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The EU rejects the Chequers plan… no deal or new vote?

Higher GDP growth in Q2 (+0.4%). Unexpected upswing in inflation. Pound hostage to the political situation. Steepening yield curve. No Brexit solution.

Key points

- Theresa May further weakened by the EU's rejection of the Chequers plan
- The option of a new referendum is making headway as a means of breaking the deadlock
- A majority of British voters would choose to stay in the EU today
- The pound remains hostage to the political situation
- GDP growth better than expected in Q2 (+0.4%)
- Dim prospects for faster year-end GDP growth, sub +1.5% growth in 2018
- Period of inaction for the BOE after the 0.25% rate hike in August
- Unexpected upswing in inflation
- Likely steepening of the yield curve
- Continued caution with regard to British equities

Theresa May further weakened by the EU's rejection of the Chequers plan

European leaders rejected the Chequers plan, further weakening Theresa May, who will have a very difficult time uniting her party behind her at the next Conservative Party conference. A mere six months from the deadline, confusion reigns, and positions are becoming more entrenched. Former foreign affairs minister Boris Johnson will likely harden his stance and try to impose the hard line he has always aimed for. The prime minister, on the other hand, is in an inextricable situation, because she has only a small majority in Parliament, which could be insufficient if a portion of her MPs rebel.

While she may claim that her proposal is the only one ensuring cross-border trade and keeping the Irish border open, it will be enormously difficult to convince her party that her proposal is in the national interest. Nevertheless, she will have to revise her proposal quickly in order to present a new, acceptable version of it at the European summit on 18-19 October. This will be hard to achieve without appearing to be making concessions to the EU.

Tensions are rising among conservatives. The various factions are girding for battle in what now seems to be shaping up as one of the turning points of the Brexit saga. It may still be a little early to fear a sudden overthrow of the prime minister, as it seems that at this stage no one really wants to take up the challenge of replacing Theresa May in terms of managing the Brexit process. However, we are nearing the point where the party could come to blows not so much with regard to the form that Brexit might take but indeed regarding the issue of organising another referendum to break the deadlock besetting British politics since the 23 June 2016 vote.

Theresa May committed to leading the UK toward a withdrawal from the EU. She is likely looking for the best way possible to reach this goal. But the right wing is only interested in discussing a hard Brexit without concessions, as had been 'promised' to the people during the referendum. Now, an increasingly large segment of the party seems willing to consider rethinking the very concept of Brexit. The Europhile wing of the party will thus make its voice heard and will likely not hesitate to propose a more pragmatic approach given the complexity and the astronomical cost of leaving the EU.

The option of a new referendum is making headway as a means of breaking the deadlock

Theresa May remains opposed to the organisation of another referendum; however, polls show that the population would vote differently today given the uncertainty that has been weighing on the future of the UK and on the country's economic prospects over the past two years, and as the risks of a 'no deal' have intensified with the rejection of the Chequers plan. The number of people who support staying in the EU has indeed increased over the past few months, while the proportion of Brexit supporters has dropped from 52% in 2016 to only 41% today. A recent YouGov poll suggested that 45% of people polled are favourable to another vote, while only 34% seem to be opposed. "What the people have done only the people can undo" – perhaps a useful maxim over the next few months in terms of justifying a complete reversal in attitude, which could well offer a simple solution to the conundrum British politicians have been puzzling over for months without finding an acceptable solution.

Part of British civil society has already taken a position on the issue and wishes to organise another referendum. Figures such as the very charismatic Labour mayor of London, Sadiq Khan, are lending their support to the idea of another vote, a notion also supported by Tony Blair (Labour) and John Major (Conservative). The leader of the Liberal Democrats, Vince Cable, supports the idea as well, stating that Brexit is not inevitable and could be stopped.

Within the Labour Party, moreover, Jeremy Corbyn has radically changed his position. He now appears to be open to another referendum, no doubt influenced by the YouGov poll showing that 86% of the members of his party are favourable to this proposal and that 93% of them would vote to stay in the EU.

With regard to the majority party, Conservative Europhiles now deem that the time has finally come to make their voice heard and to venture giving the British people another chance to vote on Brexit.

While they have not clearly stated their position on the matter, it would seem that most European leaders would welcome and support a second vote.

Thus, it is no longer improbable that this solution would make headway and become ever more popular over the next several months in an attempt to reverse the UK's fate. Brexit may no longer be inevitable!

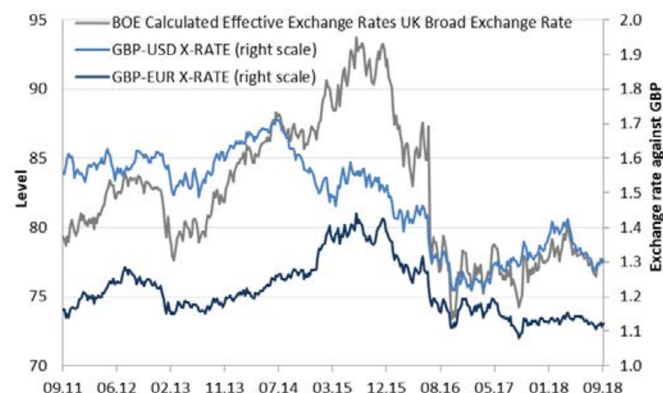
But the clock is ticking, and it may not be easy to organise another referendum before the 29 March deadline. Further pressure will likely be required in order to truly be able to envisage this outcome politically. And it may even be necessary to extend the deadline specified in Article 50 and push back the exit date in order to implement this process.

The crisis persists. Conservatives have struggled to come to an agreement, which could force, if pressed, the organisation of new elections or the emergence of a middle way. The latter seems to be preferred by an increasing proportion of the population, which seems to be more and more ready to put an end to the unending political psychodrama playing out since the 2016 vote.

The pound remains hostage to the political situation

The pound is no longer suffering major blows, despite the lack of concrete progress on defining the post-Brexit trade framework. We continue to believe that the pound has entered a stabilisation phase against most major currencies, after having experienced its historic drop following the Brexit vote.

Effective and dollar – euro exchange rate



Sources: Bloomberg, BBGI Group SA

We had predicted that the exchange rate would stabilise in H1 2018, as indeed it did after the negotiation process resumed in December 2017. We had then forecast further depreciation resulting from the return of uncertainties linked to the likely absence of an agreement only months away from the Brexit deadline. The predicted increase in volatility essentially occurred in July and August via a correction, albeit limited, of the pound to a rate of 1.10 against the euro.

We believe the pound will likely continue to fluctuate within a relatively narrow band of 1.12 to 1.15 over the next few months, supported in particular by the slightly better economic performance in Q2.

GDP growth better than expected in Q2 (+0.4%)

We were expecting British GDP to grow slightly faster in Q2 than in Q1, based on more promising leading indicators and on improvements in household and business confidence. The published GDP growth rate for Q2 did turn out to be somewhat better, mostly because of the relative strength of the service sector. The +0.4% growth rate exceeded the figure for Q1 (+0.1%), mirroring the quarterly growth trends of 2017.

Annualised GDP growth stabilised at +1.2% in June, a result similar to that posted in March 2018.

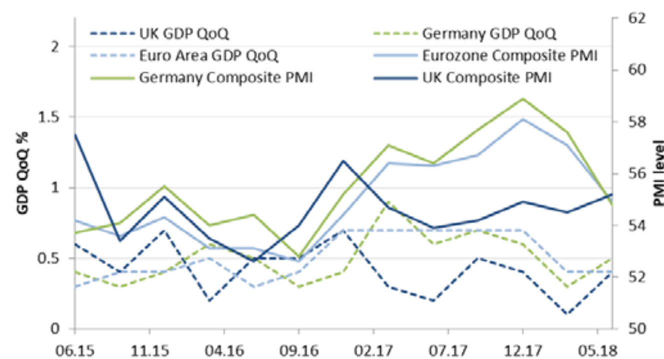
The British economy thus continues to struggle and could rapidly find itself in an even more difficult situation, with no prospects of an upturn anytime soon. The latest figures for industrial production are not showing any improvement. Industrial production progressed by only +1.1% (annualised), after having reached an expansion rate of +3% in March.

In the manufacturing sector, production is following the same trend, posting an annualised growth rate of +1.1% in July, a sharp drop from its March 2018 rate of +2.5%. This trend was not showing any sign of reversing or any indication of a potential surprise upswing in September akin to that of industrial production.

The current account deficit grew more rapidly than expected, reaching 20.3 billion pounds, or 3.9% of GDP. Investors are increasingly worried about the outcome of Brexit and are pondering the rationale of financing the British public deficit if the UK leaves the EU. Foreign investors reduced their positions in British government debt by 17.2 billion pounds in July, one of the most substantial withdrawals in the past few years.

The trade balance has grown and is thus weighing on GDP growth. Investments dropped by -0.7% after falling -0.5% in Q1. GDP growth was thus supported by an increase in consumption (+0.4%). Fortunately, domestic demand can count on increasing consumption again this quarter, but if Brexit-related uncertainty ends up more significantly impacting consumer morale, consumers may decide to save a little more (+3.9%) than usual. The savings rate is low in the UK; it could thus easily rise, correspondingly reduceing households' consumption capacity.

Quarterly GDP and PMI
UK – Eurozone – Germany



Sources: Bloomberg, BBGI Group SA

Dim prospects for faster year-end GDP growth

UK growth continues to lag behind that of other European countries, even though economic indicators are suggesting that the Q2 upswing is still on-going. The British economy is still on a decelerating trend, which could lead to a drop in overall growth to under +1.5% over the full year. Just months away from the Brexit deadline and still without visibility on the potential outcome of the process, it is difficult not to consider the risks and damage to the economy that could arise if an agreement is not reached

The manufacturing PMI posted a relatively unexpected increase in September. The purchasing managers index progressed to 53.8 after declining for three months, which is a positive surprise just a few months from the Brexit deadline. However, caution is advised in the current context, even though export orders were up slightly in September and industrial production increased significantly. Manufacturers remain cautious absent further visibility on the Brexit issue.

Growth prospects for the British economy remain rather limited in the current environment. An upturn at the end of the year seems unlikely.

New period of inaction for the BOE

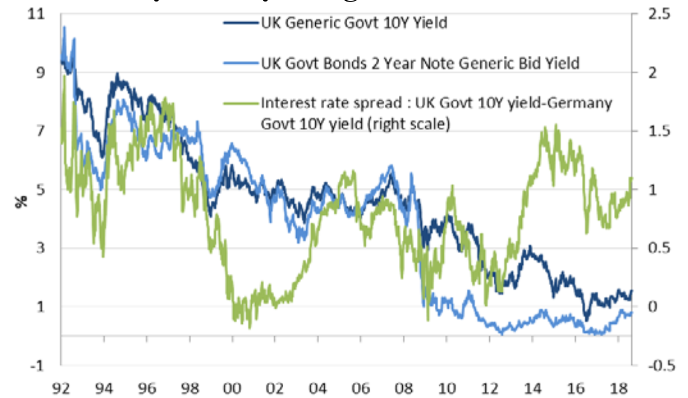
We were expecting a modest rate hike in the second half of the year, which occurred in August with the BOE raising its rates by 0.25%. Monetary policy should now remain stable and follow the strategy delineated by the BOE, which left rates unchanged at its last meeting on 12 September. The BOE deems that inflation trends are encouraging and predicts that inflation will gradually return to the bank's 2% target level. The British monetary

authorities seem relatively satisfied with recent economic developments and thus decided to keep the key rate at 0.75%. Members of the Monetary Policy Committee (MPC) appear unanimously convinced of the rationale of the strategy in place, which is unlikely to lead to any further rate hikes in 2018, but which could imply two hikes in 2019. Economic projections are in line with expectations, in particular with regard to GDP growth, still deemed to slightly exceed the British economy's potential, thereby suggesting moderate inflationary pressures over the next few months. MPC members are confident in a favourable Brexit outcome and are expecting potential positive surprises with regard to growth that would justify their planned rate hikes for 2019.

Steepening yield curve

The latest inflation figures for August were somewhat surprising to observers. The +2.7% increase in the CPI was indeed much larger than expected. This increase is of course not welcome, as it will offset the rise in nominal wages and will thus not lead to a rise in purchasing power. Moreover, the production price index also rose by +2.9% yoy last month, against a yoy increase of +3.1% in July, with a deceleration in materials and fuel prices (input costs). Price index growth is thus not yet showing the hoped-for signs of subsiding, both with regard to the CPI and PPI. We continue to predict that inflation will stabilise above the BOE's 2% target, and we continue to pay attention to the risks of a potential long-term interest rate adjustment in the event of a still relatively unlikely upturn in economic activity. However, given the context we expect that the bond market will likely be more attentive to and impacted by domestic fundamentals and by Brexit-related uncertainties.

10-yr and 2-yr UK government rates



Sources: Bloomberg, BBGI Group SA

We do not believe that the economic slowdown in the UK is sufficient to justify long-term rates being lower than inflation over the long-term, and we thus anticipate a steepening of the UK yield curve.

Continued caution with regard to equities

Given the uncertainties tied to the Brexit negotiations, the risk/return ratio expected with regard to the equity market remains unattractive. The pound, however, seems to be holding up despite these uncertainties. Nevertheless, we continue to advise caution with regard to UK equities, in spite of reasonable valuations and an attractive dividend yield.

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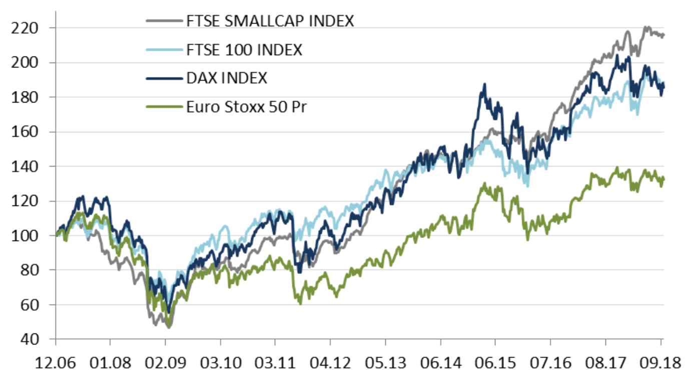
UK (large – small) – Eurozone – German equities



Sources: Bloomberg, BBGI Group SA

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