brexit or no deal) materialize".

expect Gilts to rise as growth expectations are lowered and rate hikes priced out. However, it is worth remembering markets learn: they will have noted how well UK equities have traded since the referendum amid sterling weakness. Any short positions in UK equities must therefore be pinpointed on the UK stocks that are exposed to domestic growth. The part of the stock market that gets most of its earnings abroad or which reports in a currency other than sterling, are likely to be well supported.

A soft Brexit would have the reverse implications. Gilts are likely to be less attractive, domestically-focused equities and the currency will likely improve. Whatever happens, uncertainty is likely to narrow as we head towards the end-March Brexit date. One way or another, options will be removed. To that extent, markets are likely to foresee some improvement in sterling simply from the removal of uncertainty. Options strategies have been popular as a way to protect downside: as the key dates approach, the value of those options is likely to wane, and, when we have a decision, volatility will drop. However, it is important to bear in mind the EU's track record of leaving decisions to the last moment, and then to 'kick the can down the road'. Some important elements may therefore remain unclear, even after March 29. If there is an extension of the Article 50 period, this would be even more the case.

European countries: Who benefits and who loses from Brexit?

TP: Given the need for cooperation at the European scale on economic as well as other matters, and the risk that Brexit encourages anti-system political forces elsewhere in Europe, it is unclear that any country will really benefit. At most, it could be argued that Ireland could profitably use its position as a gate between the UK and EU, even though it is also more exposed than others to potential economic damage in the UK. Some high value added activities will continue to relocate in major other European cities, but so far this move, while significant, has not been spectacular. In terms of trade flows, after Ireland, it is Belgium and the Netherlands where exports to the UK account for the largest share of GDP (goods and services combined) but, due to the complexity of European integrated value chains, the damage may be more spread across many countries than meets the eye. In case of a no-deal Brexit, there would be economic damage for all of Europe (although much more for the UK than the rest) through the financial, trade and confidence channels as well as problematic political consequences as the EU would have to manage this challenge (including major uncertainty regarding what happens with the Irish border) against an internal backdrop already complicated by the Italian situation and the general rise in political protest forces.

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