WHAT NEXT FOR BREXIT?

More than two years after the referendum on the UK's membership of the European Union (EU) and with only six months left before the UK is due to leave, political uncertainty and investor nervousness over a 'no-deal Brexit' are growing.

We have examined in detail the questions around Brexit that are of most concern to our invested clients. These are:

- The current – and potential future – state of the UK economy
- The specific details of what the final deal may look like, and its implications for investors

In our analysis we look at different scenarios and consider what they could mean for the UK economy.

PART ONE: THE STORY SO FAR

Economic impact since the referendum – a softer landing than expected

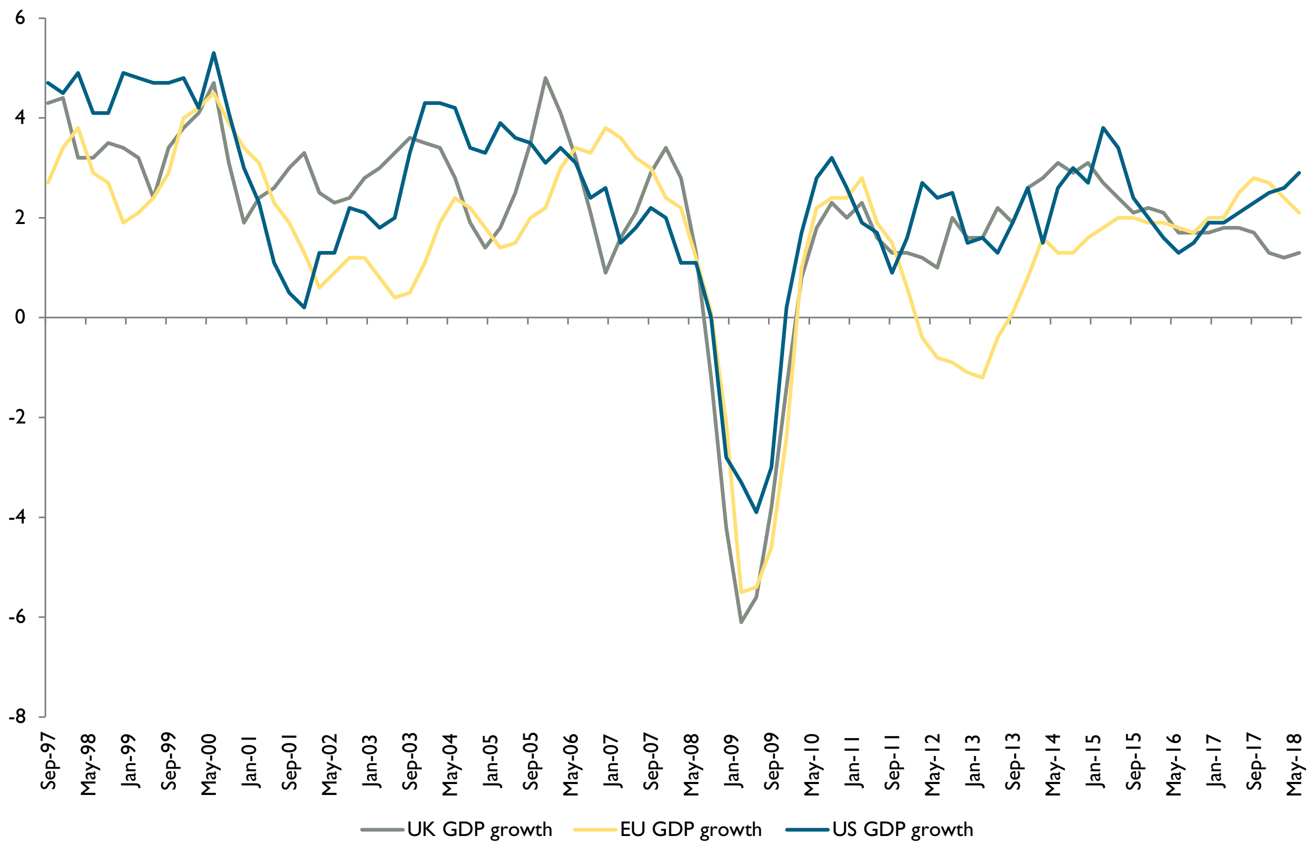
Despite economic momentum in the UK slowing markedly this year, the UK economy has defied the bleak pre-referendum predictions and performed better than expected. On the down side, the growth in Gross Domestic Product (GDP) – a key measure economic activity - has fallen to its lowest levels in six years as the depreciation of the sterling against the US dollar and the Euro led to higher inflation which weighed on consumer spending. However, at the same time, the economy has continued to grow, with an annualised growth rate of 1.5% since June 2016 and UK equities have posted solid performance – with the FTSE 100 up around 30% since the result.

This relatively benign impact can be explained by two factors:

- While notice to leave the EU has been given – causing uncertainty and weighing on investor confidence – the actual exit and the possible disruptions associated with leaving the EU have not yet taken place.
- The UK economy has benefited from a period of strong and synchronised growth across major economies – without this global backdrop it's likely that growth would have been significantly weaker.

Many studies have looked at the overall impact of the UK leaving the EU, the potential implications for jobs, and the effect on the public finances. International organisations, such as the IMF and the OECD, have contributed to the debate, and one Swiss bank recently estimated that UK GDP is about 2% lower than what it would have been without Brexit.

Any negative economic impact from Brexit is best evidenced by the evolution of UK GDP growth since 2016. While the country didn't fall into recession, as some had predicted, it is fair to assume its growth may have been stronger in the absence of Brexit. Indeed, since June 2016, Europe and the US - two regions that the UK is typically highly correlated with - have enjoyed a strong rebound in their economic activity, while the UK's GDP growth has slowed over the same period.



Sources: Office for National Statistics, Eurostat, US Bureau of Economic Analysis. Data as at 30 June 2018

	June 2016	June 2016-June 2018 (Average)	Difference
UK GDP growth	1.70%	1.50%	-0.20%
EU GDP growth	1.80%	2.20%	0.40%
US GDP growth	1.30%	2.20%	0.90%

Brakes applied to the drivers of growth

While long-term GDP growth is mainly driven by structural factors – such as productivity growth and demographics - in the short term, cyclical factors dominate. Private consumption and investment are behind most of the change in growth, with private consumption becoming the key driver in the UK as well as other developed countries in recent years, and investment playing a smaller role. By causing a sharp depreciation in sterling and an increase in uncertainty around immigration and investment, the EU referendum impacted these two key drivers of consumption.

Uncertainty surrounding the negotiations has made companies reluctant to invest. Bank of England data shows that business investment levels in 2017 and so far in 2018 have been significantly lower than predictions before the referendum result, contributing to slower economic activity in the UK. But, as mentioned, the larger impact has come from the demand side with consumer spending accounting for more than two-thirds of UK GDP.

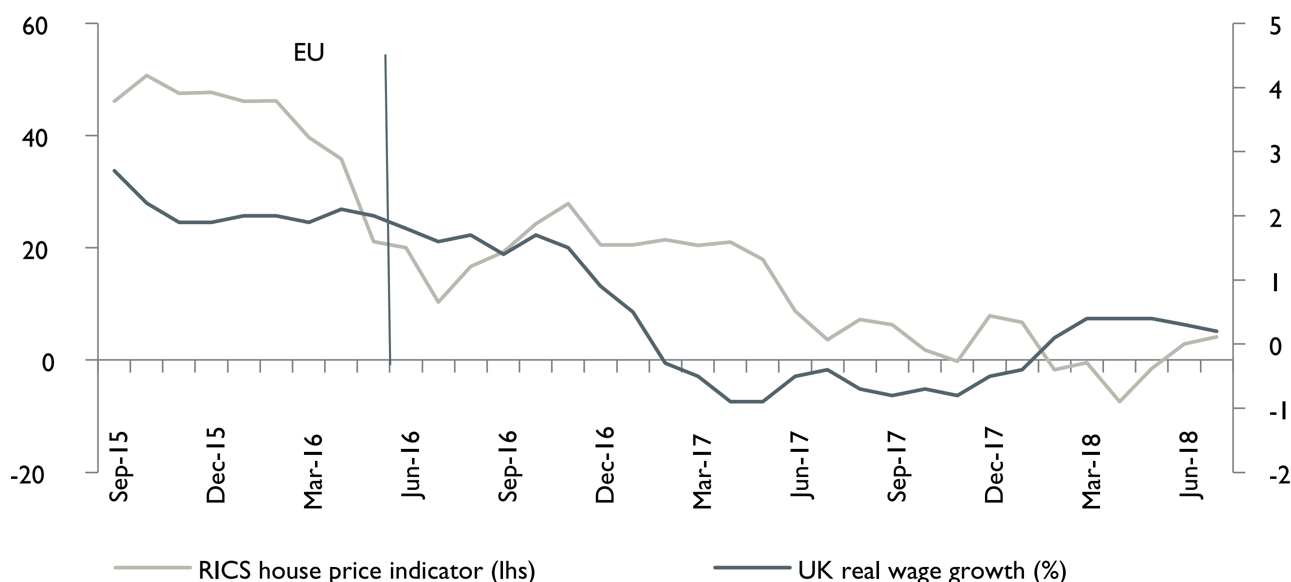
Consumption can be driven by changes in real wages and wealth effects, in particular housing wealth effects - when real house prices go up, property owners may decide to spend part of their capital gain, which boosts consumption and hence GDP. However, when prices fall, households might decide to cut back, lowering GDP growth. Meanwhile, increases in real wages – when wages rise faster than prices – lead to increased aggregate demand. Conversely demand will fall when real wages fall and consumers have less real spending power.

The sterling depreciation against the euro and US dollar caused a delayed surge in imported inflation, with the UK Consumer Prices Index (CPI) going from 0.5% before the vote to 3% in the following 18 months. This rise in prices was not matched by growth in nominal wages, leading to a fall in real income levels. The resulting drag on the UK economy as demand struggled was evident in retail sales figures, which were particularly weak between March 2017 and March 2018, and only started to recover over the summer this year.

On the other hand, residential property prices were already slowing before the referendum – thanks to structural and taxation changes – and it is likely that Brexit has created further negative sentiment. The Nationwide House Price Index shows real annual house price growth – adjusted for inflation – was around -1% at the end of June 2018, compared with levels of around 4% in the last two quarters of 2016. High street estate agent Foxtons has seen its share price fall almost 70% since May 2016, providing a good illustration of how difficult the environment has been for real estate companies operating in the UK, particularly those with a large exposure to the London residential market.

Lower property prices and negative wage growth mean that both channels that drive consumption have been hit. This largely explains weak GDP growth in the UK. Given how UK-specific these factors have been, it also explains the difference in growth with the rest of the world.

Real earnings and housing wealth have both fallen since the EU referendum



Sources: Royal Institution of Chartered Surveyors, Office for National Statistics. Data as at July 2018.

Surveys compiled by the OECD show how consumer confidence for the UK has moved in opposite directions to Europe and the US since the EU referendum.

OECD Consumer Confidence Index	Jun-16	Jul-18	Difference
UK CCI	100.86	100.80	-0.06
EU CCI	100.61	101.74	1.13
US CCI	100.68	101.31	0.63

Source: Organisation for Economic Co-operation and Development.

What could power a UK recovery or push us into recession?

Given that we see low growth as a product of depressed consumption and a general reduction in property-based wealth, a UK recovery would therefore require:

- Real wage growth
- A rebound in the property market

With inflation retreating from its recent peaks, as the effect of a weaker currency dissipates, real wage growth has recently turned positive again and should remain positive in 2019, supported by record low unemployment. This should lead to a slight pick-up in consumption growth. Changes in regulation and income tax following the exit from the EU could also have an impact. However, longer-term, low productivity growth, the UK's relatively large proportion of temporary jobs and reliance on low skilled workers means that real wage gains are likely to remain limited.

The real estate market, meanwhile, continues to suffer from the uncertainty surrounding Brexit and from high valuations, but there too, recent signs have been more encouraging. The RICS house price indicator – which measures changes in house prices reported by the real estate industry – has been rising since the start of 2018. The market could eventually benefit from a resolution on Brexit, should a final agreement be found, as buyers who have been holding off in the face of uncertainty return to the market. Longer-term, changes in approach towards immigration post-Brexit could also have an impact on the market.

Obviously, it is easy to see why a 'no-deal Brexit' could drastically damage the UK's short-term growth prospects. This would likely cause another round of 'cost-push' inflation, fuelled by higher production costs and more expensive raw materials thanks to further sterling weakness. Meanwhile the Governor of the Bank of England Mark Carney has warned that UK property prices could fall 35% if no-deal is reached (albeit as part of a worst-case stress test exercise).

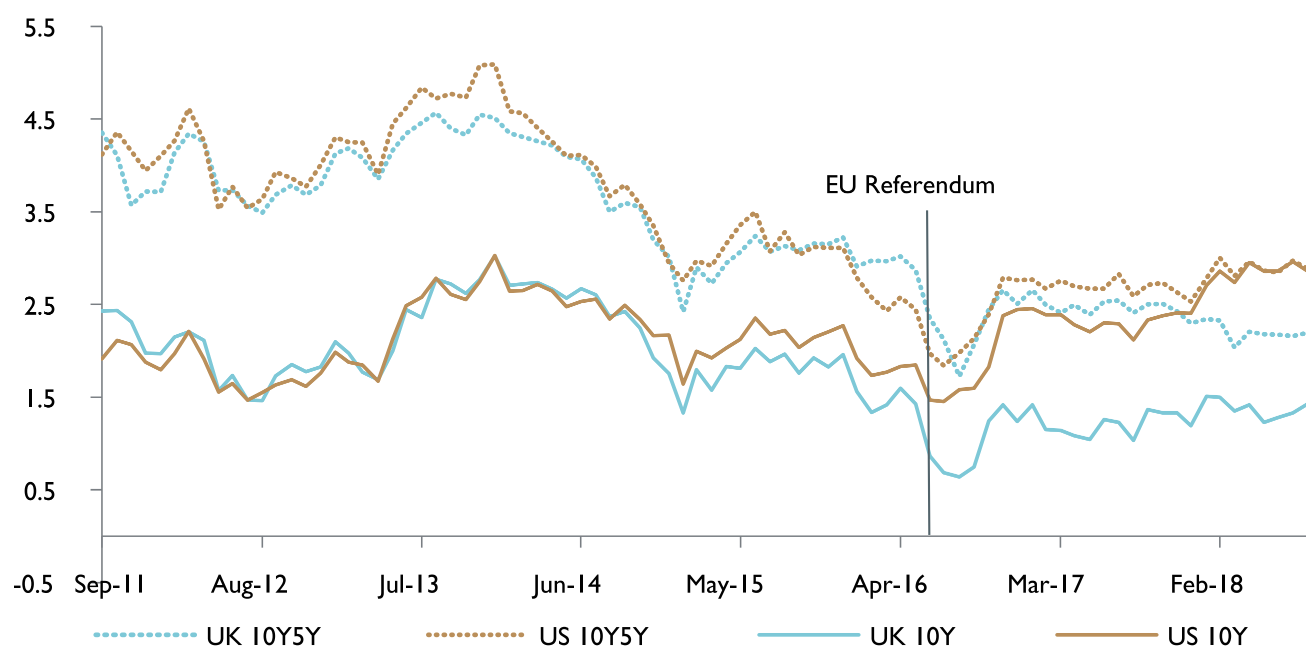
However, the possibility of a recession is generally seen as lower now than in the immediate aftermath of the referendum. Looking at what has been priced-in by investors, the probability of the UK entering a recession within 12 months, inferred by the markets and calculated by Bloomberg, reached almost 50% in the direct aftermath of the EU referendum. Today, the probability stands at around 20%.

The interest rate market has followed a similar pattern, with 10-year gilt yields falling to the all-time low level of 0.5% in August 2016 before rebounding. These rates show the market's long-term expectations in terms of growth and inflation. In today's context, they are an important gauge of how investors see Brexit and its impact on the UK economy.

Looking at the numbers, expectations remain modest. 10-year gilt yields are trading at around 1.5% and expectations of 10-year gilt yields in five years' time stand at 2.3%. This compares to almost 3% before the EU referendum, reflecting a somewhat pessimistic stance on UK growth after Brexit, akin to a lower neutral rate of growth.

Another way to look at it is that, given where inflation expectations stand for each country, the gap that opened between UK and US rates, both spots and forwards, indicates the market is pricing-in a prolonged divergence in growth between the two regions, in favour of the US.

Government bond yields imply a prolonged divergence between the US and UK economies



Source: Bloomberg. Data as at 12 September 2018.

	Jun-16	Jul-18	Difference
UK 10Y Yields	1.42%	1.48%	+0.06%
US 10Y Yields	1.84%	2.96%	+1.12%
UK 10Y5Y	2.86%	2.28%	-0.58%
US 10Y5Y	2.44%	2.99%	+0.55%

Source: Bloomberg.

PART TWO: WHAT COULD BREXIT LOOK LIKE?

Key Brexit Dates Ahead

Turning to the future and the negotiations taking place, there are currently two major unknowns:

1. Will a withdrawal agreement be in place by March 2019 or not? This is crucial for the short-term outlook on sterling and gilt yields with a 'no-deal Brexit' likely to prove negative for UK assets.
2. What kind of relationship will we see between the EU and the UK assuming a 'no-deal Brexit' is avoided? A 'soft' or 'hard Brexit' and its associated impact on trade relationship could mean very different things for gilt yields and sterling.

If things go smoothly, which remains our base case scenario, a withdrawal treaty will be agreed during the October EU summit, or sometime in November, including among other things a transition deal and a declaration outlining the broad terms of the future trade relationship.

This treaty must then be ratified by the EU and British parliaments before 29 March 2019, when the UK's membership of the EU will lapse. From there, the transition period would start and in January 2021 the new EU-UK free trade deal would take effect alongside a special treaty relationship in areas such as defence and research.

Recent headlines have indicated that the EU and the UK could use a transition period to flesh out the detailed terms of a future relationship. This means difficult decisions could wait until the UK is in its post-Brexit transition phase, during which the status quo would be maintained. As momentum in negotiations fades and the political landscape changes, it's possible that the UK could remain in this transition phase for an extended period of time, possibly far beyond 2021.

With the March 2019 deadline approaching, several scenarios remain possible which would all lead to very different outcome for the UK economy and its key market variables. Here we consider three of them, although other outcomes could still emerge:

1. No-deal Brexit

If the UK Parliament, member states and the European Parliament have not ratified a withdrawal treaty

by 29 March 2019, the UK's membership of the EU will lapse and trade will revert to World Trade Organisation rules. The January 2018 paper EU exit analysis: Cross Whitehall Briefing' [Committee on Exiting the European Union, EU exit analysis: Cross Whitehall Briefing, 31 January 2018], looked at this scenario and concluded this would reduce UK economic growth by eight percentage points over the next 15 years compared with current forecasts. This is slightly more pessimistic than the forecast produced by the Treasury before the 2016 referendum.

We could expect meaningful disruption of economic life in areas such as trade, transport, food supply and travel, leading to a sharp slowdown in activity, possibly even a recession. Despite Bank of England Governor Mark Carney warning in September that this could lead to both higher inflation and higher interest rates, the bank would likely prioritise growth over inflation, cutting rates back to zero and relaunching asset purchases. Gilt yields and sterling would fall, reflecting the greater economic risk.

It is important to note that this doesn't account for negotiations between the EU and the UK starting again, or temporary measures being put in place to prevent too much disruption for either economy.

2. Canada-style free trade agreement (FTA) for goods only

The 'Chequers plan' belongs to this category of free trade agreements, some variation of which would lead to partial single market access only. Trade in goods would remain largely free but regulatory divergence could constrain trade in some areas, particularly food and pharmaceuticals. On the other hand, the UK would be able to negotiate trade agreements with other countries.

This scenario is likely to see a short-term improvement in the economic situation. Investment and consumer sentiment would improve, leading to marginally higher gilt yields and stronger sterling. Longer-term, it would very much depend on choices made by the UK, for example regarding immigration and taxation.

3. Norway-style European Economic Area (EEA) membership

This is typically referred to as a 'soft Brexit' and would minimise the short-term impact of Brexit, in particular if custom unions are added (unlike Norway). There would be no economic gain compared to the status quo, but it would likely be well-received by investors and result in higher yields and sterling. However, it would come with a loss of UK influence on EU rules and is against Theresa May's 'red lines', making this scenario politically unsustainable and challenging in the long term.

Conclusion

Over the last 40 years, the UK economy has grown ever closer to the EU, to the point where detachment will be extremely complex. In this situation, there are many factors which are difficult to foresee. Even so, there are trends we can observe and conclusions we can draw, which we have attempted to do here.

In what we see as the most likely scenario – a withdrawal treaty and some form of free trade agreement – growth should remain modest in the coming years but will probably benefit from some normalisation in consumer demand and investment. While consumer and investor sentiment will be significant drivers, this should, in turn, lead to marginally higher levels for sterling and interest rates. However, tail risks remain and we can't discount political events that could cause further disruption along the way.

Whatever the outcome, for investors the basic principles remain the same: diversify, be guided by fact not opinion, and consider the long-term. While it is not possible to know exactly what the future holds, we can at least be guided by these principles to make investment decisions that allow for a variety of outcomes and allow us to preserve – and even grow – our clients' wealth whatever the outcome.

When investing, past performance should not be taken as a guide to future performance. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment.

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