Insight INVESTMENT

GLOBAL MACRO RESEARCH
BREXIT UPDATE

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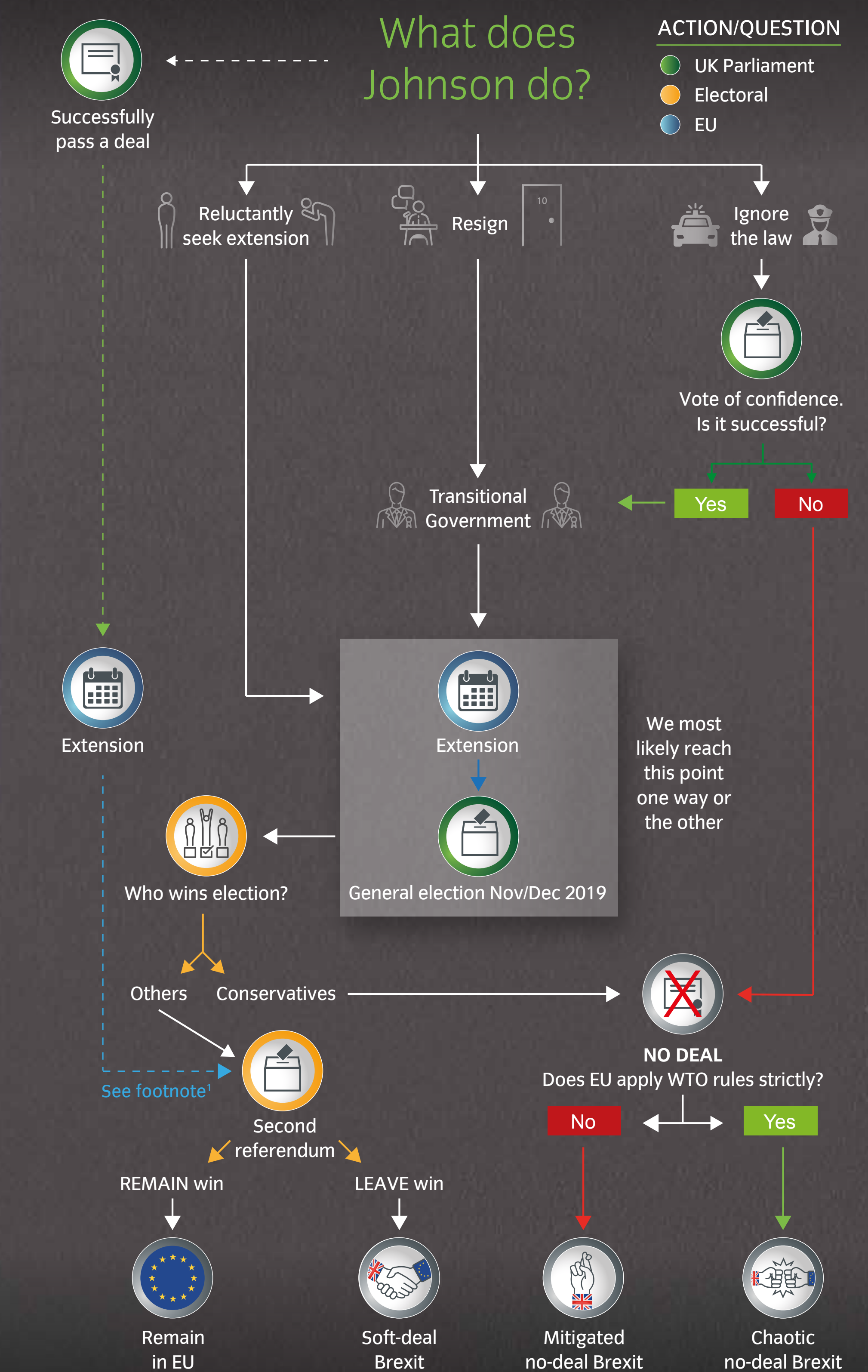
GLOBAL MACRO RESEARCH

BNY MELLON | INVESTMENT MANAGEMENT

A simplified version of a complex series of potential choices as seen by our global macro team



Source: Insight Investment as at 13 September 2019. [1] We assume that in order to get a deal through Parliament there is a high probability that an amendment will be added requiring a second referendum.

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BREXIT UPDATE

AS THE UK APPROACHES A POTENTIAL EXIT FROM THE EUROPEAN UNION (EU) ON 31 OCTOBER 2019, WE DISCUSS THE POSSIBLE OUTCOMES AND THE IMPACT THIS COULD HAVE ON BOTH THE UK AND EU.

NAVIGATING THE WAY FORWARD

The path to the end of 2019 and beyond could take many turns, depending on the decisions made by UK Prime Minister Boris Johnson and the UK Parliament. Other decisions are out of their control and would be made by the public via a general election (and possibly in the longer term a second referendum), or by the governments of the 27 other member states of the EU. We have simplified some of the potential paths the UK could take and outlined them in the diagram opposite.

A constitutional crisis

There is little doubt that the UK is in the midst of a constitutional crisis. The government lost its majority, and expelled 21 MPs from the Conservative Party after they voted with opposition parties to take control of the House of Commons timetable. Subsequently, Secretary of State for Work and Pensions Amber Rudd resigned from her post and also left the party. Historically, losing a majority would either result in a new government being formed that was able to command a majority, or a general election being called.

Although the government has attempted to call an election, opposition MPs have largely abstained, leaving the government unable to achieve the two-thirds majority needed under the Fixed-term Parliaments Act 2011. The leader of the opposition has also resisted calling a vote of no-confidence: the consequences of a vote being passed are unclear – for example, it is uncertain as to whether, if the vote passes, he would have enough support to form a new government.

The prime minister has stated he would rather “die in a ditch” than request an extension of Article 50 and has also indicated that he has no intention of resigning. The only certainty at this stage is that the relationship between the different groups in Parliament is likely to become increasingly acrimonious as we approach the 31 October deadline.

CONCERNS ABOUT NO-DEAL ARE FOCUSED ON TRADE

The main argument as to why the UK is not prepared to exit the EU without a deal centres on trade. Although leaving without a deal would potentially disrupt trade between the UK and EU, the UK would also drop out of 112 existing trade deals it currently has as an EU member. As we highlight in Table 1, the UK has signed ‘status quo’ trade deals with 41 of the 112 countries, and is in discussions with a further 32.

In addition, the EU is currently negotiating trade deals with nine countries including Australia, China and India which the UK would have to negotiate separately. The UK has signed mutual recognition agreements (MRAs) with the US, Australia and New Zealand; these facilitate some aspects of trade, and mirror current MRAs the UK benefits from as a member of the EU. Overall, 70% of current UK exports would face increased restrictions if the UK were to trade under World Trade Organization (WTO) rules.

A trade deal with the US has been raised as something that could occur relatively quickly after the UK leaving the EU, but this is unlikely to be a rapid process given indications from Congress that it could move to block a UK/US deal if there is any sign that the Good Friday Agreement is being undermined. Accepting US product standards may also be a problem if the UK remains closely aligned to the EU via membership of the single market or a customs union, even if that is only on a temporary basis.

Table 1: Trade deals with third-party countries affected by Brexit[2]

			UK		
			Status quo deal agreed	New deal under negotiation	No negotiations on new deal
			44	32	52
EU	Existing trade deal	87	41 Norway, South Korea, Switzerland	31 Canada, Mexico, Turkey	15 Japan, Pakistan
	Pending trade deal	25	–	1 Kenya	24 Singapore, Vietnam
	Negotiations ongoing	9	2 (MRA) Australia, New Zealand	–	7 China, India, Mercosur
	Negotiations suspended	7	1 (MRA) United States	–	6 Gulf Cooperation Council, Malaysia

[2] Source: EU Commission, UK government, Insight as at 13 September 2019.

THE NEXT STEPS

The EU is unlikely to move significantly, but is willing to extend

We are of the view that the EU means what it says. The Withdrawal Agreement will not be renegotiated towards easier terms, although there is the possibility that the political declaration on future arrangements could be. It appears unlikely that the EU will accept any deal without backstop arrangements for the Irish border which at least apply to Northern Ireland, if not the UK as a whole.

Although there is speculation that some EU leaders will resist agreeing an extension to the Brexit deadline, we believe the EU will likely be prepared to offer an extension to avoid a no-deal Brexit. It appears that it is only beyond December 2020, when the current EU funding period ends, that there is a higher chance that an extension may be refused.

The UK government is resolute, but probably won't be able to deliver

We acknowledge that the current UK government is determined to go for a no-deal Brexit in the absence of renegotiation of the backstop. But we question whether they would actually ignore the law to implement this and whether they would be able to get any agreement through Parliament without a second referendum being attached to it via an opposition amendment.

When Parliament returns, there are likely to be further attempts to seize control of power from the government. The Speaker of the House of Commons John Bercow has promised to use "creativity", suggesting that further legislation could be passed. There are also reports that the Labour Party will table a vote of no-confidence in the government. The government is likely to use its own 'creativity' to resist these moves. An election is likely to occur at some stage, and this is likely to be dominated by Brexit, with the Conservatives and Brexit Party on one side, willing to consider or clearly advocate a no-deal Brexit, and other parties opposed to this with varying degrees of conviction (a Brexit with a deal, a second referendum, or revoking Article 50 and keeping the UK within the EU).

DEAL, MITIGATED NO-DEAL OR CHAOTIC NO-DEAL

1 A deal

Given our view that the EU is unlikely to soften its position, and that even if they did the UK government would be unlikely to pass a deal through Parliament without amendment, we would view a deal as being a low-probability scenario in the short term.

The government, however, still suggests a deal is possible. When visiting Irish Taoiseach Leo Varadkar on 10 September, Prime Minister Johnson said a no-deal Brexit would be a "failure of statecraft" and that he would "overwhelmingly prefer to find an agreement".

If a deal was agreed, we would assume there would be very little, if any, impact on UK growth, with a transition period maintaining the status quo until end 2020. We would expect some relief rally in sterling. The Bank of England in this scenario would be likely to keep interest rates on hold for a considerable period unless there was a reacceleration in global growth.

2 A mitigated no-deal

If the UK leaves the EU without a deal, either on 31 October or later, there are actions both sides could take to limit physical border disruptions and to mitigate the economic impact.

Under the government's announced temporary tariff regime, tariffs would be reduced to zero immediately after exit. This would cover around 87% of imports until late 2020, with a 4% increase in tariffs on non-exempt imports as they revert to current EU most-favoured nation levels. The UK would then trade on WTO rules, meaning non-tariff barriers to trade with the EU would gradually increase over a two-year period.

In this scenario we would expect growth to weaken with a recession in 2020, the Bank of England to reduce interest rates and a moderate decline in sterling (5% to 10%), putting upward pressure on inflation.

3 A chaotic no-deal

If the relationship between the UK and EU breaks down, and the EU is un-cooperative in limiting disruption, we could see significant disruption at the border. Although we assume the UK would implement the measures outlined above, without EU co-operation, these would be unlikely to prevent a severe blow to the UK economy.

In this scenario we would expect a far deeper recession in 2020, and a more severe decline in sterling (c.20%). Although the Bank of England would be likely to cut interest rates at first, if the credibility of the UK's macroeconomic framework were called into question, it could be forced to raise interest rates to defend the pound.

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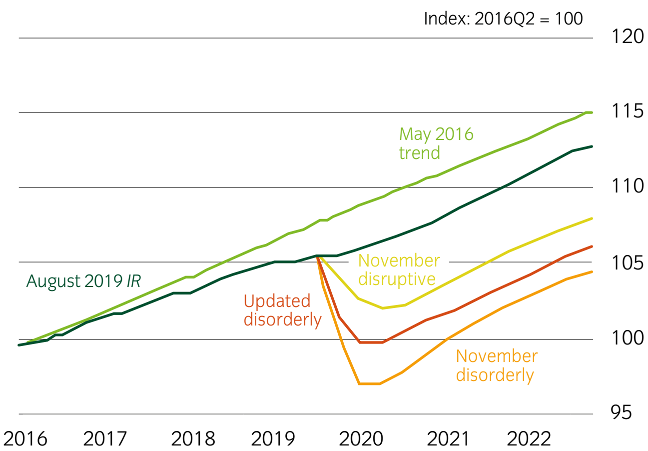
ASSESSING THE IMPACT OF NO-DEAL SCENARIOS

The UK

A number of bodies have attempted to assess the potential economic impact of Brexit scenarios. On 3 September, the Bank of England updated its scenario analysis to take into account government measures to mitigate the impact of a chaotic no-deal scenario. Its new 'worst-case' scenario suggests a peak-to-trough decline in GDP of 5.5% is possible, with unemployment rising to 7% and inflation peaking at 5.25% (see Chart 1).

Measures could be taken to soften the impact of the UK leaving without a deal, but the disruption to trade and business investment would still likely be sufficiently severe to cause a contraction in UK GDP in 2020.

Chart 1: Updated Bank of England scenarios for disorderly Brexit[3]



The EU

For the EU, we believe Brexit could impact EU economies via four transmission channels:

- **Trade disruption:** Physical border checks and additional documentation would be expected to impact trade volumes. We would expect the EU to impose more onerous restrictions than the UK, which could lead to a greater impact on UK exports to the EU – this would be a positive for EU growth. Given the uncertainty and difficulty in quantifying this impact we will leave it as a question mark, and do not include this in our calculations.
- **UK recession:** A contraction in UK growth would be expected to lower demand for imports from the EU.
- **More competitive pound:** We assume that the pound would depreciate by c.10% against the euro in a no-deal scenario and by c.20% in a chaotic no-deal scenario, with each 1% depreciation in the currency impacting imports from the EU by 0.5%.
- **Sentiment:** Uncertainty generally weighs on business sentiment and investment. Research from the European Central Bank (ECB) suggests that during the eurozone sovereign debt crisis, uncertainty negatively impacted GDP by 0.3%, so we have assumed a similar scenario for a chaotic no-deal Brexit.

We estimate the likely economic impact over 2020 in Table 2 below. In this analysis we have estimated the impact on the eurozone economy, as it represents the majority of GDP for the EU excluding the UK.

Table 2: Potential impact on economic growth of a no-deal Brexit in 2020 (relative to Brexit with a deal)[4]

	Forecast impact on UK growth	Forecast impact on eurozone growth
Deal	0%	0%
Mitigated no-deal	-3%	-3/4%
Chaotic no-deal	-7%	-1 3/4%

THERE WOULD BE A POLICY RESPONSE

We would expect both central banks and governments to respond to a no-deal Brexit scenario.

Monetary policy

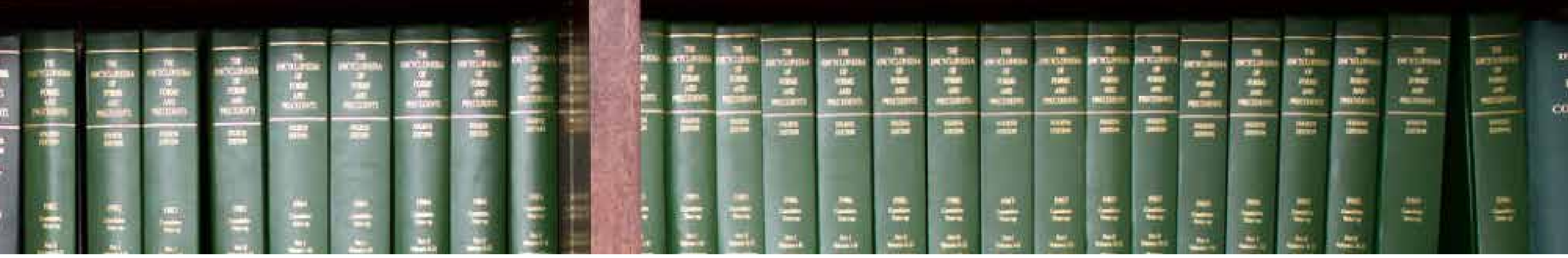
For the Bank of England, we would expect interest rates to be reduced to the lower bound (c.0.1%) in the event of a no-deal Brexit, with the potential for lending schemes to be introduced to ease credit conditions.

Under a chaotic no-deal scenario the policy response would also likely include the resumption of quantitative easing.

In an extreme scenario where the macroeconomic framework of the UK is brought into question, the policy response becomes less certain, with the Bank of England potentially forced to raise interest rates to defend sterling.

The ECB is already in the process of easing monetary policy, but is approaching the limits of what can be achieved through existing conventional and unconventional policies. Incoming ECB President Christine Lagarde may well consider more radical policies to ease policy in extreme scenarios.

[3] Source: Bank of England as at 3 September 2019. https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/BoE-Governor-Letter-to-Chair-030919.pdf [4] Source: Insight Investment. As at 13 September 2019.



Fiscal policy

In the UK, the new Chancellor of the Exchequer, Sajid Javid, has inherited a budget deficit that is a little over 1% of GDP in 2018/19, although it is forecast to be slightly higher this fiscal year with the deficit likely to overshoot the Office for Budget Responsibility (OBR) forecast. This gives the chancellor about 1% of financial headroom on the OBR's central forecast (which assumes a smooth Brexit outcome) that allows him to still hit the government's self-imposed fiscal mandate of keeping the structural budget deficit below 2% of GDP in fiscal year 2020-2021. (The OBR has warned that a no-deal Brexit would raise borrowing by £30bn – c.1.5% of GDP – a year.)

The chancellor has also announced his intention to review the fiscal rules later in 2019 and, given the likely incompatibility of recent plans and pledges with the existing framework, there is a possibility these rules will be scrapped entirely.

Under more extreme scenarios a range of government measures are possible in order to support growth, from reducing stamp duty on property purchases to stimulate the housing market, to reducing VAT and corporation tax.

Within the EU, any fiscal response to a no-deal Brexit would likely be decided at an individual country level, although we could see some co-ordination and a possible suspension of normal fiscal rules.

The impact of Brexit varies among the EU27, with Ireland facing a disproportionate impact in no-deal Brexit scenarios. Germany, the Netherlands, Belgium and France are the most exposed among the rest of the EU27 due to their exports to the UK. The EU has already agreed that Brexit should be treated in the same way as a natural disaster, which allows Ireland to access the EU Solidarity Fund and gain immediate financial relief.

IMPLICATIONS FOR US INVESTORS

We believe the US is relatively insulated from UK and European political risks. US exports account for less than 15% of GDP and growth is currently being driven by the domestic consumer. Brexit and other geopolitical risks (such as trade tensions), are, however, key drivers of volatility. The Federal Reserve has taken notice, and chair Jerome Powell noted in September that overseas risks are "actually more heightened now" and the central bank stands ready to offer further monetary support if needed. In time, volatility around Brexit could potentially create opportunities for value investors. Any prolonged weakness in sterling might make certain assets and sectors look attractive in US dollar terms but a commitment to rigorous bottom-up security selection would play a crucial role.

For now, we believe it is worth approaching UK risk – particularly rates and UK corporate credit exposure – with a great deal of caution. We do see opportunities, however, in areas such as high quality UK asset-backed securities and securitizations, given particularly robust structural protections. In our view, they can offer resilience even against severe economic stress scenarios.

CONCLUSION

What happens through the remainder of 2019 is highly uncertain, but we would view the most likely scenario as an extension being agreed beyond 31 October, followed by a UK general election.

A UK election is likely to be focused on Brexit, and if the Labour Party wins a majority or is able to form a coalition in the event of a hung Parliament, a second Brexit referendum is likely. Conversely, a renewed Conservative government would likely lead to a no-deal Brexit.

We would highlight the period between 14 and 31 October as critical (see Table 3). The UK will either agree a deal during this period, or the prime minister will request an extension – unless he finds a way to challenge or avoid the law introduced by Parliament that requires him to do so.

If there is an attempt to forge ahead with a no-deal Brexit, it would likely trigger new actions from Parliament, including an attempt to hold a vote of no-confidence in the government. The success of those moves will then determine whether the UK leaves the EU on 31 October or the deadline is extended, with a likely general election then ultimately determining the UK's longer-term path.

Table 3: Key Brexit dates – and the danger zone

Date	Event
3 September	Parliament reconvened after summer recess
10 September	Parliament suspended for prorogation
14 to 17 September	Liberal Democrats conference
21 to 25 September	Labour Party conference
25 September	Parliament reconvened after supreme court ruled prorogation unlawful
29 September to 2 October	Conservative Party conference
14 October	Queen's Speech
17 to 18 October	European Council summit
On or before 19 October	UK prime minister required to request extension by this date under new law
31 October	Current Brexit deadline
21 November to 12 December	Potential General Election
12 to 13 December	European Council summit
31 January 2020	Parliaments proposed new Brexit date post extension
31 December 2020	End of transition if current Withdrawal Agreement passed, and end of EU funding cycle

CONTRIBUTORS

Gareth Colesmith,
Head of Global Rates and
Macro Research, Fixed Income,
Insight Investment

David Hooker,
Senior Portfolio Manager,
Fixed Income,
Insight Investment

Simon Down,
Senior Investment Content Specialist,
Insight Investment

Alex Veroude,
Chief Investment Officer,
North America, Fixed Income
Insight Investment

FIND OUT MORE

Insight Investment
200 Park Avenue, 7th Floor
New York, NY 10166
212-527-1800

Call charges may vary by provider.

Institutional Business Development
institutionalna@insightinvestment.com

Consultant Relationship Management
consultantsna@insightinvestment.com

Client Service Management
clientservicena@insightinvestment.com

@InsightInvestUS

company/insight-investment-north-america

www.insightinvestment.com

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