14 December 2017

The UK to pay 50 billion, but the hardest part has yet to come

Brexit negotiations resuming. GDP holding up (+0.4%). The BOE to keep rates unchanged for a time. Inevitable increase in long-term rates. Lethargic equities market.

Key points

- GDP up +0.4%, or +1.5% yoy
- Finally, sufficient progress to move on to the second phase of the negotiations
- Is the UK giving up? The hardest is yet to come
- All sectors of the British economy are worried about regulatory risk
- The pound should benefit from the resumption of the negotiations process
- Monetary policy likely to remain unchanged
- GDP is eroding, while leading indicators are pointing to an economic slump
- Real estate prices increased +3.9%
- The bond market cannot remain indifferent to the pick-up in inflation
- Lethargic equities market

Finally sufficient progress to move on to the second phase of the negotiations

The European position had been firm for several months, requiring a preliminary financial agreement with the UK in order to initiate the second phase of Brexit negotiations. The absence of any significant progress in talks with the British had greatly frustrated the Europeans, although they finally triumphed, hailing an agreement on 13 December setting out a number of requisite terms for the divorce requested by the British people.

The European parliament thus adopted a resolution with regards to Brexit, noting that progress had finally been made after several months of negotiation and a compromise reached that opens the door to the next phase of talks, which will nevertheless be conducted with great vigilance. However, this preliminary agreement remains fragile; indeed, in the opinion of Mr David Davis, the UK's Brexit minister, the agreement between Theresa May and Michel Barnier, the European Commission's chief negotiator, who hardened his stance several months ago in the face of British prevarication, is described as merely a "declaration of intent".

The resolution, which garnered a majority of the votes (552), temporarily eases MPs' irritation. However, they are not dropping their guard and have stated that the next steps would have to be carried out in a constructive atmosphere of mutual good faith. Doubts clearly persist with regard to the UK government representatives' true intentions in terms of honoring their commitments. Michel Barnier noted that Theresa May made a commitment on behalf of the UK government and that reneging on the agreement to pay approximately 45 to 50 billion euros would very quickly result in a legally binding withdrawal agreement.

Is the UK giving up? The hardest is yet to come

Thus, the issue of the UK's financial obligations was and remains a key focus of the negotiations. Initially estimated at between 60 and 100 billion euros, the final bill could ultimately be much lower for the UK, even though it will still be a considerable sum. With a divorce bill currently estimated at 50 billion euros, Theresa May was forced to double the 20 billion euro offer made just a few weeks prior, thereby accepting the Europeans' calculation methodology. The political reversal is likely to hurt, as the Prime Minister ultimately had to give in to European

demands. She will probably obtain for payment to be spread over many years, but that is cold comfort, as the deadline for Brexit (March 2019) approaches.**

Nevertheless, this surrender opens the door to the crucial second phase of the negotiations, although it certainly does not guarantee its success within the deadlines. Countless legal and regulatory difficulties will still have to be worked out for a trade agreement to be reached setting the terms of the relationship between the two partners.

The form of this agreement remains to be determined of course, but it is up to the British to propose a draft to be discussed. Given the UK's firm stance on certain elements and in particular with regard to their determination not to be subjected to the strictures of free movement of persons, goods, services, and capital, it would seem like the future agreement will be similar to that negotiated by the EU with Canada.

All sectors of the British economy are worried about regulatory risk

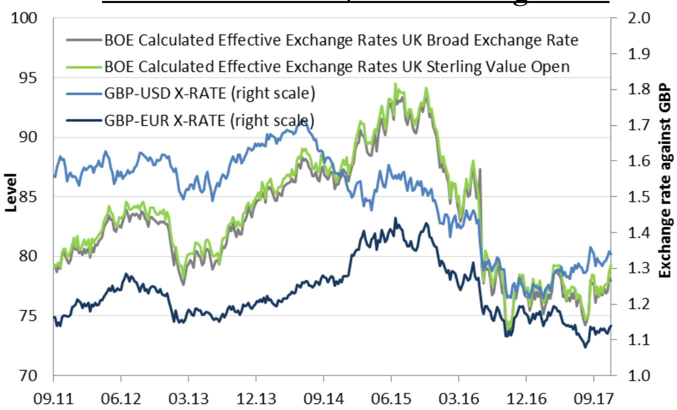
The City appears calm, but it is asking for a period of transition. The chief lobbyist of the British financial industry still appears confident but is demanding that an agreement be found with regard to a period of transition that would postpone the application and impact of Brexit for several years. If this were to happen, for two years starting on 29 March, the UK would remain in the single market but would no longer be a member of the EU. A two-year delay would allow current regulations to stay in place temporarily before new rules are introduced, adapted to the new situation. Meanwhile, banks and financial institutions are assessing the risks and opportunities, although some are already implementing backup plans.

The financial services industry is not the only one speaking out to defend its interests. All sectors in the UK are worried about the risks of future regulatory divergence, which will involve challenging adjustments for companies. A sudden and complete withdrawal from the European regulatory framework would have severe consequences that could call into question years of investments. The pharmaceutical, chemicals, aeronautics, and auto sectors are all taking the same tack, recommending to the government that it limit current rules as much as possible. The main objective is clearly to minimise the negative impact on British exports of withdrawing from the customs union.

The pound should benefit from the resumption of the negotiations process

The British currency was not really impacted by the vagaries of the negotiation process over the past quarter. We have been noting for several months that the pound has entered a stabilisation phase against most major currencies, after its record drop following the Brexit vote. In 4Q16 already we noted that the pound had likely reached a valuation level enabling a more lasting consolidation pending greater visibility with regard to the country's economic outlook. Since then, the currency's volatility has decreased, and the exchange rate has actually risen against the franc (from 1.20 to 1.30) and the dollar (from 1.20 to 1.35) in particular. It stabilised above 1.10 against the euro in a context favouring the single currency.

Effective and dollar/euro exchange rates



Sources: Bloomberg, BBGI Group SA

As the next phase of the negotiations gets under way, we continue to expect the exchange rate to further stabilise over the next several months.

Monetary policy likely to remain unchanged

The Bank of England did not alter its key rates in December, after raising them in November for the first time since 2007 from 0.25% to 0.5%. GDP growth is slowing down but remains positive, while inflation is slowly rising. We continue to believe that the November hike will not be hastily followed by further monetary tightening, although it is likely that key rates will trend upward, possibly from 0.5% today to 1% in 2019 in a context of sluggish growth and moderate inflation.

Indeed, growth is likely to slow down further in 2018, as negotiations with the EU will probably generate additional uncertainty likely to cause a steeper drop in consumption. As for inflation, current momentum could be sufficient to push the price index ex food and energy above 3%.

However, as we mentioned in our previous analysis, the rate hike to 0.5% could well be followed by a long period of inaction. Indeed, the BOE will likely keep rates unchanged or proceed with only minor hikes in 2018.

The Bank of England appears rather satisfied with the agreement reached with the EU, which should diminish the likelihood of a disorderly withdrawal from the EU. The resumption of negotiations will likely have a positive impact on consumer sentiment and on business confidence. GDP is thus rather likely to stabilise.

GDP is eroding, while leading indicators are pointing to an economic slump

Q3 GDP (+0.4%) reconfirms the previously noted erosion of economic momentum in the UK without, however, pointing to a drastic deterioration. Yoy growth stabilised at +1.5%, which bolsters our expectations with regard to reduced growth for 2017 as a whole. Exports' contribution decreased from +1.7% in Q2 to -0.7% in Q3. Consumption generated a somewhat positive surprise by progressing from +0.2% to +0.6%, which clearly helped GDP stabilise its growth rate, also boosted by a +0.3% uptick in public spending.

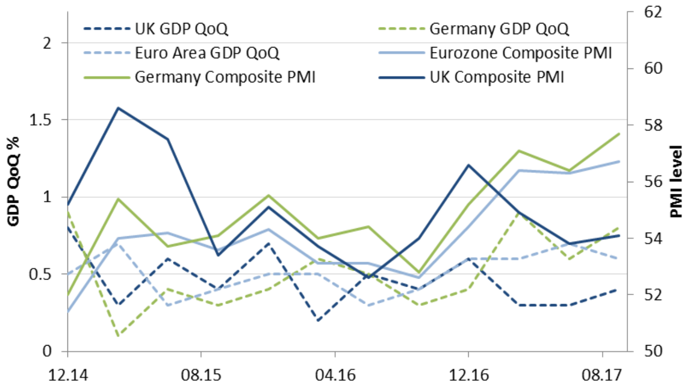
Leading indicators point to GDP's weakening resilience.

Indeed, the most recent indicators point to growth in the manufacturing sector, as the manufacturing PMI increased further from 56.3 to 58.2, its highest level of the year. As for services, the picture is somewhat less rosy, as the services PMI slid from 55.6 to 53.8, though remaining well within the growth zone. With regard to the construction sector, the leading indicator strengthened from 50.8 to 53.1, suggesting increasing activity over the next few months. Nevertheless, overall the composite index weakened, declining from 55.8 to 54.9. Consumer confidence is underwhelming, and dropped further in November. The business barometer saw no major changes, remaining in the same dispirited trend since early 2016.

In this context, the unemployment rate offered a positive surprise by remaining relatively stable (4.3%), although the labour market deteriorated, shedding 56,000 jobs in October. This confirms our previous forecast, whereby the earlier upturn was unlikely to last. The labour market participation rate declined further, which has a rather negative impact on the economic outlook for the beginning of 2018 but also leads to a reduction in the risk of upward pressure on wages.

Industrial production slipped in October (+0.1%), as did manufacturing production (+0.1%).

Quarterly GDP and PMI: UK, Eurozone, Germany

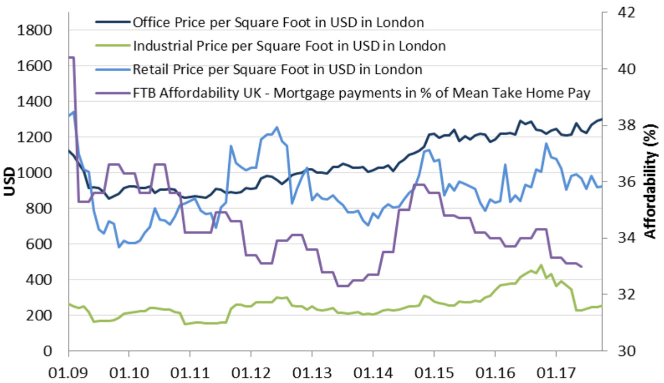


Sources: Bloomberg, BBGI Group SA

The growth prospects of the British economy are less sanguine. 4Q growth could still reach +0.3%, but the slowdown will likely be sharper in 2018.

Real estate prices increased +3.9%

Real estate prices – Real estate affordability index



Sources: Bloomberg, BBGI Group SA

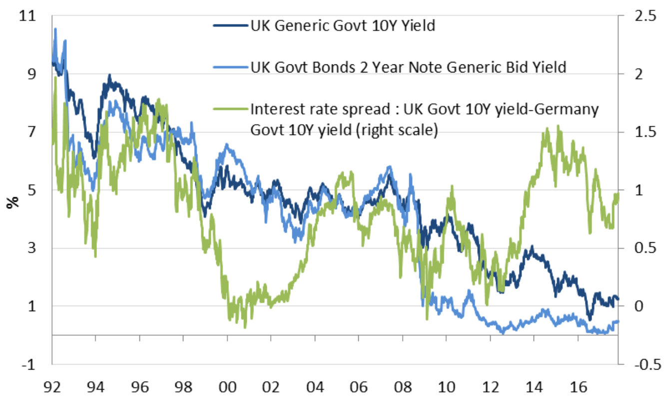
We reiterate our recent comments suggesting that the stabilisation of the pound could boost residential demand given the sustained interest of international investors and as domestic demand still exceeds supply. The past few months have confirmed this prediction, as real estate prices posted their fifth consecutive increase in November according to Halifax, indeed their highest three-month increase since January.

Overall, however, annualised price growth declined from 4.5% to 3.9%. The real estate market cooled down this year, but we are not seeing any real changes in market conditions. Supply will likely remain lower than demand in 2018.

The bond market cannot remain indifferent to the pick-up in inflation

Inflation is rising slowly but surely in the UK. By November, the consumer price index had doubled over twelve months, reaching +3.1%. The CPI index had reached a low in April 2015 at -0.1%. The upturn is significant and even clearer when looking at the trend in the production price index over the same period.

2-yr and 10-yr UK government yields



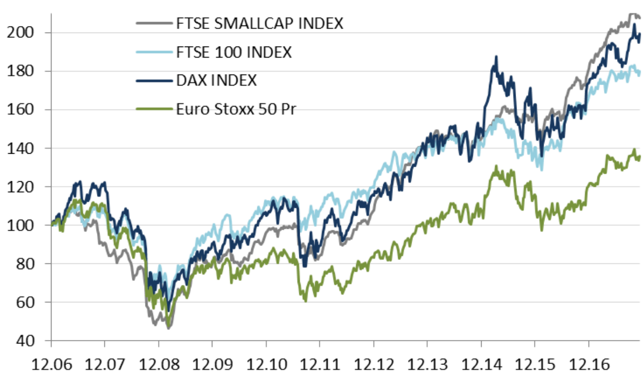
Sources: Bloomberg, BBGI Group SA

We continue to predict that inflation will exceed the BOE's 2% target in the next several quarters and could even reach 4% by 2020. It is surprising in the context of general price increases that long-term interest rates are not more affected by changes in expectations. Indeed, despite the increase in prices, the yields on UK government debt seem to have followed the trends in international bond markets and do not appear to be reflecting the increase in domestic inflation. Real yields in pounds are thus relatively stable, even declining slightly from 1.4% in October to 1.3% at the end of November. The UK bond market will likely be more impacted by domestic fundamentals in the near future, which will likely nudge long-term rates back up.

Lethargic equities market

The UK equities market entered a long phase of horizontal consolidation in 2017, which could last another few months. Performance in local currency stands at a mere +2% YTD, which is well below the results of most EU markets. At approximately 14x 2018 earnings, the UK market is still somewhat expensive, but its yield remains slightly higher (4.3). The stabilisation of the pound stopped the progression of UK shares, as we had expected. We continue to recommend caution with regard to this market, which could subsequently be penalised by the more tangible effects of Brexit negotiations on corporate earnings.

UK (large / small), Eurozone, German equities



Sources: Bloomberg, BBGI Group SA

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