Market Update

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Brexit: The Final Hurdle

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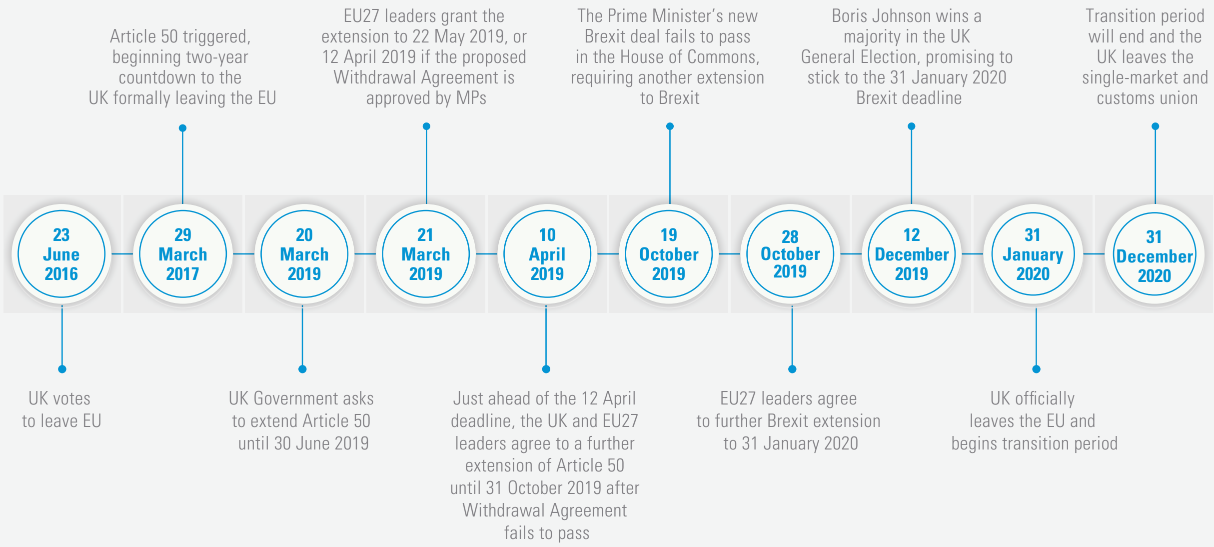
Over four years and three different Prime Ministers since the United Kingdom (UK) voted to leave the European Union (EU), the final hurdle in the Brexit saga is fast approaching. With the impending end of the transition period on 31 December, significant uncertainty still remains for the UK. Signing trade deals is a major priority. Despite some progress with other trading partners, securing deals with both the EU and the United States will be absolutely critical over the coming few months. All eyes will be on the upcoming EU summit on 15 October, which coincides with the current deadline set by Prime Minister Boris Johnson to secure a trade deal with the EU.

Brexit Timeline Recap

As we arrive at the last stage of the Brexit process, we can look back on the events since the referendum result back in June 2016 (Exhibit 1):

Exhibit 1
Brexit Timeline Recap of Major Events



As of 30 September 2020
Source: Lazard, UK Parliament

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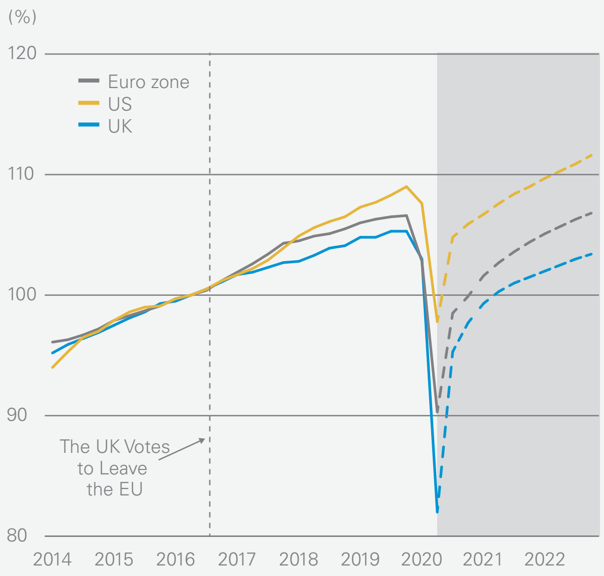
The Brexit GDP Gap

Brexit has weighed heavily on UK economic growth for the past four years. Indeed, since the vote to leave in June 2016, the UK economy has underperformed compared to global peers (Exhibit 2). A series of policy missteps and the response to the COVID-19 pandemic have only made matters worse.

Exhibit 2
UK Real GDP Has Lagged versus Global Peers since the Referendum



As of 30 June 2020

Dotted lines represent projections for real GDP rebased at Q2 2016 values.

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: BEA, Berenberg, Eurostat, ONS

For the three years prior to the referendum, the UK economy grew by 2.4% per annum, significantly outperforming the euro zone, which grew 1.5% per annum. From Q3 2016 until Q4 2019 however, UK GDP growth slowed by an average of 1.6% per year. This was driven by a combination of weak business investment, slowing private consumption growth, and messy domestic politics (including two snap elections). On the contrary, US GDP growth remained steady at 2.5%, supported by fiscal stimulus measures, while European Central Bank (ECB) quantitative easing helped euro zone growth accelerate to 2.0%.

The UK economy looks set to trail its major trading partners in GDP growth after the transition period ends. The UK is also starting from a weaker base, as it suffered a more severe economic downturn due to the COVID-19 pandemic. UK GDP shrunk by a staggering 22.1% in the first six months of 2020, noticeably worse than the US and euro zone, which fell by 10.2% and 15.2% respectively.

Three Possible Outcomes by Year End

1. Full or Partial Deal

This is the most optimistic scenario. It would see the two sides coming to a far-reaching agreement, giving the UK free trade rights across Europe. If this was the case, it would be highly supportive to the economic recovery. Given the extremely short time frame, such a deal would probably entail an agreement in principle while the details on trading rules are worked out.

Prime Minister Boris Johnson has set the ambitious target of reaching a trade deal with the EU by 15 October, likely in an attempt to avoid a cliff-edge scenario in December when the transition period ends. Both sides are likely to continue with hard-ball brinksmanship right up until the final hour to try to secure an appropriate deal.

2. Semi-Managed Hard Exit

This appears to be the outcome that markets are pricing in. In this scenario, the two sides would agree on some modest stopgap measures in order to prevent a disorderly hard exit but fall short of a deal. Trade would default to World Trade Organisation (WTO) rules while further negotiations continue around the edges. This could also involve an extension on some trading arrangements. Nevertheless, this would be a damaging prospect for the UK economy with continued uncertainty weighing on business investment and market sentiment.

It is also possible that the ongoing uncertainty and disruption from the COVID-19 pandemic results in both sides agreeing to some form of extension. However, a large Conservative majority in Parliament and Boris Johnson's determination to "get Brexit done" makes this scenario unlikely.

3. No-Deal, Hard Exit

This worst-case scenario would entail a complete breakdown in the relationship into year end without a deal, causing extreme uncertainty and disruption across the economy and markets. In this scenario trade would also default to WTO rules. Future trading terms would have to be worked out on a piecemeal basis, but only if governments come back to the table. This scenario will become increasingly likely if the UK government presses on with its proposed Internal Market Bill (see below).

A hard exit with few or no agreements in place for crucial areas such as goods trade and financial services may tip the UK back into recession in early 2021 and could potentially also stifle the EU recovery from the COVID-19 pandemic.

Late Drama Caused by the Internal Market Bill

When the UK leaves, the EU laws that currently bind the UK's four constituent parts—England, Scotland, Wales, and Northern Ireland—will no longer apply. The Conservative government now argues that the UK needs a new set of rules to govern internal trade to ensure that there will be no barriers to intra-UK trade. These could potentially emerge from future differences in laws by the devolved administrations. The draft "Internal Market Bill" proposes to provide ministers with powers over how the UK could implement the Northern Ireland Protocol (NIP) that was agreed to as part of the exit deal with the EU. This bill has the potential to derail trade talks between the two sides and the plan may also be in violation of international law. The reaction from the EU has been to start legal proceedings against the UK, highlighting the tension between the two sides as trade negotiations move into a critical phase.

The Urgency of Trade Deals

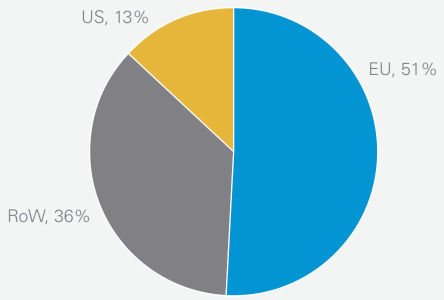
While the UK is an EU member state it can participate in the EU's 41 trade agreements spanning 72 countries. Since Brexit day on 31 January 2020, the UK has been free to negotiate its own deals for the buying and selling of goods and services. However, these are extremely complicated agreements to secure, particularly over the short time frame between now and the end of the transition period, after which the UK will cease to be a part of the single customs union. As of 1 August 2020, the UK had secured 19 trade agreements with 42 countries. Most recently, the UK signed a free trade agreement with Japan, the UK's fourth-largest non-EU trading partner, which has the potential to increase trade with Japan by an estimated £15 billion.

Despite this progress, securing deals with both the EU and the United States is absolutely critical over the coming few months. The importance of both trading relationships cannot be overstated. In 2019, over half the imports into the UK came from the EU (Exhibit 3), compared to around 43% of UK exports to the euro zone, resulting in a £71bn trade deficit. The trading relationship with the US is also strategically important. Just over 20% of UK exports last year went to America, and the country represents the UK's largest trade surplus.

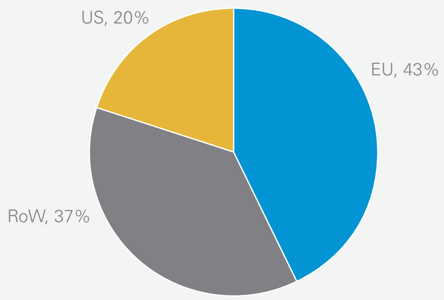
Another major challenge for the UK will be the heavy reliance of a number of key industries on intermediate inputs. For example, the UK automotive industry, which is the country's biggest exporter of goods and added around £18.6bn to the UK economy in 2018, is hugely reliant upon car parts from non-EU countries. The EU has a requirement that cars should be at least 45% "locally made" in order to take advantage of zero-tariff access to the EU in a trade deal. Since the UK government has been unable to convince Brussels to take a more flexible approach to manufacturing cars with non-EU parts, it will mean that UK car exporters are unable to enjoy tariff-free access. The food and drinks sector is in a similar situation. These "rule of origin" requirements mean that even if an overall zero-tariff trade deal was agreed to, many industries will still be unable to take advantage of free trade.

Exhibit 3
The Importance of Key Trading Partners

% of UK Imports



% of UK Exports



As of 31 December 2019
Source: ONS

The British government will need to move quickly if it hopes to avoid a sharp disruption to trade in the coming year. Talks between the UK and the EU remain at an impasse due to lack of progress on key issues, including level playing field provisions (particularly state aid), fisheries, and dispute settlement mechanisms. It is also hard to imagine the two sides reaching a deal while the issues around the Internal Market Bill remain. However, with Prime Minister Boris Johnson and EU Commission President Ursula von der Leyen now engaging directly in negotiations for the first time since June, it is possible that higher-level talks will help break the deadlock on these key sticking points.

How Is COVID-19 Impacting Brexit?

COVID-19 has undoubtedly placed a strain upon negotiations. Although the pandemic likely pushed Brexit down the list of priorities in the face of a devastating health threat, the crisis has provided some cover for both sides to take bigger risks in negotiations. The sharp decline in GDP caused by the virus and the steps taken to protect economies and markets are also likely to mask the potential adverse economic effect of a hard exit, should that occur.

The crisis has also removed the existing limitations on greater central bank action to offset or monetise economic disruption.

This was illustrated by the resumption of bond-buying (quantitative easing) policies and interest rates falling to historic lows earlier this year. Should Brexit negotiations result in a no-deal scenario, we expect the Bank of England (BoE) will maintain its accommodative monetary stance to support the economy.

With both sides currently dealing with resurgences of the virus and governments imposing tighter restrictions in response, the impact of COVID-19 on negotiations may increase as we move into the final stages of negotiations.

Investment Implications

The response of the Europe ex-UK equity market to Brexit news flow has been muddied by the ongoing COVID-19 crisis. Despite the considerable negative economic downturn, European markets have generally fared better than did the UK through supportive measures from the ECB. However, should a no-deal Brexit materialise it will certainly place significant further strain on both economies. The Europe ex-UK equity market is also likely to be influenced by the political developments in the US, where an ugly election battle and potential uncertainty over its result may lead to market volatility and even social unrest.

UK equity markets remain highly sensitive to Brexit news flow, reflected in the sensitivity of both sterling levels and bond yields. Should a last-minute deal be reached with the EU, we would expect the most suppressed domestic sectors, such as house builders and retailers, to benefit. Even though the sterling would likely strengthen, we would not expect this to hold back the performance of large-cap, non-sterling earners, which comprise a large proportion of the UK market, as the UK market would likely experience a broad-based rally.

Weaker Sterling Will Support Large Overseas Earners

The risk of a no-deal, hard Brexit increases every day while negotiations remain at an impasse. The additional issues thrown up by the Internal Market Bill are reflected by recent sterling weakness. We wrote previously that we would expect the BoE to cut interest rates in a no-deal outcome. However, given the fact that rates have dropped to effectively zero in response to COVID-19 and the BoE has so far ruled out a negative interest rate policy, we would expect rates to remain at their current record lows whatever the outcome of trade negotiations.

Weaker sterling caused by a no-deal scenario would benefit larger-cap stocks, which are by extension also less exposed to the struggling UK domestic economy. We would expect these stocks to remain in favour despite, in some cases, relatively stretched valuations. It is also possible that, as after the result of the referendum in June 2016, a hard exit could result in further outperformance of large-cap stocks versus smaller-cap stocks as investors seek the perceived safety and higher liquidity of larger companies.