Economic Research

WEEKLY ANALYSIS

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Uncertainty persists following six-month Brexit extension

More time to avoid a no-deal withdrawal. Economy on the brink. Interest rates out of kilter. Resilient currency. Caution on the pound and all UK asset classes.

Key points

- The deadline has come and gone, now what?
- More time to avoid a no-deal withdrawal
- Six-month extension until 31 October 2019
- No-deal risks not factored into interest rates
- Ten-year yields at 1% inappropriate given the UK's situation
- Significant risks of upswing in inflation and yield curve
- Currency could still be hit by a no-deal Brexit
- Avoid exposure to the pound
- Brexit-related uncertainty further threatens growth (composite PMI at 50)
- UK GDP bordering on recession
- Recession or major shock to follow no-deal Brexit
- Is the BOE prepared to hike rates?
- Caution on equities and real estate
- Real estate prices decrease

The deadline has come and gone, now what?

Since 2016, 29 March had been widely proclaimed as the last possible moment to reach an agreement with the EU, in the absence of which a no-deal Brexit would be the default outcome. Close to three years of challenging talks have yet to produce a solution to the legal and political mess that was entirely to be expected in the aftermath of the referendum.

Today, while a swift resolution seems unlikely, almost no one wants a no-deal exit. There are thus only two solutions left to explore: a temporary extension or a new vote.

After having tried several times and without success to gain approval from Parliament for the agreement reached with the EU, Theresa May is taking a different tack, reaching out to the opposition Labour Party in an attempt to achieve a broader political consensus. This last-minute overture may have come into play too late in terms of reaching a compromise that Parliament might accept.

The British prime minister is thus attempting the improbable feat of bridging the gap between Conservatives and Labour to reach a compromise on Brexit. At time of writing, talks with the opposition leader have started but have not yet produced any tangible results. It will likely be difficult to reconcile seemingly opposing views, such as Labour's demand to keep the UK in a customs union with the EU, which is clearly not an option for the Eurosceptics among the Conservative Party who want total discretion in terms of managing the country's trade policy.

Theresa May was ultimately able to obtain from the EU an extension of the 29 March withdrawal deadline to allow sufficient time for talks to succeed. She had requested that the initial postponement to 12 April be further extended until the end of June. The EU finally accepted to push the deadline back much further (to avoid bringing the Brexit issue back to the fore too quickly).

More time to avoid a no-deal withdrawal

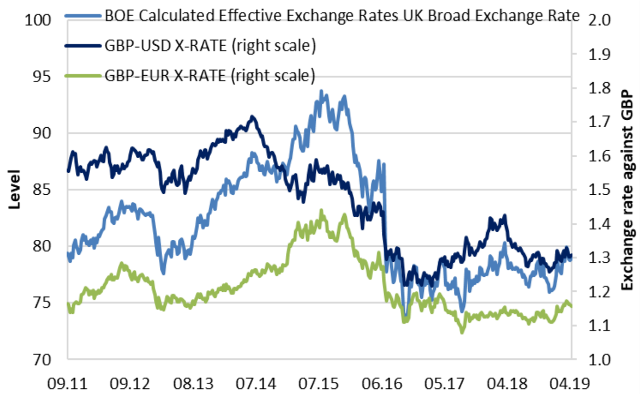
What seems clear at this stage is the shared desire to avoid a no-deal Brexit. To this end, the EU has been willing to make minor concessions, such as extending the withdrawal deadline. Recall in this respect that, at the time of the June 2016 vote, we had already predicted that

Brexit would take time and that the deadline would likely have to be extended by two years beyond the timeline provided in the EU treaty.

This possibility has now become an absolute necessity. The likelihood of an extension was thus never really in question. What had to be determined was essentially its duration and the terms and conditions set by the 27 EU members in order to give the UK time to come up with a clear and acceptable policy. As European institutions should be able to come out stronger from this process, the constraints placed on the UK for an extension were likely to be relatively strict. While Theresa May would likely prefer to come up with a solution sooner rather than later, namely before 23 May, the EU wanted to give itself some time, considering the challenges of the undertaking, and thus offered a longer extension until 31 October 2019.

While a one-year extension was occasionally mentioned, our feeling that ultimately the EU would grant a six-month extension was confirmed. Indeed, following the European summit on 10 April, Theresa May was given over six months to find a credible solution to the current crisis. The issue of the European elections, which had still been up for debate, was finally settled, and the British government will organise European elections on 23-26 May, even if the stated objective remains to withdraw from the EU before this date.

Effective exchange rate – dollar, euro

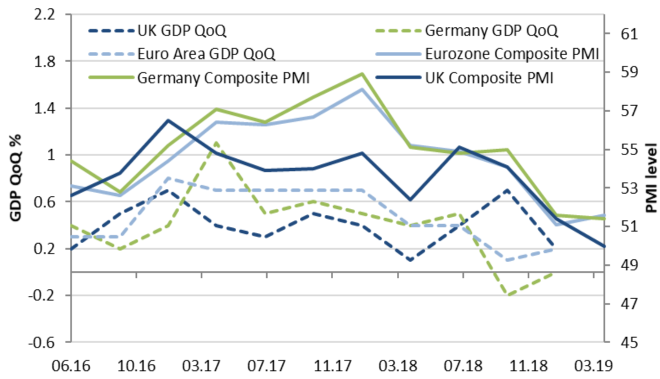


Sources: Bloomberg, BBGI Group SA

No-deal risks not factored into interest rates

The first Brexit deadline on 29 March 2019 came and went without an agreement being reached between the UK and the EU. The country's complex political situation prevented Prime Minister Theresa May from gaining approval from Parliament for her proposed solution. A no-deal withdrawal on 13 April or 23 May is increasingly likely. The impact of such a political failure does not seem to have been genuinely factored in by financial markets, which prefer not to consider this outcome, which would be particularly negative for the British currency and the country's economic growth, as well as for inflation most likely, to mention just the key points. Given the circumstances we fear that the current level of long-term rates (1%) is absolutely not suited to an economy that could very quickly fall into stagflation, i.e., slower growth and rising CPI and PPI indices. Especially low yields in pounds are indeed tied to a risk of sudden capital losses and a devaluation of the pound as well as a likely loss of investor confidence.

Quarterly GDP and PMIs
UK – Eurozone – Germany



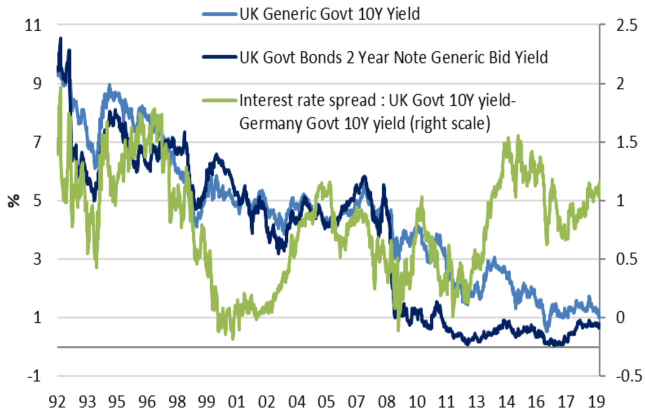
Sources: Bloomberg, BBGI Group SA

This environment is not particularly attractive, and we recommend discontinuing any exposure to the British rate market. Inflation in the UK had reached 3.1% in 2017 with the fall of the pound before gradually sliding back down to 1.8% in March. The risk that inflation will climb back up following Brexit obviously depends on how the issue is resolved and will certainly be much higher in the case of a no-deal exit.

Currency could still be hit by a no-deal Brexit

The pound is more than ever hostage to the complex political situation surrounding Brexit. The UK should already have withdrawn from the European Union on 29 March without a deal. As a no-deal exit is unquestionably the worst possible outcome for both the UK and the EU, Theresa May was granted an extension so she could attempt some last-minute political manoeuvring to avert the looming disaster. On 13 April, or ultimately on 23 May, a solution will have to be approved. At time of writing, the situation has reached a political deadlock, which surprisingly no longer seems to be affecting the pound. The British currency has indeed been stabilising for the past nine months pending a negotiated Brexit solution. The likelihood of a no-deal outcome seems not to have been factored in for now, even though the risk of devaluation is far from negligible. Given this context, we remain cautious on the pound.

10-year and 2-year UK government yields

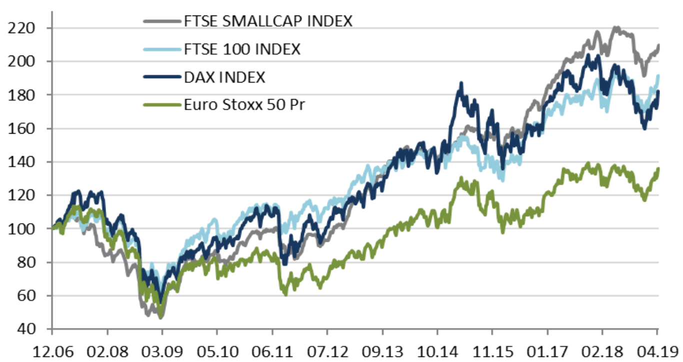


Sources: Bloomberg, BBGI Group SA

Brexit-related uncertainty further threatens growth

Months are going by with no solution in sight, as the British economy remains mired in a political crisis that is heightening the uncertainty facing businesses and consumers day by day. The latest release of the PMI Markit/CIPS UK Composite indicator in March points to a continuation of the trend underway over the past several quarters. The 50-point level reached in March (51.4 in December 2018) indicates that the British economy is now on the threshold between growth and recession. In contrast to other countries, in the UK it is the manufacturing sector that seems to be recovering after declining fairly steadily in 2018, jumping from 52 to 55.1 in March. With regards to services, which have been more resilient in other economies over the past several months, the UK PMI dropped below the growth threshold, coming in at 48.9 in March, among the lowest levels reached in the past decade.

UK equities (large – small)
Eurozone – Germany



Sources: Bloomberg, BBGI Group SA

With the decline of the services indicator, the risks of economic contraction in the UK have intensified and could predict a recession in the next few months. The 29 March deadline set in 2016 likely slowed down various projects and decisions pending better visibility, but as of April the situation is not any clearer, and confidence levels and the outlook for the coming quarters are likely to decline further. The relative resilience of the composite index is of no great comfort either, given that the main reason it did not drop below the growth threshold was because businesses have been stockpiling materials, concerned with regards to possible supply disruptions following Brexit.

Recession or major shock to follow no-deal Brexit

Leading indicators thus seem to be pointing towards a contraction of GDP following near-zero growth in Q1 2019. The postponement of Brexit, possibly to 30 June, should not be considered a positive factor in terms of the UK's GDP in the immediate future. Growth of +0.2% in Q4 2018 will likely be followed by zero growth in Q1. However, risks are increasing with regards to Q2 2019 and the year as a whole. Nevertheless, British consumers seem not to have been overly affected by the Brexit mess so far. Since 2016, they have been shoring up domestic demand, without however being able to generate enough momentum to significantly boost consumption. The unemployment rate remains close to 4% and is one factor supporting an increase in wages and purchasing power, as inflation is in fact rather moderate at this stage (+1.8%). Households' real disposable income increased, but household debt also rose for the ninth quarter in a row. The public sector may be able to shore up growth, as was the case in Q4 2018 with a +1.3% contribution. The most forceful reaction has come from businesses – unsurprisingly given the highly uncertain context, they are slashing or at least postponing investments. The contribution of business investments was thus once again negative in Q4 (-2.5%) for the fourth consecutive quarter, the longest period of contraction since the beginning of the financial crisis. This trend is rather unlikely to reverse given the current context. The current account deficit grew further to over 30 billion US dollars, or close to 4.4% of GDP. Yet initial GDP growth figures in January were showing a strong recovery (+0.5%), a volatile result offsetting the -0.4% drop in December. However, figures for February also suggest an economic upturn in Q1 2019, as GDP was up +0.2% over the month, confirming a slight upswing. Industrial output is back in positive territory yoy (+0.1%) after sliding -0.9% in January. Manufacturing and construction also seem to be faring somewhat better (+0.6% and +3.3% yoy in February, respectively). However, the IMF warned that the British economy risks a serious shock if the UK leaves the EU without a deal. The IMF, considering the possible impact of a no-deal exit, concluded that there is a considerable risk of significant disturbances at the border as well as substantial increases in the prices of imported goods, impacting both businesses and consumers.

The IMF estimates the negative impact on GDP growth to be 1.4% in the first year and 0.8% in the next year.

Is the BOE prepared to hike rates?

The recent decrease in inflation, which dropped back below the 2% threshold, gives the BOE a little more room to breathe. The Bank had had to raise its policy rates twice in 2017 and then abstained from any further action given the stabilisation of the pound, the decrease in inflation, and the economic slowdown. The Bank remains particularly attentive to political developments related to Brexit, most likely hoping that a no-deal withdrawal can be avoided. If such is the case, the BOE will likely want to 'normalise' its monetary policy, raising rates toward its long-range target of 2-3%. Nevertheless, should this be the case, we expect the BOE will be unlikely to act hastily and will likely leave its rate unchanged at 0.75% in 2019. If no agreement is reached, the BOE will have limited room to manoeuvre. However, it has already indicated that in this event it would probably have to raise rates to counter the inflationary pressure likely to be caused by a depreciation of the pound, the introduction of customs tariffs, and supply disruptions. Nevertheless, it is not clear that the BOE would implement this policy immediately, as the economy would need any help it could get. It is thus entirely conceivable that the Bank would initially lower policy rates.

Caution on equities and real estate

Given the still uncertain context surrounding the Brexit talks, the equity market's expected risk/return ratio still seems unattractive. While the pound seems to be withstanding the uncertainty, we continue to recommend caution with regards to UK equities, in spite of reasonable valuation levels and an attractive dividend yield. The uncertainty surrounding the unresolved issue of what shape Brexit will take continues to weigh on real estate prices in the UK, which are increasingly volatile this year. The recent publication of residential property prices for March (-1.6%) stands in contrast to the February upswing (+6%), which had been preceded by a -2.6% drop. Housing prices fell more sharply in London than in the rest of the country. Brexit continues to cast a shadow over the British market, which still does not offer any repositioning opportunity. We recommend staying away from this market for now, as the Bank of England is suggesting that real estate prices may plunge -25% in the case of a pessimistic no-deal Brexit scenario.

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