



Alain Freymond
Partner & CIO

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UK: A referendum as a last resort?

Worrisome decline in GDP growth (+0.1%). Theresa May has no plan B. Increasing likelihood of a referendum. Intolerable costs of a “no deal”. Avoid equities and bonds.

Key points

Theresa May will play her last card in January
Why not consider a plan B?
New referendum to break the deadlock
Only 34% of the British people are opposed to holding another referendum
Brexit still weighing on the pound
A -25% depreciation of the currency is possible in the event of a “no deal”
Worrisome threats to GDP
-10.5% decline in GDP and -30% drop in real estate prices in the event of a “no deal” according to the BOE
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Theresa May will play her last card in January

The British prime minister, Theresa May, returned from Brussels with an agreement in her suitcase, whose ratification by Parliament she was rather smugly hoping to obtain. In this sense, she once again underestimated the risk that her strategy would fail vis-à-vis British MPs, before ultimately grasping the risk of a wholesale rejection and postponing at the last minute the vote planned for 11 December. After this political defeat, she was then barely confirmed as PM after a vote of confidence organised by her party, which puts her

in far from an excellent position to carry out her policies and negotiations with the EU. She remains doomed to try again and again to find a solution to the Brexit conundrum with her European partners, who have made clear their lack of interest in renegotiating the agreement. Over the next few weeks, Theresa May will continue to seek to obtain assurances with regard to the issue of the physical border between Ireland and the British province of Northern Ireland in final attempts at conciliation, seemingly increasingly in vain. Indeed, the European Council is weary of the negotiation process, which is constantly bumping up against dissension among various factions in the Conservative Party in the UK, undermining the Brexit process.

What is now the real likelihood that an agreement will be reached amongst the parties?

Time may be up for Theresa May, who cannot bring herself to resign and who is certainly not being pushed in this direction, possibly due to the lack of enthusiasm demonstrated by those who could or should take up the challenge in her stead. Indeed, no one is hastening to replace her and take on the responsibility of managing this unique crisis with possibly dramatic consequences for the UK. Even those who fanned the flames of populism and fuelled resentment against the EU are not keen to take up the torch. Theresa May might well continue until the end to refuse to put forward the only alternative to a defeat that seems more and more likely in March, that is, a new referendum.

In reality, Theresa May no longer has any counterparty with whom to renegotiate her “agreement” and will certainly not be able to count on a “miracle” before facing MPs between 14 and 20 January 2019, when she will play her last card, following which Parliament will likely reject the proposed agreement. Uncertainty is thus at an all-time high as 2018 comes to a close. Over two years after Brexit

garnered 52% of votes in June 2016, the government is still not ready to obtain the approval of Parliament to implement the people's decree. The January vote will occur only a few weeks before the deadline, and the risks of a "no deal" have never been as high. While the worst case scenario is certainly not a given, the prime minister does not have a plan B that could save the UK from what would likely be a brutal shock if this scenario were to come to pass.

Why not consider a plan B?

The prime minister considers herself responsible for carrying out the will of the people and will likely never deviate from her trajectory. She was appointed prime minister to implement Brexit and will likely reject any initiative or proposal that would deviate from her mission. We had already brought up, several months ago, the notion of a second referendum to break the deadlock in which the Brexit vote had placed the UK, and this is now increasingly frequently mentioned as the plan B the country needs to counter a conclusive defeat of the strategy doggedly pursued by Theresa May. Just recently the latter flatly rejected any notion of organising a new referendum, whatever its source. Indeed, she seems convinced that this solution would go against her commitment to the British people – a failing and a betrayal that could call into question, irreparably in her view, the integrity of political life in the future. She seems ever more certain that a new referendum would be even more divisive, just as the country needs more unity. It is surprising that she does not realise that Brexit is precisely what has most divided the country. Doomed to pursue a single path, she will not explore the only possible alternative before a defeat in January spells the end of her project.

Absent a swift reaction, the struggle will continue, and the UK will be faced with two possible outcomes: an unsatisfactory project likely to be rejected and a brutal withdrawal from the EU without an agreement and with even more dramatic consequences. The prime minister seems to have deliberately decided to stall in order to force Parliament to accept a last-minute agreement to avoid a leap in the dark.

New referendum to break the deadlock

Theresa May is more than ever opposed to organising a new referendum, although the latter is increasingly clearly the only viable alternative. With regard to Labour, former prime minister Tony Blair chimed in to criticize the prime minister's irresponsible strategy, which he claims forces MPs to accept an agreement that

they consider bad, leaving only a "no deal" as an alternative. However, the clock is ticking, and if the deal fails as expected, a referendum will become the only realistic solution to avoid in extremis an abrupt break from the EU with no safety net. Polls are showing that close to 48% of British voters want a new referendum against 34% who do not. The British would vote differently today given the uncertainty that has been weighing on the future of the country and its economic prospects for over two years. While 700,000 people gathered in London to demonstrate their support for a new referendum, no fewer than 53 MPs also support this idea.

"What the people have done only the people can undo" – perhaps a useful maxim to justify a complete reversal in attitude, which could well offer a simple solution to the conundrum British politicians have been puzzling over for months without finding an acceptable solution.

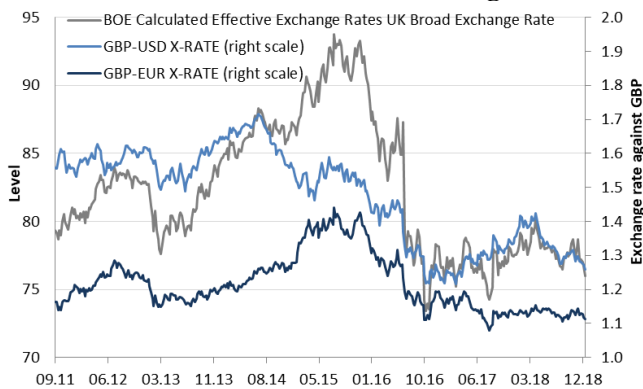
Part of British civil society has already taken a position on the issue and wishes to organise another referendum. A vast majority of British firms fear the consequences of a withdrawal from the EU. Other figures from across the political spectrum, such as the Labour mayor of London, Sadiq Khan, John Major (Conservative) and Vince Cable, leader of the Liberal Democrats, are all convinced that Brexit is not inevitable and could be stopped. Within the Labour Party, Jeremy Corbyn is now open to another referendum, in this sense following an overwhelming majority of the members of his party favourable to this proposal and who would vote in favour of staying in the EU. With regard to the majority party, Conservative Europhiles are making their voice heard and venturing to suggest the notion of a new vote on Brexit. Even the finance minister, Philip Hammond, seems to be admitting that remaining in the EU would be preferable to withdrawing. Labour's new position could well enable a composite majority to yield a different result and break the deadlock. However, we will likely have to wait until the end of January and the rejection of Theresa May's agreement for all conditions for a new referendum to be met. It may then perhaps not be easy to organise it before the 29 March deadline, but let us wager that to solve this problem via a new popular vote the EU will be willing to grant an extension. Speaking openly of a plan B amounts almost automatically to killing plan A, but the European Commission is no longer hiding its concern and is preparing member States for this contingency.

Brexit still weighing on the pound

For over two years the pound has been hostage to the complex political situation that has been generating uncertainty with regard to the UK's economic outlook. We still believe the pound has entered a stabilisation phase against most major currencies following its historic

fall in the wake of the June 2016 vote pending better visibility on the political front. A “no deal” scenario in three months would certainly be the most dramatic for the British currency, which would likely not withstand the hit and could fall another -10% to -25% (worst case scenario according to the BOE).

Effective and dollar/euro exchange rate



Sources: Bloomberg, BearBull

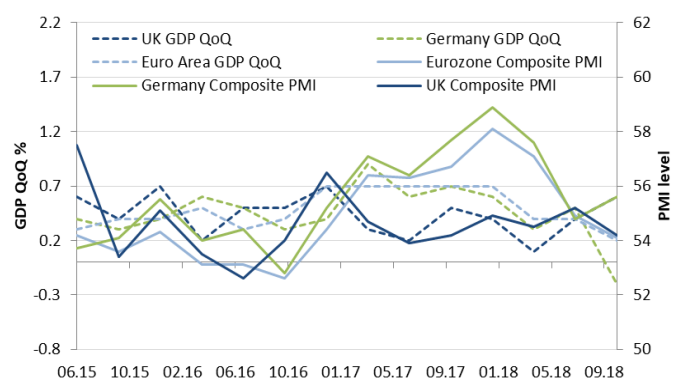
This expectation is back in full force, as shown by the recent -4% correction of the pound against the euro and the dollar. However, increasing willingness of the British over the next few weeks to organise a new referendum could help prop up the pound somewhat. Nevertheless, we are not anticipating the trend to be favourable over the next three months, unless plan B clearly becomes the solution to ending the crisis.

Worrisome threats to GDP

On the economic front, the numbers should convince MPs to accept the agreement negotiated by Theresa May, which would be less dramatic than a “no deal”. A report presented to the government in November noted that withdrawing without an agreement would exact a cost of 9.3% of British GDP over 15 years, or approximately twice the 3.9% estimate attached to the prime minister’s project. The BOE also noted that GDP could be short 7.8% to 10.5% by 2024 compared to what it would have been without Brexit, evoking an increase of the unemployment rate to 7.5%, an upturn of inflation to 6.5% and a dramatic -30% fall of real estate prices. Even if negotiations were successful, the BOE is anticipating an impact of -1.2% to -3.8% over five years. As the British wait for the crisis to be resolved, they are likely less than comforted by these figures. Unsurprisingly, uncertainty is on the rise and eating into the confidence levels of various economic agents. While Q3 GDP was up +0.6% or +1.5% yoy, figures for the past months suggest an increasingly clear loss of momentum as the year draws to a close. The three-month growth rate at the end of October was only +0.4% due to a much weaker month of October (+0.1%). The somewhat better performance

of the service sector (+0.2%) helped avoid economic stagnation, as most majors sectors were showing declining activity. The manufacturing sector contracted by -0.9% in October (-1% yoy), slightly more than industrial production, which was down -0.6% (-0.8% yoy). In spite of a weak pound, exports (+0.8%) did not grow sufficiently to make a positive contribution, while the trade balance (-11.9 billion pounds) deteriorated following a revision of the initial figures, due to the rising cost of imports (+3.5%). The services balance (8.6 billion) helped decrease the overall trade deficit to 3.3 billion pounds.

Quarterly GDP and PMI UK – Eurozone – Germany



Sources: Bloomberg, BearBull

PMI indices nearing the growth threshold

Just a few months from the deadline for the UK, the British economy remains plagued by uncertainty. The slowdown is increasingly significant and is likely to worsen, if leading indicators are to be believed. The services PMI dropped from 56 in December 2016 to 50.4 in November, close to the growth threshold, its lowest level since June 2016, pointing to growing concern as the deadline nears. The manufacturing PMI ticked up slightly to 50.7, helping the composite index remain above the 50-point threshold. GDP growth in Q4 could be limited to +0.1%.

The UK economy’s growth prospects thus diminished further, confirming that an upswing at the end of the year or in Q1 2019 seems unlikely.

BOE still in wait-and-see mode

After the 0.25% rate hike in August, we expected the BOE’s monetary policy to remain stable at least until the end of the year. The BOE will likely be reassured by the recent decrease in the inflation rate, which is trending back down toward its 2% target. The CPI index fell to 2.4% in November, while core inflation (ex food and energy) dropped to 1.9%. The BOE’s reference rate (0.75%) will remain unchanged at least until closure is

reached with regard to Brexit in March 2019. Members of the MPC still seem confident that the issue will be resolved favourably and expect possible positive surprises with regard to growth, justifying their predictions of further rate hikes in 2019.

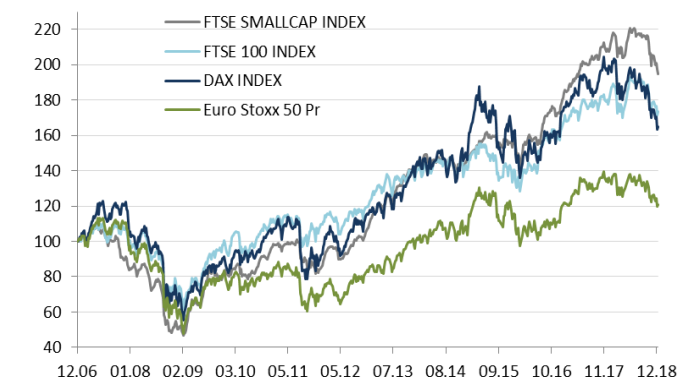
Poor prospects for pound-denominated bonds

The latest inflation figures now seem set to stabilise close to the BOE's target rate. In the UK's current context, short-term rates will remain stable, but long-term rates could still follow the downward trend seen in international bond markets in the past several weeks. Indeed, the overall global environment is also affected by the uncertainty regarding the tariffs issue and the risk of a yield curve inversion in the US. UK government bond yields participated in this trend, sliding back approximately 25 basis points on most maturities. However, we estimate that, from the point of view of foreign investors, the yields seen on the pound-denominated bond market do not compensate for the risks resulting from a possible breakdown of negotiations and a "no deal" withdrawal from the EU. The currency risk is high and is obviously not offset by a 10-year yield of barely 1.5%. The British bond market is thus currently not offering attractive prospects.

Stay cautious on equities

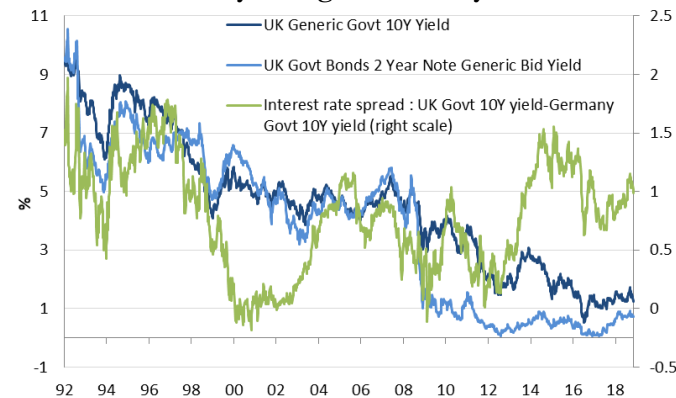
Given the continuing uncertainty surrounding Brexit, the equity market's expected risk/return ratio remains unattractive. While the pound seems to be withstanding this uncertainty, we continue to recommend caution with regard to British equities, in spite of reasonable valuations and attractive dividend yields.

UK (large, small), Eurozone, German equities



Sources: Bloomberg, BearBull

10- and 2-yr UK government yields



Sources: Bloomberg, BearBull

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BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae