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Brexit talks and British economy at a standstill

Impossible political agenda. No more hard Brexit? Sluggish GDP growth (+0.1%). Pound in wait-and-see mode. Long-term rate adjustment postponed. Caution with regard to equities.

Key points

- Brexit talks: more than ever, confusion abounds
- The European Union rejects London's proposals
- A victory for pro-European MPs that eliminates the risk of a no-deal outcome?
- Impossible political agenda
- The pound in wait-and-see mode
- Growth slows in Q1 (+0.1%)
- Some hopeful signs of GDP growth in Q2
- The BoE is not prepared to raise rates
- Rate adjustment further postponed
- Remain cautious with regard to UK equities

Brexit talks: more than ever, confusion abounds

The British government is overcome with confusion, and talks with the EU remain in a deadlock. Less than 10 months away from the deadline for divorce, the Europeans are increasingly exasperated by British prevarication and London's unrealistic proposals regarding, among others, the border with Ireland.

But the negotiations are also at a standstill on other matters, which starkly highlights the extreme complexity involved in the actual implementation of Brexit. Two years after the referendum and following 15 months of discussions, Theresa May still has not been able to establish a clear and logical strategy to withdraw from the EU.

After attempting to impose a hard Brexit, which initially seemed to correspond to the spirit of the referendum, she then understood the necessity of establishing a transition period in order to seek a more complex and certainly more realistic solution. In view of the magnitude of the challenge and of the opposition, she is now considering postponing Brexit to 2023, de facto acknowledging that the transition period, though in effect through 31 December 2020 per agreement with the 27 EU members, would be too short to carry out a genuine implementation plan.

This strategy will give her more time to extract a compromise from her majority, but her government remains more than ever divided between the pro-Europeans who wish to stay in the customs union and those who call for intransigent bilateral talks.

In this context, the Irish question is not the least of the matters that could give Theresa May trouble in the next few weeks. Indeed, it seems impossible to withdraw from the customs union without immediately having to reintroduce a physical border in Northern Ireland. This would call into question the agreements signed two decades ago among the parties and could provoke unexpected reactions. For the European Union, there is no doubt: the only solution to the Irish question is for the UK to remain in the customs union, which at this stage is not a conceivable option for proponents of a radical Brexit. In fact, the EU has already rejected the UK's proposal drawn up to avoid the reintroduction of a border in Ireland, noting that it raised more questions than it answered.

A victory for pro-European MPs that eliminates the risk of a no-deal outcome?

When the Brexit bill was under review, the British prime minister only just avoided a stinging defeat by obtaining the withdrawal of an amendment about to be passed that would have given Parliament veto rights with regard to the terms of any agreement negotiated by the government. Indeed, on 12 June, pro-European Conservatives forced Theresa May to back off from a key point, obtaining that she give up the notion of a hard Brexit. She promised them that the views of Parliament would be taken into account in the fall, when the government presents the contents of a future agreement with the EU, which remains to be formulated. The rebellion of certain Conservative MPs thus forced the prime minister to give in, a concession that further weakened her position. The no-deal strategy, which was intended as a means of putting pressure on the EU, thus seems to be cast aside, which is an important victory in terms of the immediate prospects of the negotiations. The latter could now become more constructive and pragmatic. However, this development may also open up a new path, which could potentially lead to new elections, the fall of the May government, and even the organisation of a new referendum on the withdrawal agreement once it is formalised.

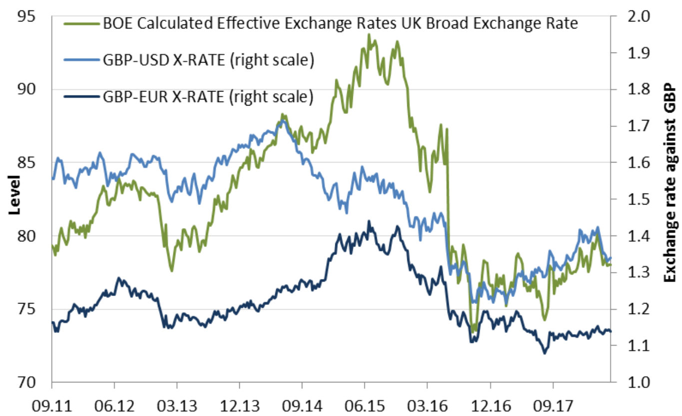
An impossible political agenda

The agenda for the European Council meeting on 28 and 29 June is impossible; among other matters to be addressed are the thorny issue of the border between Northern Ireland and the Irish Republic as well as future trade relations. Given the British government's current, particularly agitated context, it seems unrealistic to expect that the UK will present a roadmap establishing the broad outline of their proposals to the Europeans. It is thus likely that no real progress on talks will be made at this meeting and that the summer will then not be sufficiently conducive to drafting an agreement in time to be endorsed at the next Council meeting in October. As for the European negotiators, they are clearly frustrated, as they view the UK's proposals as less than satisfactory and have clearly not dismissed the risks that the talks may fail. In the UK, the business world is plainly exasperated by politicians' lack of realism, and public opinion appears to be more and more sceptical as to the rationale for Brexit. The public is having doubts, and views are progressively shifting in favour of the notion of a referendum on the final agreement negotiated by the government. The replacement at the helm of the Daily Mail of a Europhobic editor by a more Europhile editor-in-chief may be a sign.

The pound is in wait-and-see mode

The British currency still appears unaffected by the political uncertainty and the absence of concrete progress made on defining the post-Brexit trade framework. We continue to believe that the pound has entered a phase of stabilisation against most major currencies after its historic fall in the wake of the Brexit vote.

Effective dollar/euro exchange rate



Sources: Bloomberg, BBGI Group SA

After talks resumed in December 2017, the pound benefited from a slightly more constructive political climate leading to hopes of a reasonable solution between the UK and the EU. This expectation continues, for now, to bolster the pound/euro exchange rate, which has remained stable since October 2017 at between 1.12 and 1.14.

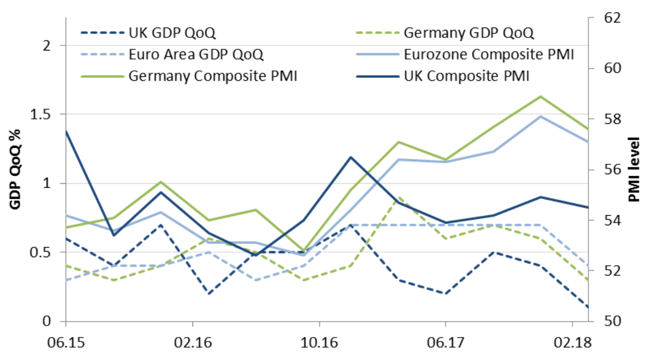
However, after having banked on a stabilisation of the exchange rate in H1 2018, we are now concerned that, as the March 2019 deadline set for Brexit draws nearer and the difficulties encountered in the negotiation process fail to abate, the level of risk will increase and once again affect investors' perceptions regarding the British currency's outlook. Less than a year away from the deadline, the level of uncertainty remains extreme, even if it looks like a hard exit is not currently the most likely outcome. It is thus not unlikely that volatility will return in the coming months along with renewed pressure on the pound.

Growth slows in Q1 (+0.1%)

The British economy continues to slowly deteriorate as it has since the Brexit vote. Indeed, growth has still not stabilised as hoped, even though the international and European economic contexts are relatively robust. After GDP growth fell back in Q4 2017 (+0.4%), Q1 2018 figures came out significantly below expectations, posting their poorest performance since 2012. The deceleration was sharp, with the economy abruptly losing almost all momentum; indeed, GDP grew only by a measly +0.1%. On an annual basis, GDP growth fell from +3.4% in December 2014 to only +1.2% in March 2018. The British economy is thus struggling and could quickly find itself in an even more precarious situation absent a genuine upturn in Q2.

The latest industrial production figures are not encouraging. The -0.8% drop in April took analysts by surprise, as they were forecasting a slight rise of +0.1%. Most sectors experienced a decrease in production except for the energy segment, which is still up +1.8% YoY but is not really benefiting from the stabilisation of the pound at low levels against the euro. Production in the manufacturing sector saw its most significant decline since October 2012 (-1.4%), even while analysts were expecting a +0.3% rise. The trade deficit increased to 5.37 billion pounds, a worrying result compared with the March figure, which was already at 3.2 billion. The trade balance thus posted its third worst result of the past five years. Given the pound's enhanced competitiveness, it is particularly disappointing to observe that exports are struggling to grow and in fact declined by -0.5% at March end. A concurrent decrease in imports (-0.6%) prevented the trade balance from worsening even further. The uncertain economic climate continued to affect British consumers over the same period, and private consumption remained anaemic (+0.2%). Domestic demand fortunately continued to benefit from the support of public consumption, up +0.5%.

Quarterly GDP and PMI: UK, Eurozone, Germany



Sources: Bloomberg, BBGI Group SA

Some hopeful signs of GDP growth in Q2

One positive factor generating hopes of a brighter Q2 for the British economy is the Markit/CIPS composite PMI index. Indeed, since March, this leading indicator has progressed from 52.4 to 53.2, closing in May on a positive note at 54.5. Despite this upswing, however, it is still well below the 56.3 high reached in April 2017. The upswing in the composite index is driven by increases in the manufacturing and services indicators (from 53.9 to 54.4 and from 52.8 to 54.0, respectively). In contrast, the activity index for the construction sector stabilised at 52.5, still well below 2015 highs. Consumer confidence and the business barometer show slightly more optimism than before. Uncertainly caused by Brexit continues to weigh significantly on the minds of economic actors, but consumer and business confidence improved slightly in May. As for the job market, it is sending mixed signals. The unemployment rate remained relatively low (4.2%), but jobless claims decreased, while job creation expanded at a slower pace in April than in March.

Analysing the job market is particularly important in the current situation to determine whether sluggish GDP growth in Q1 could be followed by further weakness. The creation of 146,000 jobs in May is positive, and these numbers are relatively high in comparison to the statistics of the past 10 years. A sustained pace of job creation in Q2 is thus an encouraging sign with regards to GDP, as are increases in wages, which indicate that the economy could benefit from a potential upswing in consumption.

The growth prospects of the British economy will likely remain rather limited in the current environment. An upturn in Q2 seems somewhat more likely today in view of the slight improvement in leading indicators.

The BoE is not prepared to raise rates

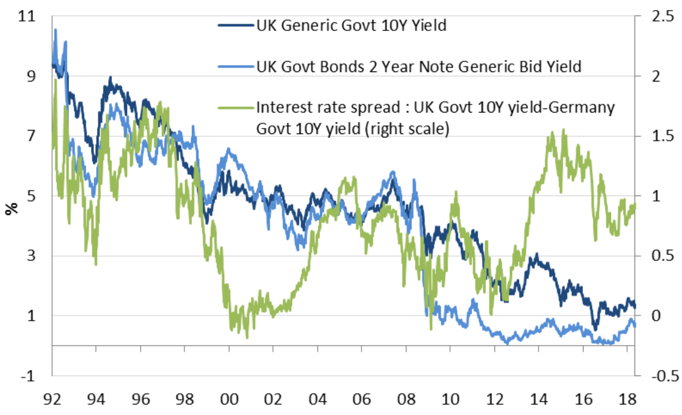
The BoE recently published the results of its survey on consumers' inflationary expectations for the next year, which increased slightly from 3.4% to 3.5%. The proportion of households expecting interest rates to rise over the next 12 months declined from 58% to 51%. The BoE's 2% inflation target had been exceeded in the Brexit context, but since the beginning of the year, the CPI index has steadily dropped from its 3.1% high reached in November to 2.4% in April 2018.

The decline in the price indices should enable the BoE to view the economic slowdown in Q1 with a little more serenity. Over the past months the bank has likely been concerned with the decrease in economic activity in the UK, but inflation trends should allow it to maintain an accommodating policy for a while longer. The rate of wage growth is now higher than inflation, which should have a positive impact on consumption. The BoE's position thus remains difficult, in particular if one considers that it may be hoping for an upward revision of GDP figures for Q1. The bank likely wishes to normalise its target with regards to key rates, currently at 0.5%, but this move seems very unlikely to occur in the near future. The likelihood of action in August thus remains below 50%. The status quo is likely to persist given the current economic slowdown. As mentioned in our previous analyses, the rate hike to 0.5% will likely be followed by a long period of inaction before a minor hike in the second half of the year. GDP growth in Q2 will be a determining factor in the evolution of monetary policy over the next several months.

Rate adjustment further postponed

Retail price indices thus eased somewhat over the past few months, among which the core index in particular, which slid back to 2.1% in April, a significant decline in the BoE's eyes given the high of 2.7% YoY reached at the end of January. Pressures fortunately did not intensify, in spite of the stabilisation of the exchange rate against the euro in particular. As for production prices, they fell more sharply in 2017 but are creeping back up in 2018 in part due to the increase in commodities prices. We maintain our forecast with regard to a stabilisation of inflation above the BoE's 2% target over the next quarters and remain alert to the risks of an adjustment of long-term interest rates should economic activity pick up. The UK bond market is likely to be further affected by domestic fundamentals and by Brexit-related uncertainties, which are not waning.

UK 10- and 2-yr government rates



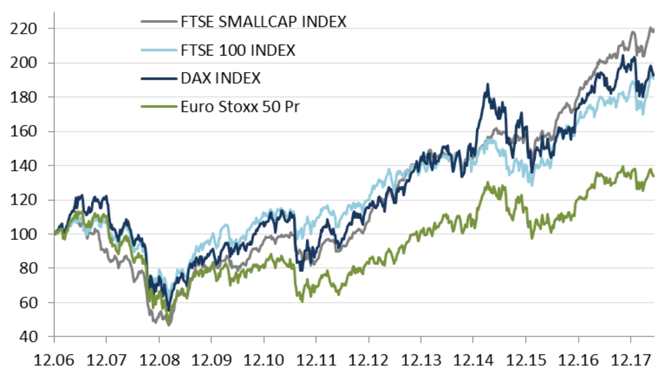
Sources: Bloomberg, BBGI Group SA

The British economy's loss of momentum at the beginning of the year could justify long-term rates being temporarily lower than inflation. Long-term rates could thus yet stabilise around 1.5% without any economic upturn, but an upward revision of the economic outlook could also push long-term rates closer to 2%.

Remain cautious with regard to UK equities

In the uncertain context surrounding the Brexit negotiations, the equity market's expected risk/return ratio remains unattractive. The pound has stayed resilient in the face of these uncertainties, but we maintain our recommendation to remain cautious with regard to UK equities, in spite of reasonable valuations and an attractive dividend yield.

Equities: UK (large – small), Eurozone, Germany



Sources: Bloomberg, BBGI Group SA

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