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Brexit: intention meets reality

Key take aways

- The UK will leave the EU on January 31, entering into a transition period that will probably run until end-2020. A number of major issues surrounding the future UK/EU relationship are still unresolved.
- Our central scenario is for a limited "phase 1" EU/UK deal in 2020. The complexity of the underlying issues – and the limited time frame – make a full deal extremely unlikely. An alternative scenario, an eventual "hard Brexit" remains possible, but less likely.
- GBP will be subject to bouts of volatility in 2020, with the FTSE 100 mainly reacting to this. More domestically-focused stocks (FTSE 250) will be vulnerable to waxing and waning "hard Brexit" fears. Gilts could be driven primarily by non-Brexit factors.

01 Brexit draws near

On January 31, the UK will officially leave the European Union and enters a new phase of the Brexit process: defining its future relationship with remaining EU members. The Brexit process so far has (in three and half years) cost two prime ministers their jobs, resulted in two general elections and has redrawn political lines in the most profound way for almost 100 years.

During this transition phase, the UK will remain part of the EU's single market and customs union until December 31, 2020. This gives the UK and EU eleven months to negotiate a deal covering multiple areas. If such an agreement cannot be reached by the end of this year, then a 'no-deal' outcome remains possible.

02 What can be achieved in 2020?

The UK government's stance on a proposed trade deal with the European Union has been that it should allow a "broad free-trade agreement covering goods and services and co-operation in other areas". This typically wide-ranging (and imprecise) political declaration is already facing significant hurdles as the UK also looks to move away from the regulatory standards set by the EU.

The UK's desire for regulatory independence is a major concern for the EU as it creates a risk that British businesses could undercut European competitors in the global marketplace, for example. Even at this early stage of the transition period – before trade deal negotiations get underway – both sides have made their stances clear. From the EU's perspective, the further Britain moves away from existing regulations, the less comprehensive any future trade deal can be. From the UK's

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perspective, or at least that of the strong pro-Brexit majority in parliament, the fundamental question is, if you have to keep regulatory alignment, why have Brexit at all?

The complexities of any trade deal with the European Union have already increased given Prime Minister Boris Johnson's insistence that the Withdrawal Agreement date (December 31, 2020) be written into UK law. Such a legal declaration stops (in theory) any idea of 'extension periods', a tactic used a number of times during the withdrawal negotiations – much to the frustration of Brexit-supporting voters. This frustration lay behind Johnson's emphatic election victory, which was delivered by increased support for the Conservative Party in large parts of the north of England, where support for Brexit outweighed voters' historic allegiance to the opposition Labour Party. The Conservative Party's simple but effective message to 'Get Brexit Done' was enough for many voters to vote Tory for the first time in their political lives. But note that many of these areas are the locations of car manufacturing plants and other industry supply chains which depend on a continuous flow of goods and parts from the EU: Johnson therefore has to square the economic needs of his electorate with their clearly-indicated political preferences.

In our view, the combination of Johnson's claim that the UK will leave the EU with or without a trade deal by the end of 2020 and his desire to have the UK forge ahead with its own regulatory framework ultimately means that any deal reached with the EU will be a limited one. Any deal must by necessity be focused mainly around the movement of goods and ensuring that zero-tariffs/quotas remains in place, but the reality is there is simply not enough time to meaningfully agree on every aspect of the UK's future relationship with the EU. (Trade deals can typically take 5-10 years or more to agree and implement.) One concern is that the needs of the UK's services industries (including financial services) might not be addressed adequately in the deal in order to reach some sort of agreement on other areas (e.g. manufacturing and fishing) deemed by the government to be more important in the minds of voters. This prioritisation of manufacturing would be regardless of the underlying importance that the services industry has for the UK economy.

Our core scenario (to which we currently give a probability of 60%) is for a basic deal to be reached before the end of 2020. In a similar vein to the U.S./China "Phase 1" deal that was recently signed, further details could be negotiated after 2020 if such a basic deal is reached. After such a long period of public and private negotiating between two sides, a pause before "Phase 2" would be appreciated from both sides, with "Brexit fatigue" very evident in the EU.

Our second scenario (35%) is for no deal between the UK and the EU before the end of 2020. In this scenario, and in the absence of a further extension, the UK's future relationship with the EU would be characterised by immediate tariffs on goods and Britain's service industry being shut out of the single market. Both developments would have an immediate and damaging effect on both economies with the UK suffering more.

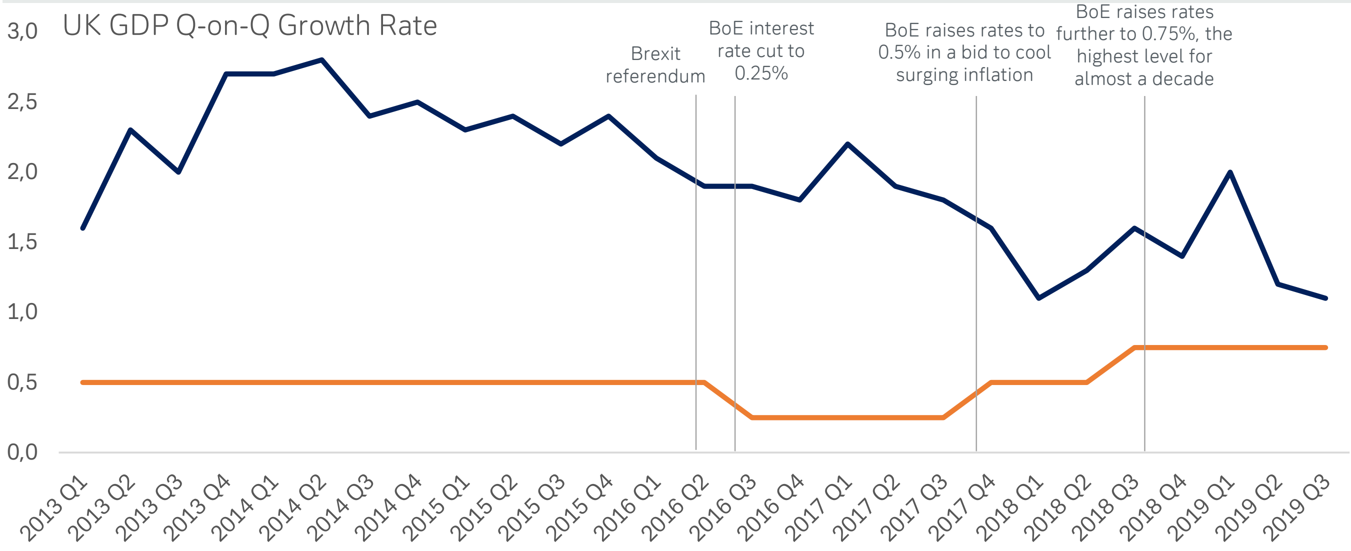
Our third, outlier scenario (5%) is for a transition extension – in other words, for the UK accepting that failure to reach a deal necessitates a politically-embarrassing extension of the transition period into 2021 and possibly beyond.

Brexit is not the only UK political issue. Johnson appears to want to move away from being simply the 'Brexit' prime minister as soon as possible and to begin working on his domestic agenda. The Conservatives' previous commitment to fiscal "austerity" has been abandoned and the government wants to increase economic growth through fiscal spending on various infrastructure projects, such as improving transport links in the newly politically-converted Northern heartlands. The EU also needs to tackle a wide range of other issues on the European agenda and not disproportionately focus on Brexit.

03 UK economy and policy in 2020

Monetary policy. The Bank of England MPC meeting on January 30 faces a tough decision. Weak indicators in both manufacturing and services, poor retail sales over the important Christmas period and a further drop in both headline and core inflation (inflation excluding the more volatile food and energy

Figure 1: Interest rate changes are not in sync with growth



Source: Bloomberg Finance LP, Deutsche Bank Wealth Management. Data as of January 23, 2019.

prices) resulted in a surge in market expectations in early January of a rate cut at the January 30 meeting. Set against this, recent employment data was relatively strong and January PMIs were better than expected. There is also some anecdotal evidence of recovery in housing prices. So while the Bank of England may acknowledge the precariousness of the UK economy, it seems likely to prefer to conserve its limited ammunition (at least in terms of rate cuts) and wait for clearer signals of what is going on.

In the following weeks we get the formal handover of the Governorship of the Bank of England from Mark Carney to his successor, Andrew Bailey, on March 16 and then, on March 26, the next BoE MPC meeting where – given the changing economic and policy environment – Mr. Bailey will need to hit the ground running. The next MPC meeting will be on May 7.

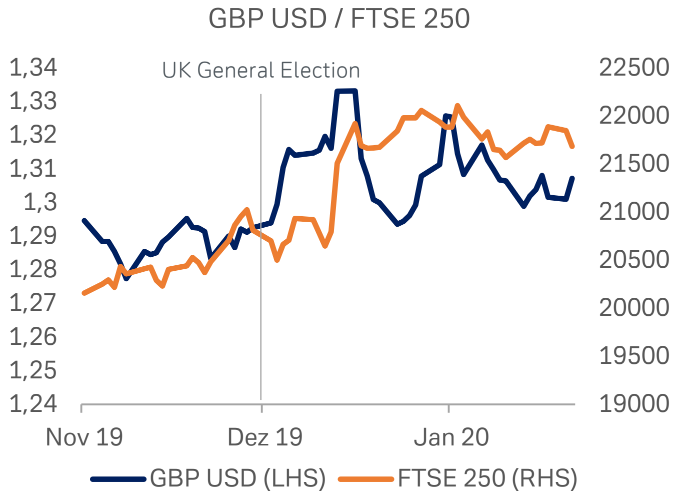
Fiscal policy. The Chancellor the Exchequer (i.e. Treasurer) will deliver his annual budget on March 11 and this is expected to deliver higher spending pledges with a greater focus on infrastructure, boost productivity and an overall desire to "level up" large areas of the country compared to London and the south-east for the country. Chancellor Sajid Javid has stated that he wants the UK economy to achieve a growth rate of 2.7%-2.8% a year, in line with the UK's post-war average. As highlighted in our recently published annual outlook for 2020, we believe we will continue to experience a prolonged period of low global growth. Such ambitious targets, if set by the UK government, will have to defy not only such expectations of low global growth, but also expectations that a less easy trading relationship with the EU than the UK has recently experienced will dent growth, at least in the short term.

04 Market impact

GBP. The progress of trade negotiations between the UK and European Union will be closely felt in the GBP market and we expect continued bouts of volatility throughout the year. We have already seen an early example of how negotiating gambits can unsettle markets: Johnson's ability to have the Withdrawal Agreement date written into UK law when it finally passed the House of Commons on December 20 meant any "relief" rally seen in UK assets after his election victory was short-lived as the chances of the UK asking for an extension to the transition period dramatically fell.

GBP volatility could potentially peak halfway through the year as, according to the Withdrawal Agreement, June 2020 is officially the last month where the British government can ask for a transition extension beyond December 2020. As highlighted above, we believe that Johnson's political victory followed by his no-extension pledge makes any transition extension unlikely. Regulatory issues (see above) have, however, already emerged as a focus of disagreement: recent comments by Chancellor Javid regarding regulatory alignment have already caused concerns from industry lobbies who are now focused the pushing the UK government to reach a more favourable deal for UK business.

Figure 2: GBP and UK domestically-orientated companies' share price



Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of January 23, 2020.

As regards other GBP assets, we continue to expect some sort of 'Brexit bounce' in early 2020 with a potential improvement in business investment and consumer spending. However, this bounce seems likely to be limited and possibly short-lived. Our UK GDP forecast for 2020 shows only a slight increase in full-year growth (1.3% Y/E 2020 from 1.2% Y/E 2019), followed by a slowdown to 1.1% in 2021.

In equities, we have seen a gradual increase in UK exposure from investors both home and abroad since Q3 2019 with a particular focus on domestic-orientated businesses (e.g. companies listed on the FTSE 250 index) since the immediate threat of a no-deal Brexit was removed. The FTSE 100 will continue to react primarily to GBP movements, given the more international nature of the constituents' revenues. Our end-2020 forecast for the FTSE 100 is 7,510.

The direction taken by the Bank of England could become increasingly important for GBP assets. As discussed above, mixed economic indicators in the first half of January do not yet present a conclusive case for a rate cut. As well as levels of economic output, low core inflation remains a concern and markets may respond the BoE's Quarterly Inflation Report, due to be published next week. Our end-2020 forecast is for a base interest rate of 0.75% at end-2020 (the same as now) but in the case of a marked deterioration in data the BoE would likely react through a rate reduction.

In fact, Gilts may end being driven more by domestic policy this year than by Brexit. As previously mentioned, Johnson has set out an economic agenda to invest heavily in capital projects across the country to improve productivity. Changes to UK fiscal rules have meant that such projects have been given increased funding of £20bn per year (£100bn over the five year term for Johnson's government). The ability to finance various campaign promises by borrowing at ultra-low interest rates will lead to higher yields as the Gilt market begins to see increased supply. It should also be noted that if global growth stabilises further throughout the year, sovereign bond yields in general should start to see their respective yield curves steepen. Our end of year forecast for UK 10 year yields is 0.95%.

Figure 3: UK inflation is moving down

Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of January 23, 2020.

Figure 4: Inflation helps hold Gilt yields down

Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of January 23, 2020.

05 Conclusion

UK has finally reached the 'end of the beginning' in regards to the long-debated Withdrawal Agreement and Brexit will happen this week. Boris Johnson and his government can then begin negotiating the future relationship with the European Union.

But, despite his decisive victory in the December 2019 elections, and his strong domestic political position, Johnson still needs to resolve multiple issues. These include the rights of EU citizens in Britain, the outstanding financial obligations owed to the EU and the complicated matter of maintaining an open border between Northern Ireland and Ireland via customs checks in the Irish Sea. Resolving these problems will be difficult and could create significant problems for the prime minister, not least because his newly-converted supporters will want their voices heard in Westminster and Brussels before midnight on December 31, 2020.

Despite these domestic political pressures on Johnson to avoid a "Brino" (Brexit in name only), the complexity of the issues involved and the limited time available means that we expect any deal struck this year to be limited in scope and that further negotiations will be required in 2021 and beyond – but this "Phase 1" deal will need to map out a clear path ahead. This our main scenario (60%) and associated market forecasts are given in the sections above. The initial deal might, for example, include tariff and quota-free trade and regulatory equivalence for some financial services. Such a deal would likely still have costs compared to the status quo.

There remains a risk of a "hard" Brexit, which we put at around 35%. Exit from the EU free trade area (FTA) and trade on WTO terms would have both economic costs and an immediate market impact – most obviously through a fall in the GBP and increased concerns around UK risk assets (although FTSE 100 companies would be shielded to some extent by the their global focus). Gilt yields might also rise on fears about the UK's long-term prospects. A "hard" Brexit would, of course, also have a large impact on the EU, both via its general impact on overall levels of growth and trade, and also through damage to specific EU industries and geographic locations.

A third, outlying and low probability scenario, remains whereby the absence of a deal forces the UK into an extension of the transition period into 2021 and possibly beyond.

We think that GBP and UK risk assets will remain volatile in early 2020 as negotiations get under way, with UK domestic policy also potentially important. In H2 2020, evident progress towards a "Phase 1" deal – even it was only limited – could lift GBP assets but, we have stressed throughout the lengthy Brexit process, "it's not over until it's over".

Glossary

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

The Bank of England (BoE) is the central bank for the United Kingdom.

The UK Conservative Party is a centre-right political party, in power since 2010, often referred to as the Tories.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

The European Union (EU) single market is designed to boost trade within the region by removing restrictions to trade and harmonizing national rules at an EU level. The Eurozone is the currency area, partly overlapping with the EU, where the Euro is the primary currency.

The FTSE 100 Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

The FTSE 250 Index includes the 10st to 350th largest companies on the London Stock Exchange.

GBP is the currency code for the British pound/sterling.

GDP stands for Gross Domestic Product, i.e. the value of all goods and services produced in a country in a given period of time.

Gilts are bonds that are issued by the British Government

The House of Commons is the lower elected house of the UK parliament.

The UK Labour Party is a centre-left political party, and is the main opposition to the Conservative Party.

The UK Liberal Democrats, or Lib Dems, are a centrist political party formed in 1988.

MPC meeting stands for the Bank of England Monetary Policy Committee meetings.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

USD stands for US dollar, the official currency of the United States.

The Brexit Withdrawal Agreement is a treaty between the European Union, Euratom and the United Kingdom, signed on 24 January 2020 and at present still unratified, setting the terms of the withdrawal of the latter from the former two.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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