

December 13, 2019

## With Brexit All-But Done, Now Comes the Hard Part

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The Conservative party's sweeping victory in Thursday's general election was a landmark event on several fronts. It was the largest Conservative margin of victory since Margaret Thatcher's win in 1987, and the party won a few seats for the first time in the history of UK polling. It also marks the lowest number of seats for the Labour party since 1935.

It was a campaign where Brexit outweighed all other considerations, which was underscored by many traditional Labour voters who were not prepared to support an increasingly leftist agenda at the cost of "risking" Brexit. As a result, and barring the unforeseen, the UK will leave the European Union on January 31, 2020 based on the deal that Prime Minister Johnson previously reached with the EU. While significant, the split does not remove the possibility of a hard Brexit, rather it essentially starts the next chapter of the separation with the UK and EU now attempting to agree on future trade terms.

### The Clock is Ticking

The strong Conservative majority will bring a degree of policy certainty, which should be positive for the UK economy in the near term. However, it will take far longer to see if the benefit from this clarity is enough to offset the economic loss from a future trade deal vs. the UK's current level of access to the EU.

Assuming Brexit happens by January 31, negotiating a future trade deal will run into significant time constraints with only 11 months remaining until the end of the transition period. If a deal is not reached by the end of the transition period, the UK would leave the EU without a deal. Therefore, concerns about a hard-Brexit scenario may linger for a good part of 2020 unless PM Johnson reverses his election pledge to not request an extension to the transition period. But with a solid victory in hand, time will tell if PM Johnson starts ignoring the party's right-wing, "hard-Brexit" supporters and instead starts pursuing a BRINO (Brexit In Name Only) arrangement.

Given the tight timeline on the transition, Johnson's stated goal to negotiate a "zero-tariff, zero-quotas" trade deal with the EU sounds overly ambitious. While European officials have not entirely ruled out the possibility of reaching such a deal within the transition period—and likely welcome negotiating with a team that has full control and a clear mandate—they nonetheless see little realistic chance that the complex issues of a future trade relationship can be addressed during such a short timeframe. Hence, the rationale behind the German proposal for a standard, less ambitious "step 1" agreement that could be updated at a later stage.

A standard and limited trade deal would essentially be an off-the-shelf Free Trade Agreement (FTA) and would have a better chance of approval by the EU, but would bring serious implications for the UK. Not only would this agreement fall short of the comprehensive, frictionless trade agreement that PM Johnson wants, but it would also significantly constrict access to the EU market relative to the current arrangement and would likely exclude financial services.

However, from a political perspective, an FTA-like trade deal ticks a few boxes that are key with pro-Brexit Conservatives: it would ensure that the UK does not pay into the EU budget, is not under the jurisdiction of the European Court of Justice, and has full control of its borders. As for the Labour party, it may have put itself out of office for a decade as the scale of its loss seems nearly impossible to recover from in time for 2024. It remains to be seen if the Conservatives make an effort to improve the National Health Service, general government services, delivery of benefits, and the other domestic areas typically on the Labour agenda. However, for now, Conservatives see pushing Brexit through as a major achievement.

## Market Impact

With the release of the exit poll, the GBP rallied strongly against the U.S. dollar and the euro. In equities, UK-centric names generally traded 5-10% higher, and utilities rallied hard on the removal of the nationalization threat. Financial and homebuilder equities outperformed as well.

In corporate credit, UK financials outperformed significantly. With Barclays tier 2 callable securities often regarded as a proxy for UK sentiment, they tightened by 25 bps following the election and traded at the tightest levels of the last three years. UK banks now trade at very small concessions to non-UK European banks and look very close to fair value. The yield on the 10-year UK Gilt initially rose by 6 bps before falling by 3 bps to 0.79%.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of December 2019.

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2019-6218

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PGIMJ201912161460