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## Twelve-month countdown for an agreement on Brexit terms

**GDP is flagging. Twelve months to reach an agreement on Brexit terms. The pound remains stable and monetary policy unchanged. Long rates rise. Caution advised on**

### Key points

- Economic activity flags in Q4 (+0.4%), 2018 expectations at +1.5%
- Agreement on post-Brexit transition period offers relief given tense context
- Forestalling failure in 12 months
- Cost estimates of various possible trade agreements are concerning
- British taxpayers will pay for Brexit until 2064
- Rising unease among businesses and multinationals – Unilever decamps
- Pound remains stable and confident against the euro
- Policy rates will remain unchanged in H1
- Likely increase of long-term government bond yields to 2%
- UK equities: caution advised

### Agreement on post-Brexit transition period offers relief given tense context

The agreement comes as a relief, as it appears to finally offer a solution with regard to the issue of citizens' rights for two additional years following the 29 March 2019 deadline. A two-year transition period has been granted to the UK, during which time the country will no longer participate in EU decision-making processes while nevertheless retaining the benefits of the single market, the customs union, and EU policies. The UK will thus have to abide by all European regulations just like member states. Yet, although the agreement signed by the UK and the EU was a predictable relief, it does not resolve any of the underlying issues.

This agreement essentially buys time and flexibility, but in and of itself it does not resolve outstanding issues. In fact, it is nothing more than a logical and rational concession to the various actors involved to enable a less brutal application of the rules, yet to be defined, which would otherwise have come into effect without further delay on 29 March 2019. It thus sets a transitional period that will allow smoother planning and adjustment of institutions, businesses, and citizens with regard to newly applicable rules. However, it does not provide a future outline for Brexit. Clearly the news will to some degree alleviate current tensions in the negotiations, but it is far from representing major progress, as it had already been perfectly obvious that a transition period had to be established in order to avert regulatory chaos in a year's time. The risk of this agreement is that it may foster the tendency once again to minimise the urgency of the situation and the necessity of finding tangible solutions to the very real problems posed by Brexit. Let us hope that this new stage will reinvigorate discussions between the parties regarding fundamental issues.

### Forestalling failure in twelve months

At the beginning of the year, a deadlock in the negotiations was narrowly avoided thanks to an agreement in principle extracted from Theresa May. On 13 December 2017, European negotiators cheered a shift in the British position, which finally opened the door to a second round of talks between the two parties. The Europeans welcomed this shift warily, noting that they would engage in this new phase with great vigilance. Three months later, the commitment that had already at the time seemed like a fragile declaration of intent extracted at the last minute has not been shored up. Certainly, the British government is not calling into

question the basic principles of a financial agreement whose outline remains vague and which involves a minimum payment of 45 to 50 billion euros, but it continues to prevaricate, which is hampering a process that had barely resumed. The attitude of the British negotiators constitutes a major problem with regard to the negotiation process, even though the latter is crucial for the UK. The British parliamentary committee overseeing the Brexit negotiations is now realising that talks between London and Brussels are stalling and threaten to delay the UK's withdrawal from the EU. Little progress has indeed been made on the issues of expatriate citizen rights, the border between Northern Ireland and the Irish Republic, or what tariff model to apply. This comes as a surprise to no one, but time is running short, yet the urgency of the situation does not seem to be rousing parties to find realistic common ground. The two-year timeframe set for the UK to withdraw from the EU ends on 29 March 2019, that is, in less than a year; half of the time allocated to finding an exit route has thus passed. The Europeans are justifiably exasperated by the UK's indecision. Michel Barnier, the European Commission's chief negotiator for Brexit, showed signs of annoyance after British Prime Minister Theresa May rejected the legal draft of a withdrawal agreement that will have to be discussed yet again during the next European member state summit on 22 and 23 March. His stance could harden, as the EU's irritation is increasingly noticeable in the face of the UK's "unrealistic" demands. While the UK may well withdraw from the customs union's internal market and reclaim regulatory autonomy and legal independence, it will have to accept to pay the price. The European Union has no intention of letting the UK devise a customised withdrawal that would allow it to select an "à la carte" internal market and the elements that suit it while rejecting those that cross its "red lines". Impatience is mounting once again. The president of the European Commission, Jean-Claude Juncker, also called on the UK to show a little more discipline and realism, urging it to focus rapidly on key elements. Talks thus far have focused on delineating a Brexit agreement addressing the divorce's financial costs as well as the expatriate and Irish border issues. However, it is now urgent to also clarify the UK's position on the issue of post-Brexit trade and customs relations.

**A full year has gone by, and it is now time as Juncker stated to 'translate speeches into treaties, to turn commitments into agreements, broad suggestions and wishes on the future relationship into specific workable solutions', to prevent the negotiations from failing on 20 March 2019.**

## **Cost estimates of various possible trade agreements are concerning**

The British government recently estimated that withdrawing from the European Union would cost the country 4.8% of its expected economic growth over the next 15 years. The economic impact of Brexit is thus starting to be better understood, as a lower growth rate could entail an increase in the country's borrowing of approximately **55 billion pounds** over the same period—enough to challenge the arguments put forward by the Brexit camp at the time of the vote in 2016. Figures released by the ministry in charge of Brexit negotiations with regard to the other two potential scenarios are also worrisome. Membership in the single market, an option that has already been ruled out by Theresa May, would result in lost growth worth 1.6% of GDP, while a no-deal exit would cost 7.7% of GDP. The amount required to service the public debt could in that case reach 80 billion pounds. Brexit's potential costs keep rising, while solutions involving new free trade agreements with the US and other countries are unlikely to come to fruition before March 2019. At any rate, even an agreement with the US would have only a limited impact of +0.2% of GDP and would be altogether insufficient to compensate for the estimated impact of withdrawal from the EU.

## **Rising unease among businesses and multinationals**

Unilever recently announced its decision to consolidate its headquarters in the Netherlands, after having had a mixed presence in the UK for almost a century. The multinational will henceforth pay taxes only in the Netherlands. The news came out perhaps at the worst time for British negotiators, unless it finally makes them come to grips with reality and with businesses' perceptions of the likely consequences of Brexit. Even if Unilever's CEO, Paul Polman, refrained from linking the decision to the threats posed by Brexit, it is difficult not to infer a clear causal link. A recent study suggested that the costs of a UK withdrawal without an agreement with the EU were estimated at around 30 billion euros in tariff and non-tariff barriers. These extra costs would essentially be borne by the automobile, agrifood, chemical and financial sectors. The City accounts for close to 10% of GDP and is moreover the only sector operating a trade surplus with the EU. The City favours mutual recognition of regulations, which still seems to be rejected by Brussels, which would prefer to implement equivalency systems such as those in place with Switzerland, for instance. Businesses will likely welcome the agreement on

a two-year transition period. While this period will help to prepare for the change, it will not reduce concern related to the glaring absence of a clear vision regarding the nature of the change that will affect them in a year.

### The British taxpayer will pay for Brexit until 2064

Brexit supporters continue to be surprised, shocked, and caught wrong-footed by the withdrawal's impacts. Indeed, the Office for Budget Responsibility released an estimate viewed as credible of the costs of Brexit showing surprising consequences. What should most shock the population is the duration of the payments owed by the UK to the EU, as the report concludes by mentioning that British taxpayers will make payments until 2064 to cover the UK's share of the pensions of EU civil servants. This detail will likely cause no small amount of distress, as it is approximately equivalent to what will have been paid between 1973 and 2019—a bitter pill to swallow.

### The pound remains stable and confident against the euro

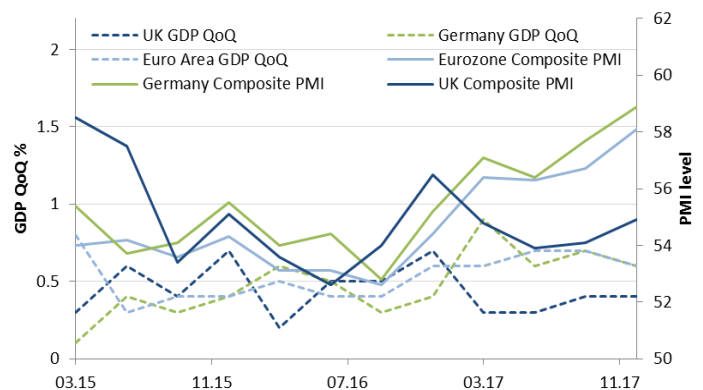
The British currency does not seem to be affected by the absence of any tangible progress in defining a post-Brexit business model. We continue to believe that the pound has entered a stabilisation phase against most major currencies, after its record drop following the Brexit vote.

between 1.12 and 1.14 since October 2017. At this stage, we continue to bank on a stabilisation of the exchange rate in H1.

### Economic activity slows

Q4 GDP (+0.4%) remains on a decelerating trend, though without worsening significantly. Yoy performance stabilised at +1.4%. Exports continued to lose steam in Q4 (-0.2%), and the rise in imports (+1.5%) does not bode well for the trade balance. Private consumption weakened again (+0.2%), although the +0.6% increase in public spending is compensating somewhat for this loss of momentum.

### Quarterly GDP and PMI, UK - Eurozone - Germany

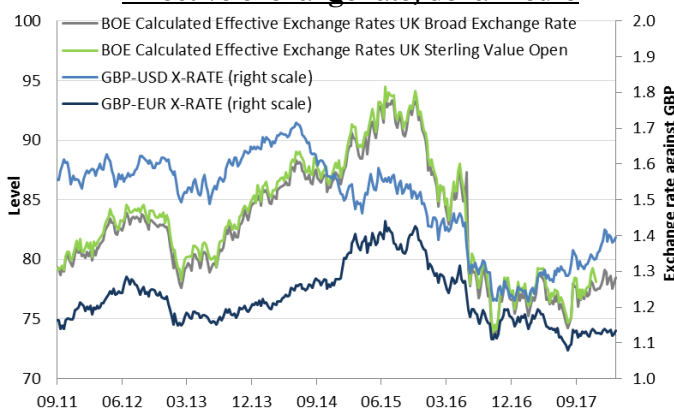


Sources: Bloomberg, BBGI Group S.A

Leading indicators are showing no sign that any sharp deterioration is to be expected in the beginning of the year. Manufacturing PMI's decline from 58.4 in November to 55.2 in February suggests a slowdown in the sector's activity. On the services side, the picture is somewhat rosier, as the PMI rose slightly from 53 to 54.5 in February. Construction exhibited a similar trend, increasing from 50.2 to 51.4. Overall, the composite index improved slightly, progressing from 53.5 to 54.5. Consumer confidence and the business barometer did not exhibit any significant change and continue to reflect the uncertainty caused by Brexit. In this context, the very slight uptick in the unemployment rate (from 4.3% to 4.4%) in December may already be pointing to a deterioration in the job market, which has nevertheless been growing (+88,000) after shedding 56,000 jobs in October. The increase in industrial production (+1.3% in January) and in manufacturing production (+0.1%) is encouraging.

**The growth outlook for the British economy is rather stable, with a growth forecast of +0.4% for Q1 and +1.5% for 2018.**

### Effective exchange rate, dollar - euro



Sources: Bloomberg, BBGI Group S.A

Since talks resumed in December 2017, the pound has benefitted from a rather constructive environment, anticipating a reasonable solution between the UK and the EU. This expectation is still bolstering the pound/euro exchange rate, which has remained stable

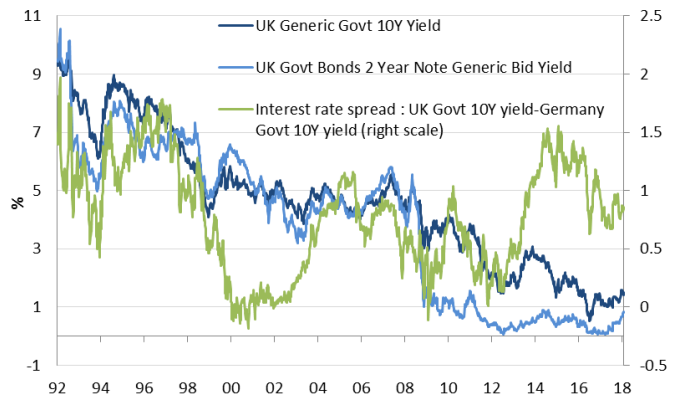
## Policy rates remain unchanged

The status quo should persist given the current context and in view of the economic slowdown and higher inflation figures observed at the beginning of the year. In November we stated that the BOE's +0.25% rate hike would not be hastily followed by further monetary tightening, due to the risk of an economic slowdown. As we mentioned in our previous analysis, the rate hike to 0.5% could thus be followed by a long period of inaction. The BOE will likely keep rates unchanged or proceed with only minor hikes in the second part of the year. The Bank had applauded the agreement with the EU that decreased the probability of a disorderly withdrawal. It must now wait for the negotiations to proceed and develop their effects on consumer and business confidence to assess the likelihood of an upturn or downturn in GDP and inflation.

## Long-term rates increase to 2%

The BOE released its one-year (+2.9%) and five-year (+3.5%) inflation forecast, indicating an expected increase. However, inflation has stabilised somewhat over the past months, clocking in at 2.7% yoy in February. Pressures have not intensified; production prices even fell from +19.3% to +3.4% over twelve months. We continue to predict that inflation will stabilise above the BOE's 2% target in the next quarters. It may seem surprising that long-term interest rates are not experiencing larger shifts in this context. The UK bond market is likely to soon be somewhat more affected by domestic fundamentals and the approaching 29 March 2019 deadline. The rise in 10-year yields we had mentioned in our latest investment strategy reached 1.6% before stabilising above 1.4%, but these levels still seem low in the present context and should rise to 2%.

## 10-yr and 2-yr UK government bond yields

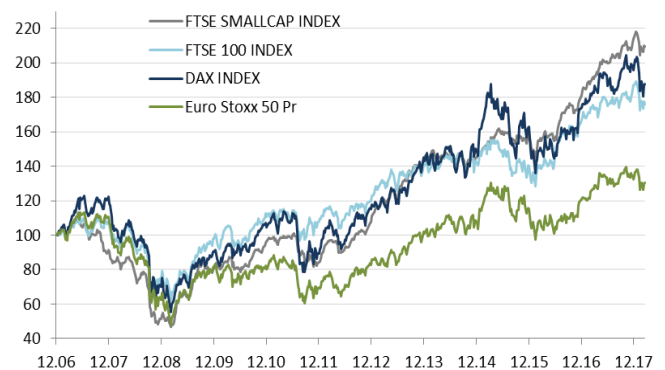


Sources: Bloomberg, BBGI Group S.A

## UK equities: caution advised

The UK market is currently trading at the same level as in October 2016, a few weeks after the vote (7,000 UKX). The drop in share prices over the past weeks has adjusted the valuation level. At around 13x earnings and an expected yield of 4.5%, the UK market does not yet present the opportunity we expect given the still uncertain context of the Brexit negotiations. The pound has remained resilient in the face of these uncertainties, but we maintain our advice to remain cautious with regard to UK equities at this time.

## UK equities (large - small), Eurozone - Germany



Sources: Bloomberg, BBGI Group S.A

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