Economic Research

WEEKLY ANALYSIS

Alain Freymond
Partner & CIO

24 September 2019

Supreme Court reduces threat of no-deal Brexit

GDP down -0.2% in Q2. Real risk of recession. Likelihood of no-deal withdrawal decreases. BOE in wait-and-see mode. Possible upswing of long-term sterling rates.

Key points

- Boris Johnson's strategy defeated by the Supreme Court
- Threat of a no-deal Brexit diminishes
- A technical recession might be avoided following the -0.2% decline in GDP in Q2
- The risks of recession are real
- Still no sign of optimism from leading indicators in August
- Consumers also worried about uncertainty
- Brexit outcome will determine the BOE's strategy
- Reduced likelihood of rate hike
- Real estate market stabilisation
- Capital markets less attractive
- The key question for the pound's valuation is: What sort of Brexit?
- Uncertainty persists with regard to equities and real estate

Boris Johnson's strategy defeated by the Supreme Court

A few weeks after taking office, Prime Minister Boris Johnson seized power, suspending Parliament until 14 October or just two weeks before the Brexit deadline, in an attempt to postpone debate until after the Queen's speech presenting the government's agenda precisely on 14 October, namely just three or four days before the European Council meeting on 17 and 18 October. In theory, if Boris Johnson managed to thrash out an agreement before this date, Parliament would have time to ratify it.

While the UK Parliament is traditionally on break for several weeks in September due to the various political party conferences, the suspension decreed by Boris Johnson was going to prolong this break well beyond the last conference of the Conservative Party. The Supreme Court ruled this decision to be unlawful, thus dealing a severe blow to the PM. Parliament will thus reconvene on Wednesday, 25 September, and will be able to deliberate and organise urgent debates about Brexit.

The situation will thus not remain at a standstill, as Boris Johnson had hoped, and the PM is already bringing up the possibility of new elections. Given this context, the likelihood that the UK will withdraw without a deal on 31 October has diminished but nevertheless remains high. It is not certain that the reduced "political time" will enable the UK's political class to counter the Prime Minister's stated determination to leave the EU with or without an exit agreement.

The odds of such an agreement now seem increasingly low, following the Prime Minister's latest trip to Luxembourg, which turned into a diplomatic fiasco, as London rejected the EU's request that the UK government present a written proposal avoiding a no-deal withdrawal before the end of September.

The EU's ultimatum was obviously rebuffed. Thus, even though the President of the European Commission, Jean-Claude Juncker, had joined the UK Prime Minister in stating his determination to reach an agreement, an abrupt withdrawal seems to be the most likely scenario on 31 October, unless a further extension to Q1 2020 is ultimately granted by the EU at the last minute.

A technical recession might be avoided following the -0.2% decline in GDP in Q2

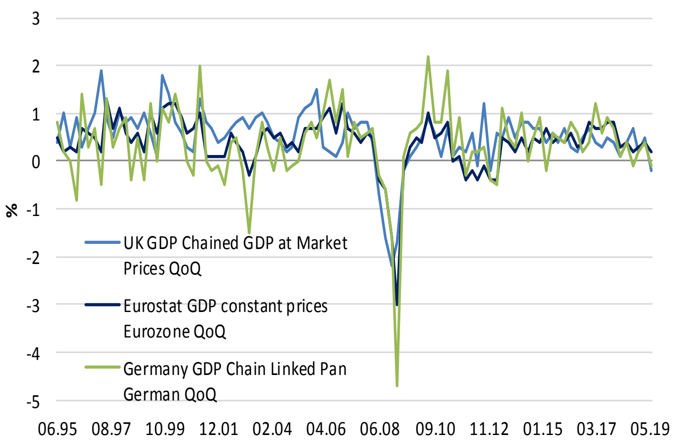
The British economy posted its first quarterly contraction since the end of 2012. Following seven years of growth, GDP finally felt the impact of the uncertainty tied to Brexit, dropping by -0.2%. On an annual basis, GDP still expanded by +1.2%, which is nevertheless significantly lower than its performance in March (+1.8%). Businesses that had built up inventory ahead of a withdrawal which they initially expected to happen at the end of March started to reduce inventory in Q2, which was detrimental to the GDP tally for the period.

Consumption and government spending progressed by +0.5% and +0.7%, respectively, while investment (-1%) and exports (-3.3%) fell. However, a technical recession seems unlikely, even though uncertainty remains very high just days away from the current Brexit deadline.

Indeed, the UK economy seems to have fared relatively well in July and August according to initial estimates.GDP was up +0.3% in July, raising the economic growth rate from -0.2% to zero over three months. These results are surprising, as GDP was forecast to grow by only a very slight +0.1% in July. The manufacturing sector as well as services and construction all participated in the upturn, posting stronger performances than expected, with a surge of momentum in manufacturing in particular and a strong showing by the service sector (+0.4%).

Indeed, momentum grew in the economy overall, dampening the immediate threat of recession thanks to upswings in industrial and manufacturing output of +0.1% and +0.3%, respectively. Construction also posted an increase of +0.5%. Results also seem to have improved in August, thus possibly pointing to growth of +0.2% to +0.3% in Q3.

UK GDP quarterly growth

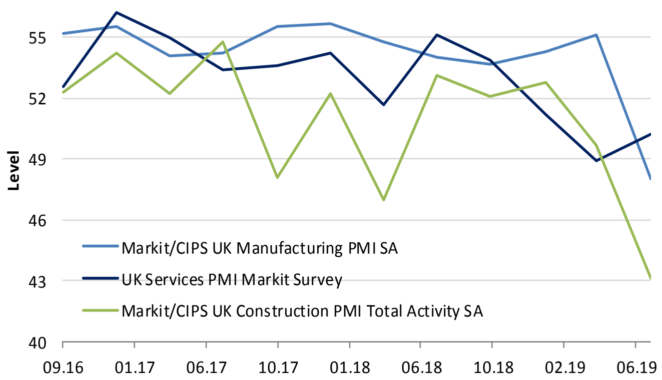


Sources: Bloomberg, BearBull

Still no sign of optimism from leading indicators in August

In spite of this stronger economic performance in July and August, the manufacturing PMI for August slid back yet again from 48 to 47.4 for the fourth consecutive quarter. The new orders index also reached its lowest level since July 2012. Brexit is not solely responsible for this decline, as the internationally-oriented segment of British manufacturing is also feeling the effects of the global slowdown tied to the uncertainty resulting from the trade dispute between China and the United States. Nevertheless, a growing number of businesses are modifying their production chain ahead of Brexit. In terms of the UK economy overall, months seem to be going by with no clear solution in sight to the political crisis, which is exacerbating the feeling of uncertainty among businesses and consumers. The service PMIs also fell significantly in August (50.6), leaving barely any margin above the 50-point mark separating growth from economic contraction.

Manufacturing, services, and construction PMIs

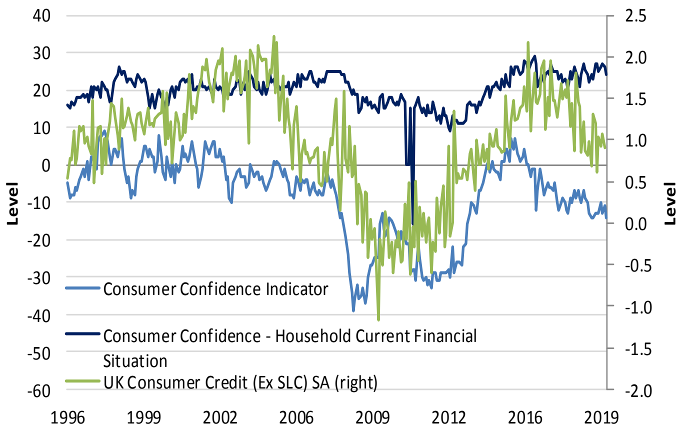


Sources: Bloomberg, BearBull

Consumers also worried about uncertainty

British consumers remain relatively worried, and rightly so, following a summer rife with uncertainty and given the unending political crisis surrounding Brexit. Household confidence fell once again to a six-year low in August. While yoy wage growth was particularly satisfactory until July (+3.8%), jobless claims increased significantly, giving rise to some uncertainty. The unemployment rate continued to decrease, from 3.9% to 3.8%, but job creation declined from 115,000 to 31,000 in July, reinforcing a feeling already widely shared among the population that the situation is rather precarious. In September, yoy real estate price growth was once again close to zero, which is unlikely to help improve household confidence. Moreover, the upswing in inflation in August (+0.4% over a month) and the increase in retail prices (+0.8% over a month) will bite into consumers' purchasing power and depress confidence indices.

Consumer confidence



Sources: Bloomberg, BearBull

Brexit outcome will determine the BOE's strategy

As expected, the Bank of England did not change its monetary policy at its more recent meeting in September. The nine members of the Monetary Policy Committee voted unanimously to keep rates steady at 0.75% and maintain its asset purchase objective of 435 billion pounds. The GDP growth forecast for Q3 was reduced from +0.3% to +0.2% and the inflation forecast was revised down to 1.6%.

The political uncertainty surrounding Brexit is still hampering any decision and action by the BOE, which will proceed differently depending on the scenario that will ultimately materialise on 31 October or in the following months if talks are unexpectedly extended once again.

Should the UK withdraw with an agreement, the growth outlook will likely be revised upward, and given the current rate of inflation, interest rates could rise. However, we do not expect the BOE to act swiftly, as it will likely want to observe the impact of an agreement on confidence, growth, and inflation, before acting in a way that will likely be very deliberate either way. In the event of a no-deal exit on 31 October, the BOE will be compelled to act, cutting rates in an attempt to counter the negative impact of a brutal divorce on the UK economy. The costs associated with Brexit uncertainty have been estimated to amount to 2% of GDP growth since 2016.

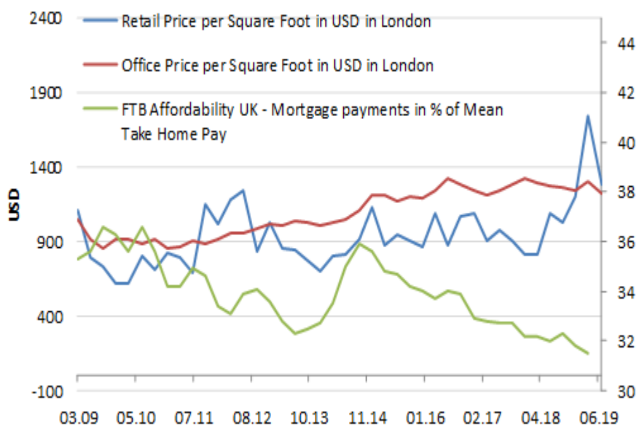
The question of what sort of Brexit will be implemented is thus now more important than the direction of inflation, which has been steadily decreasing in spite of the pound's depreciation. Inflation dropped from 2.1% to 1.7% yoy in August, while core inflation fell to 1.5%. As for producer prices, they stabilised at 2%.

Real estate market stabilisation

Real estate prices continue to trend up, increasing by +0.3% in August according to Markit/Halifax's updated calculation methodology. However, yoy price growth has slowed to a mere +1.8%. Another measure of price growth published by Nationwide Building Society already seems more pessimistic, showing yoy price growth of barely +0.6%. While monthly data has been somewhat volatile in 2019, the real estate market has stayed resilient until now despite the mounting uncertainty resulting from Brexit.

In the absence of any agreement with the EU, investors will likely remain worried, although the imbalance in the real estate market, with excess domestic demand, will remain favourable, especially if borrowing costs remain as low as they are today and if job market conditions remain robust. Wage growth has stabilised, and mortgage rates are still at historic lows. Mortgage approvals rebounded in July, reaching 67,300 mortgages approved, the highest level seen since Q3 2017. The situation in London is somewhat different, however, with more negative price trends and more significant price drops.

Real estate prices per square foot

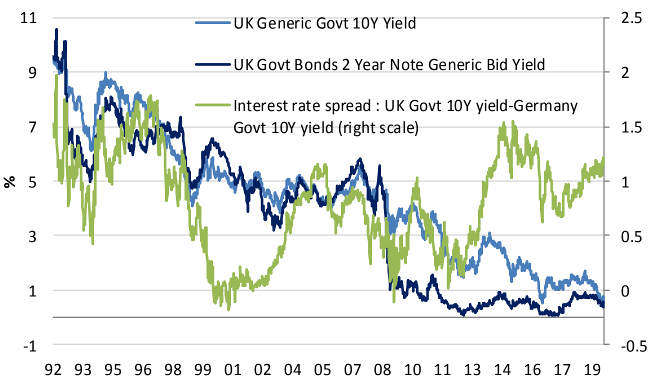


Sources: Bloomberg, BearBull

Capital markets less attractive

The drop in long-term interest rates in the UK has been particularly severe over the past several months. The fall from 1.6% in September 2018 to only 0.4% at the end of August 2019 took place in the context of generalised fear around the world regarding US and global growth. It was exacerbated by economic conditions within the UK and increasingly high risks of recession in the country. The uncertainty tied to the absence of a solution to the Brexit conundrum and the risk of a genuine collapse of economic activity in the event of a no-deal withdrawal thus pushed long-term rates below the lows reached just after the 2016 referendum.

10-yr and 2-yr UK government yields



Sources: Bloomberg, BearBull

Pound-denominated capital markets are not attractive in the current context marked by political risks that are difficult to evaluate. A no-deal exit would plunge the UK into a unique situation with unpredictable consequences. The BOE would be forced to act to attempt to tamp down, if at all possible, the risks of a recession, whose magnitude and duration are obviously not easy to estimate. The likely outcome for the British currency would initially be negative.

Thus, the risk of holding pound-denominated bonds seems high given the significant FX losses that would ensue. If on the other hand an agreement became possible, the risks of recession would abate, and long-term rates would then likely gradually rise and the pound may stabilise. Given the uncertain context, we recommend that international investors avoid any exposure to pound-denominated capital markets and take positions in other bond segments.

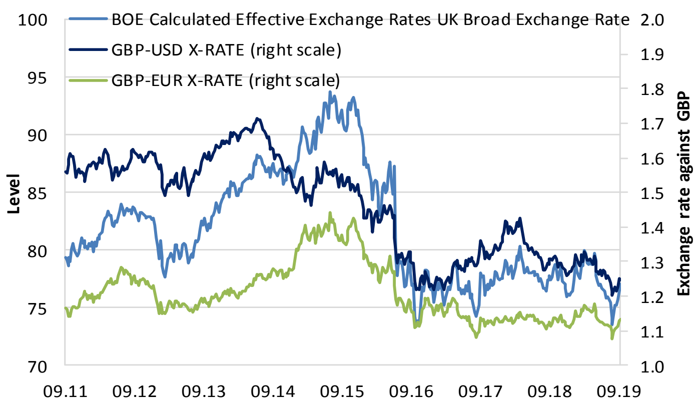
The key question for the pound's valuation is: What sort of Brexit?

The pound remains impacted by the complex political situation that will determine whether Brexit will be brutal or whether a negotiated solution will help manage or limit the effects of a withdrawal from the EU. The latest development regarding this political impasse is the Supreme Court's decision to rule unlawful Prime Minister Boris Johnson's attempt to suspend Parliament.

This decision could well push Boris Johnson to call for new elections. In this context, we maintain a cautious position with regard to the pound.

We had predicted that the pound would likely drop below its December 2018 level of 1.25 against the dollar, and indeed the pound reached a short-term low of just under 1.20. However, we believe that there is a higher likelihood that the pound will stabilise above 1.24 if the likelihood of a no-deal scenario recedes once Parliament reconvenes on Wednesday, 25 September.

Effective, dollar, and euro exchange rates



Sources: Bloomberg, BearBull

Uncertainty persists with regard to equities and real estate

In this persistently uncertain environment, the equity market's expected risk/return ratio does not seem attractive. While pressure on the pound could abate somewhat given the government's political setback, instability remains high.

We thus continue to recommend caution on UK equities, in spite of reasonable valuations and attractive dividend yields. With regard to securitised real estate, the risks of further deterioration of market conditions seem high enough to us that we recommend staying in wait-and-see mode. Recall that the BOE had mentioned that real estate prices might drop by 25% in the pessimistic scenario of a no-deal Brexit.

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