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CIO Viewpoint

Brexit's stranglehold on the UK

Investment Solutions

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Just over two years ago economists warned of a "Brexit shock" to the UK when the British voted to leave the European Union (EU). Investors and companies were expected to shun a country that had decided to leave the world's largest trading bloc, dealing a damaging blow to the economy. In reality, the aftermath is turning into a slow economic asphyxiation.

Political scenarios

Brexit has steadily taken a stranglehold on British public life, leaving the UK's political class in bickering disarray while sterling has tumbled and the economy struggles to keep pace with its peers.

In mid-July Prime Minister Theresa May unveiled a Brexit White Paper which angered all sides of the debate and was given a sceptical welcome by EU chief negotiator Michel Barnier over some key issues.

Given the difficulties of securing an agreement among her own ministers, the prime minister has presented what she hopes is something that looks like a final offer. Any agreement with the EU will inevitably require further concessions, increasing the odds of additional clashes within May's own Conservative party and making her more reliant on opposition parliamentarians' support. And this in an environment where the opposition Labour party leader Jeremy Corbyn would love to trigger a general election.

Tick, tock

Let's remember that the UK is on a tight schedule. On 18 October May's proposals will form the starting point for negotiations at an EU Summit in Brussels. Less than six months later, the UK is scheduled to leave the EU at 11pm UK time on 29 March 2019 and enter a transition phase ending December 2020.

We see four potential scenarios.

1. Teresa May survives the political melee in her own party and arrives at the October summit with a "softish" proposal, infuriating Brexiteers
2. A hardline Brexiteer replaces May. This scenario is less likely if the new prime minister attempts to force a so-called "hard Brexit" through a vote in parliament where two years ago a majority voted to remain in the EU
3. The least likely possibility is that a general election raises the prospect of a new government headed by Labour's Corbyn, whose views on Brexit are still opaque

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4. In fact, the viciously divisive debate in Britain makes it difficult to imagine any route through parliament to a Brexit deal, increasing the likelihood of no deal at all.

   In this fourth case, there is regular talk of a World Trade Organisation option, falling back on WTO rules that would generate fresh complexities in the form of a carve-out from existing EU quotas and a global search for consensus[1]. To put it kindly, it's no exaggeration to say that the UK's political landscape is being redrawn and in so doing, gambling with the country's economic prospects. Put less kindly, it's an utter mess.

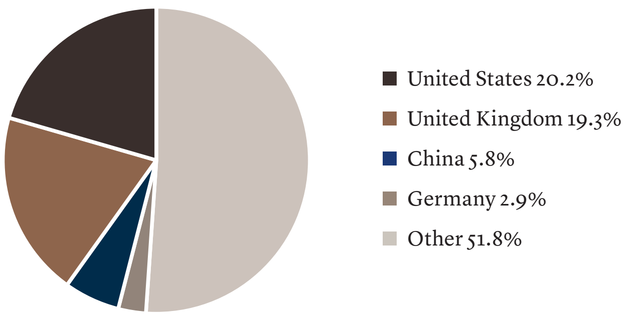
That explains why there has been some discussion of a second referendum on whatever final deal is hammered out with the EU. The latest survey from pollsters YouGov, published on 27 July, showed for the first time a majority in favour of a new vote[2]. It's very hard to predict how public opinion in the UK may have evolved by then.

Underwhelming data

Among the reasons for that uncertainty is the fact that the worst projections for the post-referendum economy failed to materialise. Just days before the 2016 referendum, for example, the International Monetary Fund warned of a stock market crash and a 5.5% fall in GDP by 2019 while the UK Treasury at the time predicted an "immediate and profound shock" with a year-long recession. So how has the UK fared over the last two years?

One bright spot has been the performance of the FTSE 100 index of leading UK shares. That is in large part due to currency effects. Sterling has fallen by more than 13% against both the euro and the US dollar since the referendum. The declines, driven by Brexit uncertainty and, more recently, USD strength, have supported UK blue chips that earn only 19% of their revenue from within the UK (see chart).

FTSE 100 sources of revenue by country



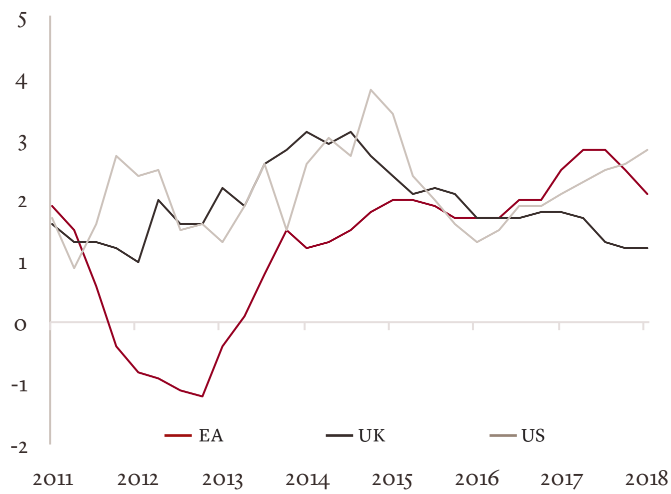
Source: Bloomberg.

Our view is that further support for UK equities is limited. Sterling is approaching levels that already price in a high level of Brexit-related risk. Still, there is potential we believe, for a dip as low as USD 1.20 (from about USD 1.30 at present), but little more than that. Our three-month view on GBPUSD is at 1.29, and our 12-month forecast at 1.33. Our EURGBP targets over the same period are stable around the current level of 0.89.

A lack of a Brexit agreement would undoubtedly be GBP-negative, and while not our expectation, the scenario should be taken seriously given its economic implications.

In the wider economy, annual growth in gross domestic product (GDP) in the UK has averaged 1.6% since June 2016. Over the same period, eurozone GDP has averaged 2.2% and 2.1% in the US (see chart). The UK unemployment rate has continued to fall since 2016 and now stands at 4.2%[3], but the long-term trend in wage growth is persistently weak[4]. The UK's enduring productivity puzzle shows little sign of a solution, and still lags key European peers[5].

Annual GDP growth



Source: Bloomberg, Office for National Statistics, Eurostat, Bureau of Economic Analysis, Lombard Odier.

One key support has been continued loose monetary policy from the Bank of England (BoE). This shows signs of fading as the Bank unwinds its post-crisis stimulus and, on 2 August, it lifted the base rate by 25 basis points to 0.75 per cent, the highest level since 2009.

The decision looks like a "dovish hike," in other words a modest rise with a signal that another won't follow soon. The BoE warned that the economy "could be influenced significantly by the response of households, businesses and financial markets to developments related to the process of EU withdrawal."

[1] http://ukandeu.ac.uk/wp-content/uploads/2017/09/No-Deal-The-WTO-Option-Fact-sheet.pdf
[2] https://yougov.co.uk/news/2018/07/27/first-time-more-people-support-second-referendum/
[3] https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment/timeseries/mgsx/lms
[4] https://www.ft.com/content/c4437c9e-7ec4-11e8-bc55-50daf11b720d
[5] https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures

End game

The UK is in political limbo and slowing economically. In reality, it can do little while such an enormous change dominates the landscape. May has thrown away what little political capital she still had by forcing a compromise through a hostile parliament. The next few months will decide both her political future and the UK's path as a fragile EU withdrawal strategy exposes it to inevitable compromises.

It may yet dawn on the UK's political class and a part of the population that the balance of power in its EU negotiations isn't, and rarely ever was, in Britain's favour. That miscalculation, which is in the process of swapping a powerful neighbour and ally for a powerful neighbouring rival, is leaving the British government and the UK economy struggling for air.

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