SEEKING ADDITIONAL UNCERTAINTY? BREXIT BRINGS IT

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In a year of abject uncertainty, there is still some clarity to be found: Brexit is happening and the UK's relationship with the European Union will never be the same. Beyond that, Brexit remains mired in uncertainty that will affect the British economy and investors' allocation decisions for years to come.

The UK's recently tabled Internal Market Bill, which would unilaterally override provisions in the Withdrawal Agreement, has once again raised the prospect of a no-deal Brexit and severing decades-old economic ties between the UK and the EU. Yet, the introduction of the Bill has not totally extinguished the potential for a deal, as skinny as one might be, which could still help cushion some of the Brexit-related impact on the UK economy. Given the deterioration in the economic outlook[1] amidst the Covid crisis and the need for both sides to remain engaged in many areas of common interest, our base case is that a so-called "skinny deal" will likely be reached by the end of October or early November and in time to be ratified by the respective parliaments.

However, the somewhat acrimonious split raises longer-term implications. Perhaps the most important result of the current negotiations is its effect on the mutual trust between the UK and the EU going forward. Furthermore, the Bill undermines the UK's reputation as a negotiating partner and hurts its prospects for future trade agreements with other countries, including the U.S., in its post-Brexit existence. It has also been cited as a risk to the Northern Ireland peace process and giving new impetus to the Scottish drive for independence, where the voting majority is now in favour of a break from the UK.

A Closing Window of Options

Unlike the period following the 2016 Brexit referendum, which allowed for a broad spectrum of possible outcomes, far fewer options are now left on the table. The so-called "skinny Canada deal"[2] under discussion would allow for tariff-free goods trade, but that's pretty much it. For a services-based economy, such as the UK's—which is vastly different than Canada's commodity-heavy exports—such a deal would leave the bulk of UK trade subject to a new set of still unestablished rules. The bottom line is that, deal or no deal, the UK's new trading relationship will be very different to the one it had as a member of the EU, and that in turn means the economic consequences of Brexit are largely baked in.

Businesses More Prepared, But Few Will be Left Unscathed

The good news is that businesses appear more prepared for the potential extra requirements of trading with the EU once the transition period concludes. For example, in September, 61% said that they were either fully prepared or as ready as they could be, which was up from 54% when the survey first asked the question in February 2020 (Figure 1).

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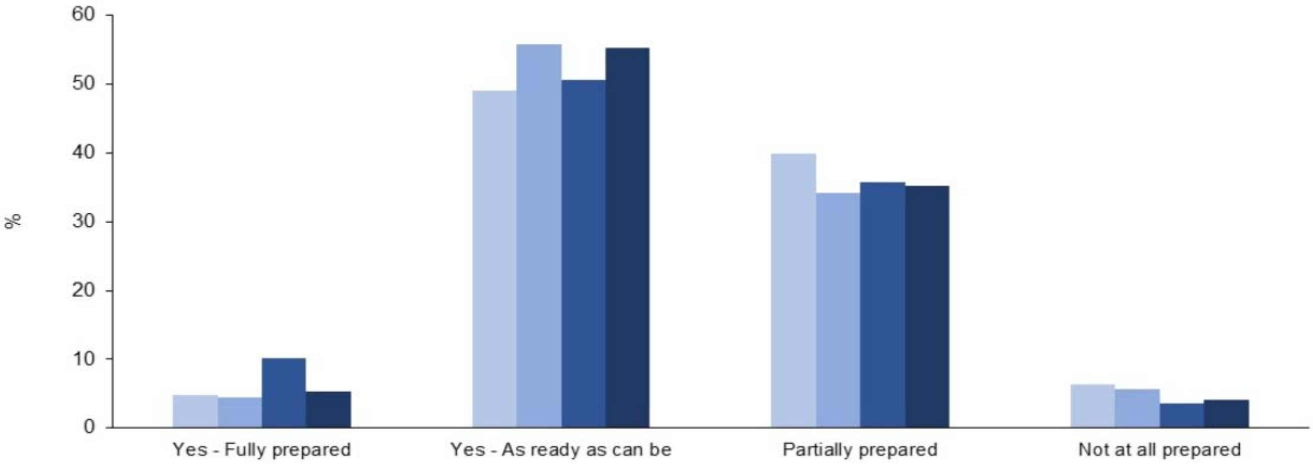
FIGURE 1: POST-BREXIT TRADE PREPAREDNESS (% OF UK BUSINESSES THAT TRADE WITH THE EU, SURVEY RESPONSES*)



Source: Bank of England Decision Maker Panel. *The results are based on the question "Do you think your business is prepared for the potential extra requirements for trading with the EU once the current transition period comes to an end?"

Despite the signs of preparation, the gravity of the situation remains palpable, particularly given the additional challenges from the Covid pandemic. A recent study found that the industries most affected by the Covid shock may be the least affected by Brexit, suggesting that no corner of the UK economy will be spared between the two (Figure 2).

Furthermore, a survey taken over the summer by the Descartes Business Group found that two-thirds of large firms are very or extremely concerned about delays in their supply chain impacting their business post-Brexit and noted that their Brexit preparations have been disrupted by Covid-19. Indeed, the UK government has outlined a plausible worst-case scenario of significant congestion between the Dover-Calais crossing, a major hub for goods trade in the UK. So, another key takeaway is that, deal or no deal, the UK will experience a degree of economic disruption in the early part of next year.

FIGURE 2: INDUSTRIES RANKED BY PERFORMANCE DURING ECONOMIC SHOCKS*

Industry Name	Brexit (predicted)	COVID-19 (April 2020)
Printing and Publishing	1	20
Basic Metals	2	14
Agriculture	3	6
Food, Beverages, and Tobacco	4	17
Other Manufacturing	5	1
Other Non-Metallic Minerals	6	9
Other Machinery	7	12
Hotels and Restaurants	7	15
Rubber and Plastics	9	13
Transport Equipment	10	10
Wholesale trade	11	16
Retail trade	12	7
Recreation	12	19
Transport Activities	14	2
Real Estate Activities	15	11
Post and Telecommunications	16	18
Renting of Machinery	17	5
Textiles and Leather	18	4
Electrical Equipment	19	3
Chemicals	20	8

* A value of 1 = best. Source: De Lyon & Dhingra (2020).

It May Not be 2016 for the Markets, But…

The anticipated market reaction to the current trade negotiations could follow the patterns forged throughout the Brexit process. In a hard break, no-deal scenario, sterling may weaken further—possibly along with a slight weakening in the euro—while UK gilt yields may decline, and spreads on UK-centric and deal-sensitive credits could widen. However, a decent amount of that anxiety may already be priced into the market, so the reaction could be more subdued than the one following the referendum.

On the other side, a friendlier break with a trade deal may have a fairly strong, positive impact on sterling, a slightly positive boost for the euro, a mild lift for gilt yields, and a positive tailwind for UK / Brexit-centric credits. To that end, we remain solidly overweight UK credits in our European investment grade and high yield strategies.

Brexit is a Process, Not an Event, and Its Uncertainty Will Remain for Years to Come

Beyond needing to negotiate a new trade agreement, the UK and EU will need to agree to arrangements covering a whole host of issues, such as transport, data protection and financial services, to name a few. The task and the uncertainty that it creates adds another item to the "unprecedented" list of recent developments as the separation unwinds more than 40 years of economic integration.

Furthermore, the Vote Leave campaign was primarily about taking back control; so, what will the UK do with its new-found sovereignty? Whether the vision is for a "Singapore-on-Thames" or "State Aid for Winners," there has been surprisingly little public debate on the desired future state of the UK. The ambiguous vision coupled with a new trading arrangement, which will be anything but comprehensive, sets the UK on a course for regulatory competition as it diverges from the EU. As the UK looks to define its future, there is little doubt that its historic task could be made even more uncertain by a deep freeze in its relationship with the EU, rather than the current, mild chill.

[1] Our forecast for real GDP growth in the UK is -10% in 2020 and 7.0% in 2021.

[2] Modelled on the Comprehensive Economic and Trade Agreement between Canada and the EU.

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