Confidence must be earned

Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Brexit muddles through the approaching parliamentary vote

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"The probability the UK will remain in the EU beyond March 2019 has slightly increased after the recent news flow concerning Brexit".

- ***Developments and scenarios ahead:*** *The Brexit-related newsflow since the UK/EU agreement on 25 November 2018 has been quite intense. In our view, it has slightly increased the probability that the UK remains in the EU beyond March 2019, thus prolonging the uncertainty over how (and even whether) Brexit will happen. Nonetheless, our most likely scenario remains that the* ***Brexit deadline arrives with a ratified deal (60% probability).*** *Note that this probability covers deals other than the recent UK/EU agreement (as long as they lead to a transition period during which the UK will still be part of the European Single Market) and potentially very rocky paths to deal ratification, which would only come after major episodes of uncertainty and stress.*
- ***Investment views:*** *Regarding the markets, at the moment, they continue to price in some sort of weak muddle-through scenario. As uncertainties around Brexit outcomes remain high,* ***sterling*** *will likely continue to be under pressure, with some downside risks remaining (especially vs the Japanese yen), given the increasing probability of no deal. We would return to a more neutral view in a phase of excessive market pessimism. In* ***fixed income****, our view on* ***duration*** *is around neutrality, given two contradictory forces in play: the excessive valuation regarding 10-year real yields (now at -2.15%); and the downward revision of economic growth prospects leading to more a dovish Bank of England. We believe that current market volatility creates opportunities for active managers, but all positions have to be managed actively and even reversed could more positive developments appear regarding the Brexit situation.*

1. What are the latest developments regarding Brexit?

DB/TP: The newsflow concerning Brexit has been quite intense since the UK government was able to secure an agreement with the EU on 25 November 2018. The most notable developments have been:

- 4 December: The "Grieve" amendment, giving MPs more influence regarding the Brexit process if a Brexit deal is voted down.
- 10 December: The decision of the UK government to postpone the ratification of the deal by the UK Parliament as it was bound to fail by a very large margin (a new attempt has been scheduled for 15 January 2019).
- 10 December: The confirmation by the European Court of Justice (ECJ) that the UK can unilaterally revoke Article 50.
- 12 December: The failure of a no-confidence vote held among Tory MPs against PM May.
- Since mid-December: Various announcements regarding contingency planning measures in case of no-deal Brexit.

In our view, these events (despite the last item) have slightly reduced the probability that the UK will exit the EU as soon as March 2019, either with or without a deal (although the exit with a deal remains the most likely scenario), and have increased the probability that the UK will remain in the EU beyond March 2019, with prolonged uncertainty regarding how (and, possibly, even whether) Brexit will happen.

2. What scenarios do you see ahead?

DB/TP: **We see a 60% chance that the Brexit deadline arrives with a deal agreed.** This scenario does not necessarily imply the ratification of the 25 November deal, but any other ratified agreement following which the UK can exit the EU on (roughly) 29 March 2019 and start a transition period during which it remains within the European single market, at least until the end of 2020. Of significance, this 60% probability includes the expectations of potentially "rocky paths" (from scare tactics and fears of no deal to political crises and new elections). The deal could also take the form of a Norway or Norway+ (with customs union) agreement, notably if it comes after new elections and is secured by a new UK government majority (although a short-term extension of Article 50 would probably be required). The factors lowering the probability of a deal include the scale of discontent regarding May's deal from Tory Brexiters, the Democratic Unionist Party (DUP), and opposition parties, which looks to make ratification extremely challenging. Conversely, the maintenance of an above-50% probability is based on four factors:

1. the possibility that PM May manages a combination of minor concessions from the EU on the Irish backstop;
2. the possibility that she convinces a sufficient number of MPs that there is no other option apart from no deal (no further concessions from the EU and no possibility of triggering new elections);
3. the possibility that the combination of the Grieve agreement and ECJ ruling persuade Tory brexiteers that Brexit itself is at risk if May's deal is not ratified and the Article 50 countdown is stopped or new elections are triggered;
4. the residual probability that new elections are won by the opposition, which could allow a softer deal (ie, based on EEA membership and customs union).

"Our base-case scenario is that UK/EU will reach a deal before March 2019, but the path will not be straight".

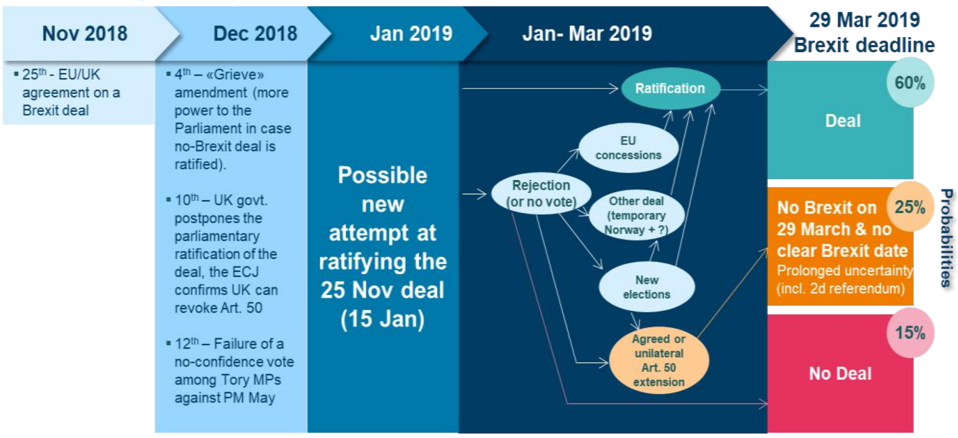
We attribute a 15% probability to a no-deal scenario. We refer to a situation in which the UK exits the EU without a temporary single market arrangement (or only a very short-term one) in March 2019. This does not necessarily mean that UK/EU trade relations will be governed by WTO rules only (which is very unlikely). We believe that mitigation measures ("deals-under-no-deal") can be negotiated (bilaterally and with the WTO) once it becomes more certain that the March 2019 outcome is a "no deal". Importantly, even under a "no-deal" scenario, we believe that measures will be agreed, at least temporarily, to avoid the building of a "hard border" in Ireland, as this would face immense opposition. We cannot exclude a combination of transition arrangements, sectoral agreements and specific agreements regarding Ireland potentially mitigating a "no-deal" shock to the point that it looks very much like some form of "deal" (although there would still be a larger uncertainty shock and some trade shocks).

The probability of prolonged uncertainty is assumed at 25%. This probability covers various scenarios that see the UK remaining in the EU considerably beyond March 2019 upon the occurrence of one of the following (not mutually exclusive) events:

- an agreed extension of Article 50;
- a unilateral repeal by the UK of its invocation of Article 50;
- new elections not immediately followed by a deal;
- the announcement of a new referendum.

In these cases, there could be different outcomes, including a re-start of negotiations (possibly following a change of government and/or a "Brexit" confirmation after a second referendum) or a "Bremain" (also after a second referendum). **Basically, we continue to give "Bremain" a single-digit probability within the above-mentioned 25%.**

The Brexit pathway and scenarios ahead



Source: Amundi Research. Data as at 7 January 2019. Scenarios and probabilities refers to Amundi Research views and are subject to change at any time.

"Our view on duration is around neutrality, given two contradictory forces in play".

"In a disorderly Brexit, sterling would fall sharply, gilt yields decline, and the domestically exposed parts of the FTSE 250 suffer".

3. What is your current view on GBP and UK rates?

LC/CM: As uncertainties around Brexit outcomes remain high, sterling will likely continue to be under pressure, with some downside risks remaining, given the increasing probability of no deal. **We therefore view downside risk for sterling, especially vs the Japanese yen, and a return to a more neutral view in a phase of excessive market pessimism.**

On the rate side, more value can be extracted from the flattening of the yield curve, with the long end performing against shorter maturities.

Our view on duration is around neutrality, given two contradictory forces in play: the excessive valuation regarding 10-year real yields (now at -2.15%); and the downward revision of economic growth prospects leading to more dovish Bank of England. This is a means to avoiding too much correlation with the short bias on sterling.

We believe that current market volatility creates opportunities for active managers, but all positions have to be managed actively and even reversed could more positive developments appear regarding the Brexit situation.

4. What market reactions do you expect for the various possible scenarios?

LC/CM: Regarding the markets, at the moment, they continue to price in some sort of weak muddle-through scenario. The UK has a coordination problem rather than a policy problem: the question is how we can get the MPs at Westminster to put aside their grandstanding and accept what for many of them will be a second-best approach? Some see no potential mechanism to overcome this coordination issue and the implication for them is a disorderly Brexit in which sterling falls sharply, gilt yields decline, and the domestically exposed parts of the FTSE 250 suffer. But, markets appear reluctant to move to that extreme.

A critical moment will come on 21 January, when the government has indicated it will make a statement regarding its intentions. A threat by PM May to resign and also trigger a general election at that time might cause MPs to fall in line, but this would be a high-risk strategy as the polls are neck and neck. A call for a second referendum would also be perilous for the government, as it require an extension to the two-year Article 50 period and would potentially produce an inconclusive result. It would be better to threaten to revoke Article 50. A threat by PM May to do this could conceivably provide the coordination mechanism needed to get MPs from all sides to vote for her compromise text. All sides will have something to lose. Were this the case, investors would likely want to buy sterling, sell UK gilts, and sell domestically oriented shares in the FTSE 250.

Another last-gasp approach might be to try to divide up the agreed text into a number of 'mini agreements' and pass the least contentious of those through parliament. This is unlikely to be acceptable to the EU, as it would breach the principle that 'nothing is agreed until everything is agreed'. But, it is still a possible tactic that would avoid some of the downside consequences of a chaotic no-deal Brexit. The implications for markets are less easy to estimate.

Crises generally happen when surprises arise with little warning and governments find themselves ill-prepared to react to these. That cannot be the case with Brexit: officials have seen this one coming slowly over the horizon for at least two years. There can be mis-steps, but there can be no excuses for bad preparation this time.

There is near unanimity in the UK that a no-deal Brexit scenario – one that would mean no movement into the two- to four-year transition period (during which little would change) – would be hugely disruptive for investors and should be avoided at all costs.

Day by day, options that earlier existed are becoming impractical: that factor in itself must reduce uncertainty and be positive for the pound (and negative for gilts).

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