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CIO Insights Special

Brexit: routes and destinations

Economic and asset class implications

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Introduction

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As Brexit approaches, the key components of the eventual deal are still far from being decided: the Salzburg summit of EU leaders in mid-September rejected the UK government's so-called Chequers agreement, with the UK now required to deliver an alternative proposal in time for the next EU summit in mid-October.

As the old British expression puts it, "there's many a slip between cup and lip" and the possible routes to an eventual agreement (or the lack of it) are numerous, with both through roads and potential dead-ends. Even if all EU members can be persuaded to agree to the Brexit deal, there is still uncertainty around the UK political landscape – and what might happen if the ruling Conservative party found itself with a new leader, or were the UK parliament to reject the Brexit agreement that the UK government offered to it.

This report is intended to explore the various Brexit scenarios that we think are still possible at this time. Three scenarios are essentially market-friendly (at least in the medium term) as they would allow discussions around key Brexit details to be pushed back. Deferring Brexit conundrums to a transition period does not of course guarantee their easy solution. We give these three scenarios (see pages 3 to 5 for the details) a collective probability of around 65%. Conversely, we think that the probability of the "Hard Brexit" scenario is around 35%. We then present economic and market forecasts based around the main "market-friendly" scenarios and the alternative "Hard Brexit" scenarios. The forecasts for the latter must be, by their nature, only tentative.

We think that investors trying to anticipate the Brexit end-result are likely to have to continue evaluating these scenarios for some time: many twists and turns are likely along the way. But I hope that these scenarios provide a framework to help you approach this complex issue.

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01 Possible scenarios

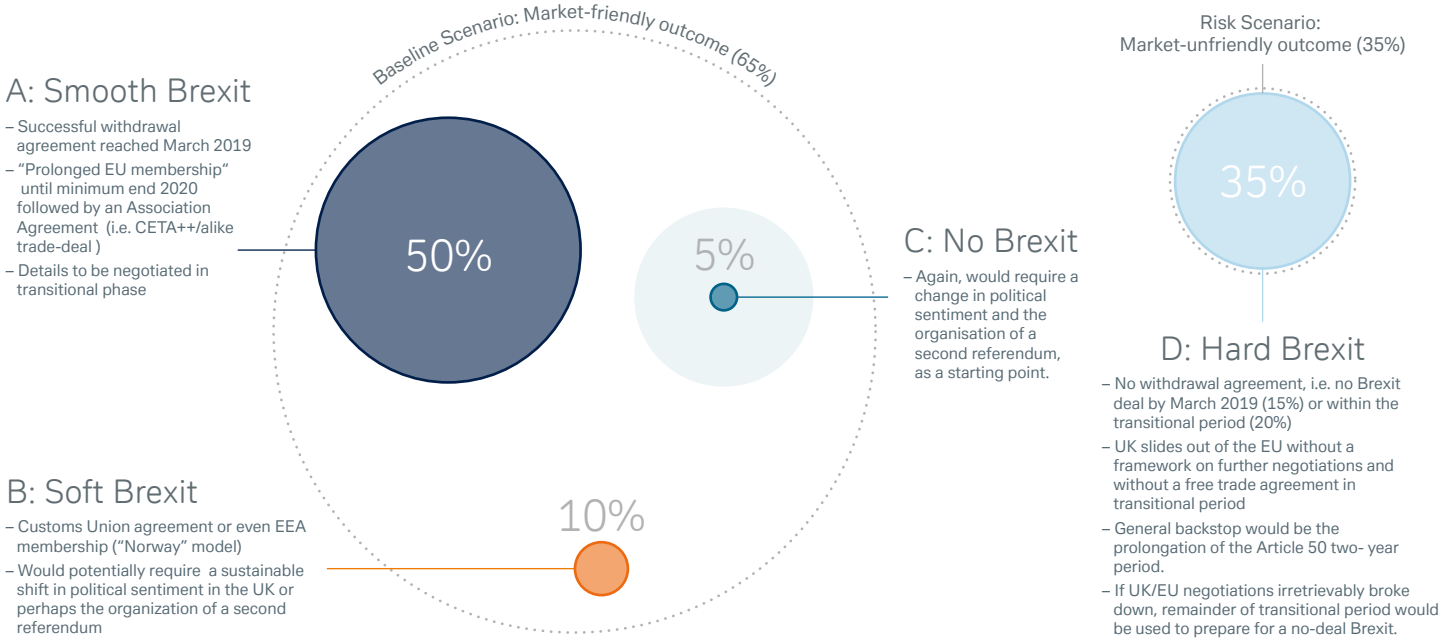
In this report, we focus on the market implications of the various routes to Brexit, rather than the political consequences. In this regard, we have four possible scenarios (see Figure 1) which we put in two groups. Scenario probabilities given below are indicative and should not be interpreted as precise forecasts.

The first three scenarios could be seen as broadly relatively market-friendly, with a combined likelihood that we estimate at 65%. Under these scenarios, the basic framework of future EU-UK relationship is agreed in principle in a ratified withdrawal agreement by March 2019, and this is followed by detailed negotiations within the transitional phase until at least December 2020, ultimately leading to some form of comprehensive free trade agreement - either outside the EEA & customs union (Scenario A: "Smooth Brexit", estimated probability 50%) or even within the EEA & customs union (Scenario B: "Soft Brexit", 10%) or even an exit from Brexit (Scenario C: "No Brexit", 5%).

While these three outcomes differ in the quality of the resulting EU-UK relationships and the roadmap of how these relationships evolve, we think that the capital markets can cope with the immediate problems: ensuring a stable framework for change will not avoid the related economic side-effects, but can therefore be described as "market friendly".

The fourth, risk scenario is for a market-unfriendly "Hard Brexit", which we estimate has a probability of 35%. This could take the form of either a disorderly

Figure 1:
Brexit scenarios
Source: Deutsche Bank Wealth Management. As of September 28, 2018. Scenario probabilities are indicative only and should not be treated as precise forecasts.



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"over the cliff" Brexit before or at the end of March 2019 (15% probability) or a "no deal" Brexit in the transitional period afterwards (20%) as detailed EU-UK negotiations fail to reach agreement before December 2020. Either of these sub-scenarios would likely result in high political and economic uncertainty and capital market volatility, particularly for the GBP.

The exact paths to any of these scenarios is unlikely to be smooth, but it is possible to see some possible routes.

In the case of Scenarios A-C, we expect the closing of the negotiations by end 2018, followed by a ratification process in UK and the EU in Q1 2019. We would flag up the risk of headline volatility and market jitters around various points of the timeline (Figure 2). Most immediately, this could be triggered by the breaching of the informal October EU summit deadline for agreement. At the time of writing, there seems likely to be an emergency EU summit in November as the December meeting would be too late in terms of completing the ratification process, particularly given the EU elections and budget process. This is already discussed in markets and should be increasingly priced in.

As the withdrawal agreement only foresees an "overall understanding of the framework for the future relationship" we expect the real negotiations on this future relationship (as well between the UK and third party countries) to happen within the transition phase. This means than any market relief due to the avoidance of an immediate "hard Brexit" could be short-lived. Going forward, prolonged uncertainty on the final outcome of the EU-UK negotiations is likely to unsettle markets, in particular in 2020 when the deadline is approaching. So a kind of "déjà vu" around the negotiating process cannot be ruled out during 2019/2020. We look at market implications from page onwards.

Based on the initial red lines drawn by the UK, the Chequers White Paper and the "no arbitrage" conditions of the EU, we expect a rough outline on the future relationship (serving the needs of Article 50) indicating a final solution that is somewhere in the space between a CETA++ (in essence, something similar to the Comprehensive Economic and Trade Agreement with Canada with a higher degree of goods market integration) and a so-called Association Agreement (brought up by the EU – e.g. Ukraine, Turkey) – depending on the negotiations over the next EU summits. We think that negotiations within the transitional period (until December 2020) are likely to be tough and volatile, with last minute deals reached in Q4 2020, ultimately leading to a comprehensive Free Trade Agreement – either outside EEA & custom union (60%) or within (10%) or even an Exit from Brexit ("no Brexit" – 5%).

For the risk Scenario D, defined as the UK leaving the single market without a framework for future relations to the EU, we think the three most likely triggers are as follows:

Trigger 1: Change in UK government leadership. A leadership challenge within the governing Conservative party requires 15% of the number of Conservative MPs (i.e. 48) to initiate such a process (feasible as 70-80 MPs are thought to support no-deal Brexit). Conservative MPs would then hold a vote of confidence in Mrs. May. If she was to lose, an election for her successor would be held, with Conservative MPs deciding on a short-list of two MPs, which is then voted on by the party membership. At present, such a challenge looks unlikely before the initial withdrawal deal, but the impending Conservative Party conference could change the political dynamic in the party. At the time of writing, another immediate threat seems new general elections, in effect called by Mrs. May, and threatening a complete change of government, not just party leadership.

Trigger 2: UK parliament does not ratify the negotiated withdrawal agreement. This could happen because either the negotiated terms (especially around the Northern Irish Border issue) are seen as unacceptable, or because the parliament might attempt to make the EU make further concessions. But we expect the parliament to approve the initial deal, as it is likely to be broad enough for all parliamentary groups

Figure 2:
Key events on the Brexit timeline
Source: Deutsche Bank Wealth Management. Data as of September 28, 2018.

Sep 30 - Oct 03	Conservatives' party conference
Oct 16/18	EU Article 50 Council (Oct 16) and EU Summit (Oct 18)
21 Jan 2019	If no withdrawal agreement i.e. Brexit deal - UK government must explain in the UK parliament how to proceed further
End Jan 2019	Ratification of withdrawal agreement (if there is one) in UK and EU parliament
End-March 2019	UK exits EU, Transitional Phase begins (base case)
April 2019 – Dec 2020	Transitional phase: real and detailed negotiations of future relationship with EU/3rd countries
Dec 2020	Final exit (possibly to be deferred further if more time needed). However, "Brexiternity" unlikely as next regular UK general election looms and UK contribution to UK budget expires

Figure 3:
What each scenario would mean

Source: Deutsche Bank Wealth Management. Data as of September 28, 2018. Scenario probabilities are indicative only and should not be treated as precise forecasts.

	Scenario A Smooth Brexit/ (out of EU, but trade agreement, similar to CETA or equivalent)	Scenario B Soft Brexit/ (Official EU customs union/ EEA-type agreement)	Scenario C No Brexit/ Full EU membership	Scenario D Hard Brexit/ (No EU-UK deal until March 2019 and in the transition period)
Probability	50%	10%	5%	35%
Free trade within the area	Yes for most goods but very few services	Yes on almost most goods and most non-financial services	Yes	No
Financial passporting within EU	No	No – but with possibility for equivalence agreements	Yes	No
Customs union in goods with EU (i.e. no border controls)	Yes , but not official EU customs union, i.e. "customs 'arrangement"	Yes	Yes	No
Freedom for UK to set external trade policy with 3rd countries	Yes, in all markets not covered by the customs arrangement mentioned above	No, except for sectors not covered by UK-EU trade arrangements	No	Yes
Coverage by EU external trade agreements	Partly – in sectors included in the UK-EU customs arrangement	In all sectors included in the UK-EU customs union	Yes	No
Migration/ Free movement of people	Some restrictions on EU citizens entering the UK labour market (details to be negotiated)	Yes (very few exceptions possible; details to be negotiated)	Yes	No
Votes on EU laws/regulations	No	No	Yes	No
Under ECJ jurisdiction	Yes (indirectly)	Yes (indirectly)	Yes	No
Contributions to EU budget	Some (possibly)	Yes	Yes	No

(remainers/leavers/hard leavers) to see some scope for advancing their case during the transition negotiations. It is also likely that agreement on particularly contentious issues such as the Northern Ireland border will be deferred until the transition phase. But UK no-vote to the Brexit deal is certainly a significant tail risk to our baseline scenario.

Trigger 3: UK/EU negotiations break down (No deal at all). This scenario depends on negotiation tactics and finally on the political will and ability (on both sides) to compromise. Despite the rhetoric around "no deal is better than a bad deal" we see considerable willingness around both sides to reach an agreement and the "no deal" noise could be seen as a negotiating tactic. If Mrs. May fails to make a deal the "sensible center" in the UK parliament would presumably request an Article 50 suspension while the UK held either a new election or second referendum - and the presumption is that the EU 27 would agree to a time-limited suspension rather than risk the turmoil from a "no deal" Brexit. In aggregate, we estimate the overall likelihood of a hard Brexit at 35%.

Figure 4:
Agreement models in the light of UK "red lines"

Source: European Commission, Deutsche Bank Wealth Management. Data as of December 2017.

Red Line	EU membership	Norway	Switzerland	Ukraine	Turkey	Canada	WTO
No ECJ Jurisdiction	✗	✗	✓	✗	✓	✓	✓
No free movement	✗	✗	✗	✓	✓	✓	✓
No financial contribution	✗	✗	✗	✓	✓	✓	✓
Regulatory autonomy	✗	✗	✗	✗	✓	✓	✓
Independent trade policy	✗	✓	✓	✓	✗	✓	✓

02

Economic and asset class implications

The UK's macroeconomic outlook

Our macroeconomic forecasts are based on the assumption of Scenario A: a successful withdrawal agreement being reached by March 2019, then prolonged EU membership until at least the end of 2020 followed by an Association Agreement (i.e. CETA++/alike trade-deal). Under this relatively benign scenario, UK GDP growth would remain positive (1.4% in 2018 and 1.6% in 2019 as some degree of certainty returns), but would be low both compared to recent history and the Eurozone (growth forecast at 2.0% in 2018 and 1.8% in 2019). Consumer price inflation (as the Bank of England expects) edges back towards the 2% bound over the forecast period, but we see some expansion in the fiscal deficit.

Equities

Our 12-month (end-September 2019) forecast for the FTSE 100 is 7,400. UK valuations in price/earnings terms would be expected to remain broadly in line with the Eurozone, but we have revised down our earnings per share estimates for 2018.

After the June 2016 Eurozone referendum, UK equities initially performed well against U.S. and European equities – helped by GBP

Figure 5:
UK forecasts at a glance
Source: Deutsche Bank Wealth Management.
Data as of September 28, 2018.

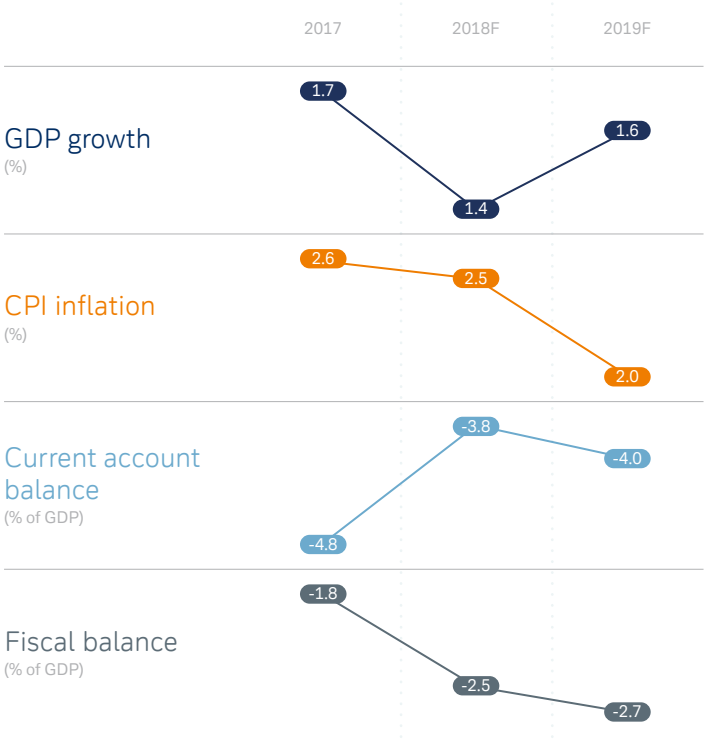

Figure 6:
UK equities and Eurozone PMI
Source: Deutsche Bank Research, Deutsche Bank Wealth Management.
Data as of September 18, 2018.

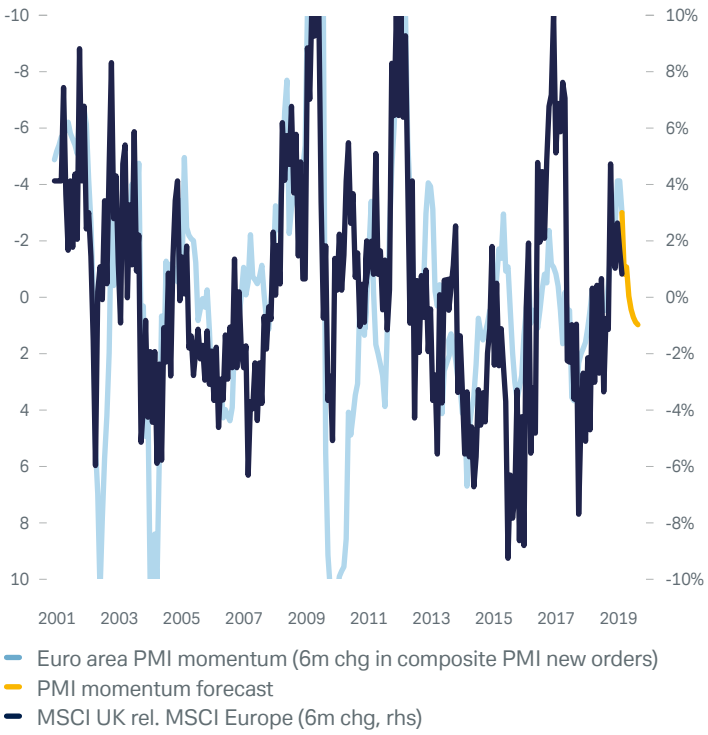

Figure 7:
The UK dividend/bond yield gap is high in a historical context
Source: Deutsche Bank Wealth Management. Data as of September 21, 2018.

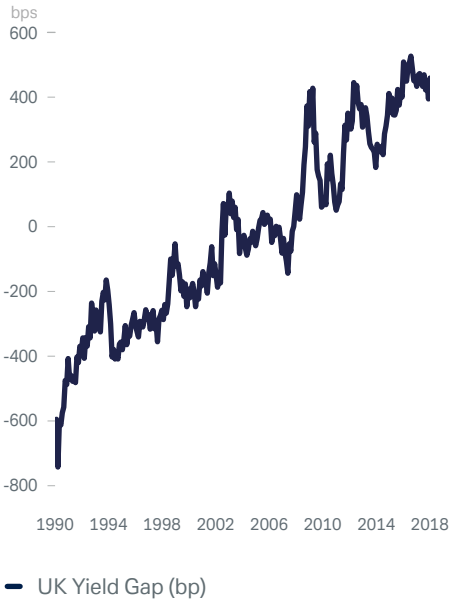

Figure 8:
Asset class forecasts for end-September 2019
Source: Deutsche Bank Wealth Management. Data as of September 28, 2018.

FTSE 100	7,400
10-year Gilts	1.75%
EUR vs. GBP	0.90
GBP vs. USD	1.28

depreciation. Since then, however, UK equities have underperformed US equities. Much, of course, depends on the index used: the FTSE100 has greater foreign exposure than broader indices such as the FTSE250. Around 70% of revenues from FTSE100 companies is non-domestic – a much bigger share than in the other major European indices. This could provide a limited buffer against UK domestic slowdown. Note also that energy stocks are equivalent to just under 20% of the FTSE 100 market cap – again, a higher weighting than in other major indices, meaning that oil price trends can have an impact. On the positive side, the UK is essentially a defensive market, however, so can relatively outperform when Eurozone PMI momentum is weakening, as appears to be the case (see Figure 4). Valuations also currently appear cheap on some measures and UK stocks are currently offering a particularly attractive dividend yield of 4.3%. The yield gap between UK stocks and bonds (the difference between the current bond yield and the dividend yield on the relevant index) is also attractive at present, at least in a historical context (Figure 7).

But even under relatively positive scenarios, domestically-focused UK firms, for example in consumer discretionary, would be likely to suffer from weak consumer sentiment in the UK which could exacerbate underlying problems (e.g. related to structural or regulatory issues).

Government bonds

We think that the Bank of England would be content to leave rates on hold for some time. The bank's August quarterly Inflation Report outlined an inflation and growth profile that was based around rate rises to 1.1% over the next three years. As of early September 2018, market expectations of a rate hike this year or early next were limited. We expect one more rate hike next year, but probably in the summer after the outcome of the Brexit negotiations is clear.

It is worth noting Governor Carney's recent comment that, in the event of a no-deal Brexit, rates could go higher. This reminds us that rates could still have to be used to counter inflationary pressures, even if the economy remains weak.

The central 12-month (end-September 2019) forecast for 10-year Gilts is 1.75%. This reflects the upwards trajectory of global markets, but with some risk premium for Gilts, given the obvious uncertainty about growth, inflation and the Bank of England. Recent data shows a decline in foreign purchases of Gilts, but a favourable technical supply situation, plus consistent-demand for long-dated bonds and little corporate issuance has helped keep the Gilts market in a state of equilibrium.

GBP

The overall trend is for a weaker GBP, although the currency has waxed and waned in recent months. Net short positions on the GBP vs. USD have been pared back in recent months, leaving macro as a driver of the exchange rate. We think that GBP volatility would pick up, with likely highs around the Conservative Party conference starting at the end of September, the October EU summit and through to late November as details for the Brexit solution are thrashed out. GBP volatility could then fall back temporarily, before rising again as the UK parliament vote on the EU deal approaches. A "no deal" scenario would push up volatility further.

Real estate

The commercial real estate market in the UK is negatively affected by Brexit concerns but there are some factors which serve as shock absorbers. There is substantial foreign demand for UK property from overseas investors which are traditionally price-inelastic. Roughly 80% of central London office buyers are international, around 50% for the UK market as a whole. Demand remains strong and the yields achievable in the UK look relatively attractive globally. A depreciation of the GBP would also mitigate the impact on this asset class. Residential real estate is likely to be sensitive to changes in employment, real interest rates and to aggregate shifts in the labour force because of migration shifts, but we see few signs of visible financial distress in the housing market, unlike in previous downturns.

What a hard Brexit could mean

Economy:

In a "hard Brexit" scenario Deutsche Bank analysts expect that Eurozone GDP would be around 0.5ppt lower than under our central scenario by the end of 2019. Among the Eurozone economies, Ireland would be the most vulnerable but the Netherlands, Germany and Belgium have sizeable exposures to the UK too. As well as trade, there would be three other channels of contagion: uncertainty and sentiment, migration and politics.

The UK economy could be hit hard and longer-term GDP potential growth is likely to be reduced (by up to 2% per year), due to less migration, a weaker trade relationship with the EU and damage to investment (with heightened uncertainty around both domestic politics and the longer-term relationship with the EU). Assessing the exact short-term impact is difficult, but Figure 9 summarizes a recent Deutsche Bank assessment. Much of course will depend on the fiscal response, which could limit the loss of output and a weaker GBP will also help offset the impact on exports.

FX:

A "hard Brexit" would likely lead to higher GBP volatility and further pressure on the currency. We would also be cautious on EURUSD, since we expect investors to start questioning the stability of the whole European project again. In the aftermath of a hard Brexit, the market could see a 7-8% fall in the trade-weighted value of the GBP. Investment approaches to deal with the prospect of a hard Brexit could include option strategies focused on higher implied and realised GBP volatility, or out-of-the money GBP puts.

Fixed Income:

In a severe scenario we would expect a flight to quality in the Eurozone sovereign bond markets. Overall peripherals repricing could be encouraged by a perception that Brexit would undermine the commitment to the European project. Core and semi-core spread widening would however be much more muted and non-Eurozone economies such as Switzerland, Sweden and Denmark could outperform on a relative basis. Gilt market reaction might however be ambivalent as uncertainty and higher risk premia for stocks might counterbalance concern about a higher public sector borrowing requirement (PSBR), higher current account deficits and a weaker GBP.

In credit, a no-deal Brexit would likely increase peripheral risk premia in credit markets and result in under-performance of financials versus non-financials. The focus is likely to be on three areas: UK corporates dependent on EUR funding, European corporates with UK exposure and the political premium for peripheral credit.

Equities:

The most immediate consequence of an uncontrolled Brexit would come via a large spike in uncertainty which would equate to higher risk premia and lower valuations for all but the safest assets (geopolitical and economic contagion would happen via trade links and sentiment). Available predictions, including from Deutsche Bank analysts, foresee a wide range of possible stock market reactions, depending on the index used, the movement of the GBP and the assumptions made about the policy response. Against this background, and considering the market reaction in June 2016 (when UK stocks fell by much less than feared and recovered quickly due to the fall in the GBP), a drop of 5-10% in the broad market cannot be ruled out in the case of a "hard Brexit". Financials would likely be the biggest underperformers while internationally-exposed defensives (e.g. food, beverage & tobacco and healthcare) and large-caps should do relatively better, as the latter should be less exposed to UK and Eurozone domestic economies. It might be worth concentrating on stocks that could benefit from GBP depreciation. 12M Forward price/earnings (P/E) ratios could fall by around 8-10% in Europe to around 12x, which would be roughly midway between the average seen during 2011/12 and current valuations. Accordingly, the MSCI Europe could fall by a similar range in a hard Brexit, and at a sectoral level we would underweight European financials (given their gearing to weaker economic activity, fallling asset prices and worsening sovereign and credit market caps).

Real estate:

Despite the mitigating factors outlined on page 7, a hard Brexit will likely negatively impact in particular the London office market, even though larger occupiers will look through the shorter term uncertainty. Markets estimate the impact of a no deal Brexit on UK commercial real estate as being a drop in prices of 5% to 8%. As discussed above, residential real estate is likely to be sensitive to rises in unemployment, real interest rates and to labour force changes. All these factors point to price losses in the case of a hard Brexit, but we do not see visible signs of distress in terms of housing borrowing, which may provide some relief.

Figure 9:
Potential implications of a hard Brexit on demand components

Source: Deutsche Bank Research, Deutsche Bank Wealth Management. Data as of September 24, 2018.

Households

TRIGGER	POTENTIAL IMPACT
Real income/wages	Falls from current 0.5% to -2.0% yoy
Consumer confidence	Sharp drop
Labour market	Increase of IR by ca. 2.5 - 3% ppt
House prices	Decrease by ca. 5%

Investments

TRIGGER	POTENTIAL IMPACT
FDI	Falling, reallocation to EU
Demand	Sharp drop
Financial conditions	Tighter
Confidence	Sharp drop

Trade

TRIGGER	POTENTIAL IMPACT
Export	Drop of ca -8% by end 2020
Import	Drop of ca -10% by end 2020

03

Conclusion

As the scenarios above demonstrate, the form that Brexit takes is important not just for the UK but for the Eurozone as a whole – in economic, investment and political dimension. A hard Brexit would be advantageous to few and we continue to think that it is unlikely.

Within the other forms of Brexit available, reaching the March 29, 2019 deadline will be the end of one phase of the process – and the start of another. This is not an issue that will be quickly resolved. For this reason, it remains important that investors differentiate between short-term market moves (driven by news snippets), medium-term investment concerns (as the direction of negotiations becomes clearer) and longer-term structural changes in the new, post-Brexit world.

In the short term, we expect GBP volatility to be the principal conduit in the run-up to the March 29, 2019 deadline. This volatility could wax and wane as we move through key run-up events, as we explain above. On a 12-month horizon (end-September 2019), assuming a market-friendly Brexit (65% probability), we think here is some scope for equity market gains and, while we expect an increase in the 10-year Gilt yield, this is unlikely to be sharp. GBP could fall slightly from current levels against the USD. Any market predictions in the event of a market-unfriendly Brexit must be more tentative, but would evidently be more severe and also have a greater impact on the rest of Europe. We offer some views about possible outcomes on page 8. In the longer term, whatever Brexit scenario happens, we think that current structural issues around the UK economy (e.g. productivity, personal credit) will remain a concern for some time. As we note earlier, the actual moment of Brexit is not the end of this story, just the start of a new, much bigger saga as the UK starts to redefine its place in the world. We will keep you updated as the story progresses.

Glossary

The Bank of England (BoE) is the UK central bank.

The Comprehensive Economic and Trade Agreement (CETA) is a free-trade agreement between Canada, the European Union and the EU's member states.

The UK Conservative Party is a centre-right political party, in power since 2010.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

EUR is the currency code for the euro, the currency of the Eurozone.

The European Council includes EU members' government leaders, the European Council President and the President of the European Commission. It defines the EU's overall political direction.

The European Court of Justice (ECJ) is the supreme court in the European Union dealing with European Union law.

The European Economic Area (EEA) is designed to ensure the free movement of persons, goods, services and capital through Iceland, Lichtenstein and Norway and all member states of the European Union.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

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

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

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Gilts are bonds that are issued by the British Government.

The House of Commons is the lower elected house of the U.K. parliament.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings. In this context, LTM refers to last twelve months' earnings.

Risk premia refer to the return in excess of the risk-free rate of return that an investment is expected to yield. It is a form of compensation for investors who tolerate the extra risk.

USD is the currency code for the U.S. Dollar.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Volatility is the degree of variation of a trading-price series over time.

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