

THE WATCH

17 October 2019

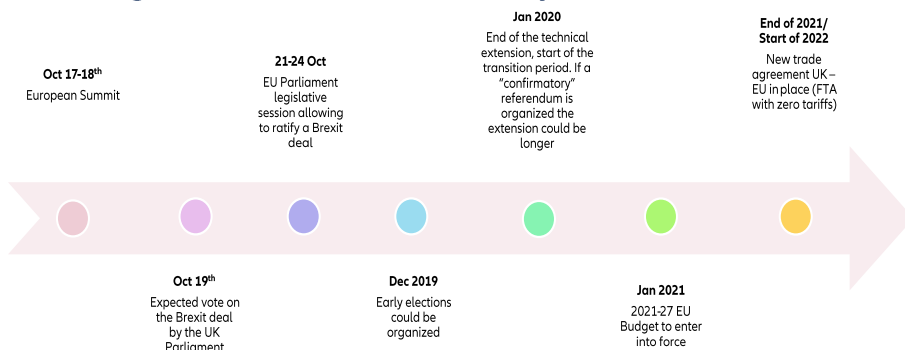
We have a deal: So what?

- A Brexit deal with Europe, but limited time for ratification could require a (short) technical extension. On 17 October, the European Commission and the UK government managed to agree on changes to the Withdrawal Agreement and the Political Declaration ahead of the EU Summit. The Heads of State need to approve it (likely) before it is ratified by the UK Parliament on 19 October (tough but not impossible) and by the EU Parliament next week during the plenary session (likely). The deal lowers the uncertainty (-0.3pp of UK real GDP growth per year since 2018), and should progressively help the UK return to “business as usual”. However, mind the risk of early elections by the end of Q1 2020 and/or a second Brexit referendum.
- In the short-term, the deal will not help the UK avoid a technical recession. In the medium-term, a soft Brexit (zero tariffs) would depend on a successful set up of the technical details related to the dual-customs system between Great Britain and Northern Ireland. The unwinding of contingency stockpiling will still shave off -1.5pp of real GDP growth over the next two quarters. Hence, we expect GDP to fall by -0.1% q/q in Q4 2019 and Q1 2020. A recovery is expected thereafter, with quarterly growth reaching +0.6% q/q on average in H2 2020. Higher volatility, with a limited rise in uncertainty, can be expected during the transition period, which should last until end 2021, after which growth should return to pre-referendum levels (+1.7%).
- **What does this mean for markets?** The deal, even with the ensuing technical extension, should be positive for the FTSE 250, which is domestically oriented (+5%). The sterling should continue its rally (1.20 vs the EUR by year-end) since it was almost the only Brexit risk barometer. Movements in long-term government bond yields should remain limited and temporary (room for a +40bp short-lived increase in the long-end of the rates curve). Despite the temporary volatility, the global ultra-low rate environment should keep the long-end of the UK gilts curve below fair value (1.5%).
- **What does this mean for corporates?** Lower uncertainty, given that the probability of a no-deal scenario has significantly reduced. We expect the rise in business confidence to boost domestic investment, which contracted over the past two years. Foreign investment should also gain momentum. Labor shortages should reduce and support corporates’ margins. For Europe, the cost of uncertainty (-0.2pp of real GDP growth per year) will slowly fade away but we expect a negative base effect on Eurozone exports due to frontloading of imports from the UK ahead of the previous Brexit deadline of October 31st.

An earlier-than-expected Brexit deal with Europe, but limited time for ratification could require a (short) technical extension. On 17 October, the European Commission and the UK government managed to agree on changes to the Withdrawal Agreement and the Political Declaration ahead of the EU Summit. The Heads of State need to approve it (likely) before it is ratified by the UK Parliament on 19 October (tough but not impossible as some Labor MPs could give support) and by the EU Parliament next week before the last day of its

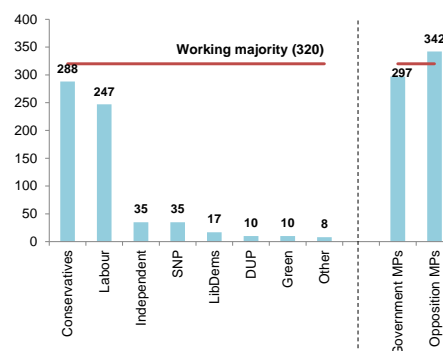
plenary session on 24 October (likely). With the limited time available, the UK government might be forced to ask for a technical Brexit extension until early 2020. Once the Withdrawal Agreement and the Political Declaration are ratified, the UK will kick-off of the 21-month transition period (until end of 2021). This will also see the start of negotiations on the future trade agreement with the EU, which is planned by both sides to be a “comprehensive and balanced Free Trade Agreement” that will “ensure no tariffs, fees, charges or quantitative restrictions across all sectors with appropriate and modern accompanying rules of origin and ambitious customs arrangements.”¹

Figure 1 – Brexit: what are the key dates to watch for?



Sources: Various, Allianz Research

Figure 2 – UK House of Commons seats



Sources: Allianz Research

How is the deal different from Theresa May’s version? In the previous version of the Withdrawal Agreement, the Northern Ireland backstop would have forced the whole of the UK to remain in the EU customs union in case no technological solution was found to avoid physical checks on the island of Ireland. The latest deal stipulates that Northern Ireland would be treated differently from the rest of the UK as an entry point to the EU, aligning with the EU’s regulatory arrangements for goods while remaining in the UK’s customs union. A customs border in the Irish Sea would be set up between Northern Ireland and the rest of the UK and customs declarations on goods sent from Great Britain to Northern Ireland would be needed.

Goods imported to Northern Ireland and the Republic of Ireland from other countries (non-EU, including the UK) would either face a UK tariff or the EU’s Common External Tariff, depending on their final destination. As an example, let’s imagine that a car is imported from the U.S. into Northern Ireland. If this car would stay in Northern Ireland, the UK import tariff would apply (10% if there is no Free Trade Agreement with the U.S. or less in the contrary case); if it is re-exported to the EU, then the EU tariff will apply (10%).

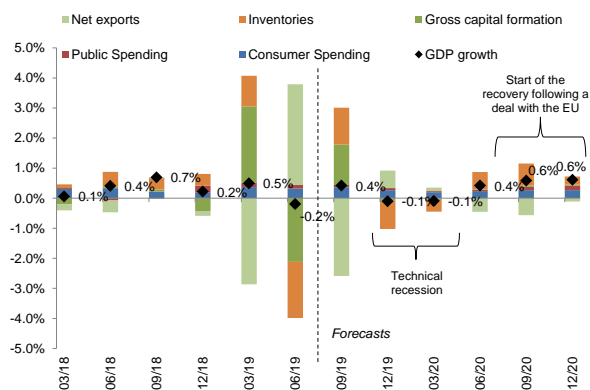
The deal lowers the uncertainty and could help the UK return to “business as usual”, but mind the risk of early elections. We think the UK Parliament is likely to either call for early elections to be organized by the end of Q1 2020 or push for a second referendum once the technical extension is approved and prospects of a no-deal are off the table. Under the 2011 legislation, a national ballot can be called only if (i) two-thirds of MPs vote for one, (ii) if the government loses a confidence vote or (iii) if the PM calls for an election and obtains the Parliament majority. PM Boris Johnson’s majority falls short by 23 seats (see Figure 2).

Elections could result in a weak governing coalition, with the Labor party in the driving seat. A second Brexit referendum could turn into “no Brexit”. Current polls (though they have not been reliable over the past years) show that the Conservative Party would only gather 33% of the votes and the Brexit Party 13%, while Labor would get 25% and Liberal Democrats 20%. The first two seem unlikely to form a coalition, but the last two parties could join forces together with SNP and the Greens. Hence, we give 55% probability to having a soft (weak) coalition in place, which would considerably reduce the Brexit uncertainty. As a reminder, the Labor Party is in favor of organizing a second referendum, while the Liberal Democrats said they would revoke Article 50 should they be part of the governing coalition. In a soft coalition scenario, the “no deal” probability would decrease to 10% from 20%, while the “no Brexit” probability would increase to 30% from 10% currently.

¹ https://ec.europa.eu/commission/publications/revised-withdrawal-agreement_en

The deal would not help the UK avoid a technical recession at the turn of the year. Even if uncertainty is lower, the absorption capacity of the precautionary stocks is limited in an environment of low global growth. Consumers have front-loaded their spending, as witnessed by the strong retail sales growth over the past few months, while companies have accumulated high levels of stocks (at a peak since the 2009 crisis). Hence, we expect two quarters of negative growth (-0.1% q/q) in Q4 2019 and Q1 2020 (see Figure 3). While the Bank of England is likely to cut interest rates once by year-end (-25bp to 0.5%), this would not be enough to prevent a liquidity risk for some UK companies, which have borne the brunt of the uncertainty and the higher financial costs related to Brexit preparations. Overall, business insolvencies will continue to increase (+5% in 2020 after +11% in 2019). We expect the recovery to only be visible in H2 2020, provided there is political stability, which should allow annual GDP growth to reach +0.8% on average in 2020.

Figure 3 – Real GDP growth by component, %



Sources: ONS, Allianz Research

The sterling will be the biggest winner from the Brexit deal but it will remain a prisoner of the political environment (i.e. volatile). The sterling has been the main Brexit risk barometer. It lost more than -20% since the start of 2016, and -15% since the referendum. The cost of hedging against sterling volatility reached a two-month high in early October. We believe that the sterling is undervalued and that the lower Brexit uncertainty should boost it up to 1.20 against the EUR at end-2019.

Figure 4 – Key forecasts for the UK

	2016	2017	2018	2019			2020*		
	Pro-Brexit vote in June	EU exit negotiations with EU	EU exit negotiations with EU	A deal with a (short) technical extension of Art. 50 (70%)	No deal, disorderly Brexit, WTO rules (20%)	No Brexit (10%)	EU exit in Q3 2020, transition period until Q3 2022 (60%)	No deal, disorderly Brexit, WTO rules (10%)	No Brexit (30%)
Assumptions				Early elections and/or second referendum likely			A soft coalition (Labor, Liberal Democrats, Greens and/or SNP) more likely (55% probability) than a hard coalition (Conservatives, Brexit party, 45% probability)		
Real GDP (y/y)	1.8%	1.8%	1.4%	1.2%	0.8%	1.4%	0.8%	-1.0%	1.5%
Real private consumption (y/y)	3.1%	2.1%	1.7%	1.8%	1.3%	2.0%	1.6%	-1.3%	2.1%
Real business investment (y/y)	-0.2%	1.5%	-0.4%	-1.5%	-2.6%	-1.0%	-0.3%	-4.0%	1.0%
Real total exports (y/y)	1.0%	5.6%	0.1%	0.3%	-2.4%	1.0%	0.5%	-7.2%	1.0%
Real total imports (y/y)	3.3%	3.5%	0.7%	6.0%	3.3%	5.0%	2.2%	-5.9%	1.5%
Inflation (CPI, y/y)	0.9%	2.7%	2.4%	2.0%	3.5%	2.0%	2.0%	3.0%	1.8%
BoE benchmark interest rate	0.25%	0.50%	0.75%	0.50%	0.50%	0.75%	0.50%	0.25%	0.75%
GBP/EUR (eop)	1.17	1.13	1.12	1.15 - 1.20	0.85 - 0.90	1.20 - 1.25	1.15 - 1.20	0.85 - 0.90	1.25 - 1.30
Business insolvencies (y/y)	0.0%	-3.0%	10.0%	11.0%	12.0%	6.0%	5.0%	15.0%	-5.0%

* Scenarios and probabilities are based on the assumption that there is an Article 50 extension and a soft coalition in power post general elections

NB:
 Soft Brexit = Custom Union with the EU or a Norway+ type of trade agreement
 Limited FTA = CETA-type of trade agreement
 Hard Brexit = WTO, Most Favored Nation principle will apply (equiv. to more than 5% weighted average on goods, 20% to 30% additional costs for trade in services)

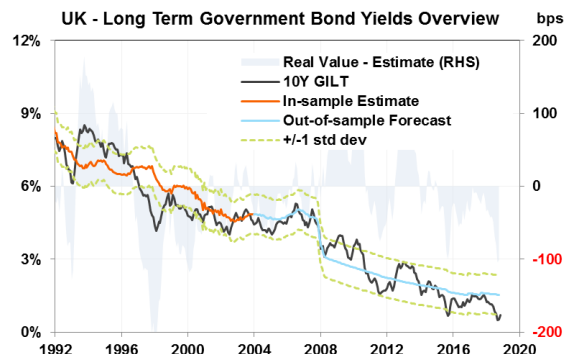
Sources: ONS, Eurostat, Allianz Research

The deal would bring short-lived good news as the state of the global economy matters more to financial markets than Brexit. Taking a quick glance at the performance of the UK capital markets since the end of 2015, it is hard to find any Brexit-specific movement but for that of the currency. Overall, the moves in both equities and fixed income seem to be synchronized with the ones of major economies, making it hard to distinguish between domestic and international effects.

Looking at past performance, it seems like financial markets (equity, fixed income) never believed in a Brexit. The FTSE 100 Index was always seen as a gauge of prosperity for businesses regulated by UK law. Many of these are multinationals for which 71% of revenues are generated outside the UK, so the index's movements are a fairly weak indicator of how the UK economy is faring. In addition, FTSE 100 is negatively corrected with the moves of the sterling, as a sharp rise in the pound would lower earnings that are earned abroad and converted into sterling. As a result, it is not surprising to see an increase of 10% in the index since the Brexit referendum. Hence, the FTSE 100 index is more affected by global trends and currency swings than Brexit itself. But the FTSE 250 index, which has a greater domestic exposure, does have a greater sensitivity to the Brexit outcome. Since the majority of the FTSE 250's income is generated within the UK, it has little to no exposure to exchange rate risks. The FTSE 250 should register positive gains from the extension of Article 50 (below 5% within the day of announcement).

In terms of **government bond yields**, most of the recent decline in UK nominal bond yields is attributable to a fall in real yields, which is also the case for most developed markets. Market-based inflation expectations, on the other hand, have been on an ever increasing trend since the Brexit vote. As a result of this global ultra-low yield trend (not Brexit-related), long-term UK government bonds look seriously overpriced. According to our proprietary valuation model, 10Y UK Gilts currently trade 80bps below fair value (1.5%). Phrasing it differently, referring to fundamentals, the likelihood of an upward move in UK long term yields is far greater than that of a downward move. Interestingly, in the current environment, the persistent lack of bond market directionality has led to an almost one to one transmission of short-term monetary policy expectation changes to long-term yield changes. What is more, the correlation between the short and the long end of the curve has been on an ever-increasing global rampage. In the case of the UK, the short-to-long relationship has shifted from a negative value in 2016-2017 to an extreme +0.9 correlation and a 0.5-0.7 pass-through coefficient. In other words, for each 25bps decrease/increase in monetary policy expectations (e.g. market pricing one more rate cut/hike) the long-end of the UK yield curve currently declines by almost 15 to 20bp.

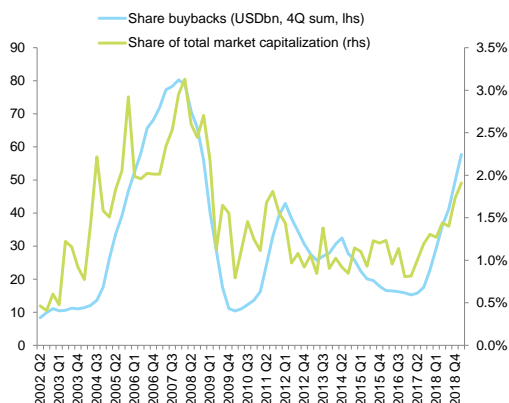
Figure 5 – 10-yr UK Government Bond Yield (GILT) – Valuation Model



Sources: Refinitiv, Allianz Research

The recent de-equitization of equity markets in the UK increases downside risks to the debt sustainability of UK companies in the medium term. De-equitization is the substitution of debt for equity, which occurs through share buybacks, M&As, and similar transactions. There is a recent trend of de-equitization in the UK, as the amount of equity circulating around the market has shrunk. The number of companies coming to the market in recent months has also decreased. With the amount of Initial Public Offerings and issuances falling, share buybacks continue to keep the pace. In 2018, FTSE 100 companies repurchased more than GBP 57.7bn worth of shares (see Figure 6). Share buybacks tend to have a positive impact on equity prices: Among others, the earnings per share increase after a company repurchases its shares. However, the danger of de-equitization lies behind high piles of debt (which reached 78% of GDP in Q1 2019 for UK companies). The low-rate environment opened the door for companies to issue cheap debt. While de-equitization reduced the market exposure and dependence, in the long run, companies should watch out for rising debt levels and diminishing growth expectations.

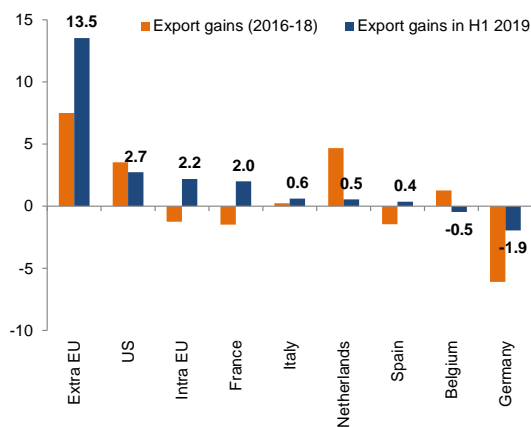
Figure 6 – Share buybacks, FTSE 100



Sources: Bloomberg, Allianz Research

The deal would mean a lower uncertainty cost for Europe going ahead, but we expect EUR2bn less of EU exports to the UK in 2020. For the EU, Brexit cost -0.2pp of real GDP growth annually since 2018. Germany was by far the hardest hit, with an export loss of close to EUR8bn since the referendum. The EU managed to compensate for its 2016-18 losses of EUR1.5bn in H1 2019, thanks to UK companies and households' preparations for a no deal, which brought EUR4.3bn of additional export demand to the EU overall. The Netherlands, Belgium, Italy and France have benefitted the most from the contingency stockpiling wave in 2019. They should also be those to suffer the most from the negative base effects in the coming months. Overall, EU exports to the UK should fall by EUR2bn in the coming six months and recover thereafter, thanks to the pick-up in domestic growth in the UK.

Figure 7 – Export gains to the UK by country, EURbn



Sources: Eurostat, Allianz Research

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