The long and winding road

The reality of Brexit has the U.K. embarking on a lengthy and uncertain journey.

Frédérique Carrier
The long and winding road

The Brexit vote has opened Pandora’s box. One question has been answered only to be replaced by a myriad of unknowns. While the U.K. voted against the EU, it is unclear what exactly it has voted for. The collapse of political leadership adds a significant new complication that won’t be resolved until autumn (if then) with the election of a new prime minister. Whatever the political resolution, the new shape of the U.K.’s relationship with the EU will not be known for many years. This will weigh on the U.K. economy and is likely to periodically rattle financial markets for some time to come.

Perfidious politics

Having made the momentous decision to leave the EU, the U.K. is in the grips of intense political uncertainty.

Prime Minister David Cameron, who had campaigned for “Remain,” decided new leadership would be needed to take the country down the Brexit path and immediately resigned. A new prime minister will be chosen by all Conservative Party members by September 9. The leadership campaign will be inextricably linked to:

- Discussions regarding the timing of triggering Article 50 of the Lisbon Treaty, the mechanism to start the exit negotiations. EU officials are adamant that no negotiations will start (not even soft ones) without this. Article 50 sets out a two-year deadline for the terms of departure to be agreed to by all other 27 EU countries.
- The shape of negotiations concerning the new model the U.K. wishes to seek to adopt.

The Conservative Party may have a relatively free rein in forming this strategy as the Labour Party is in disarray, depriving the country of a credible opposition. The Labour leader, blamed for a poor endorsement of the Remain campaign, has so far resisted a vote of no confidence. Here too, a new leader may emerge.

Many are referring to this as the worst political crisis since the Second World War.

A roadmap to Brexit

Despite uncertainties and unanswered questions, it can be useful to map out a plausible process which could unfold as the U.K. reshapes its relationship with the EU.

The process will begin with the election of a new Conservative leader and prime minister (PM) by September 9. While members of parliament (MPs) will conduct the initial vote, the new PM will be chosen by the 150,000 Conservative Party members, the large majority of whom voted for “Leave,” according to polls such as that conducted by ConservativeHome. It is reasonable to expect the new PM will thus seek to implement the result of the referendum.
The new PM could either unilaterally trigger Article 50 or seek parliamentary approval for submitting the request to leave the EU. Given the referendum was not legally binding, it is more likely parliamentary approval would be sought.

How the 650 MPs vote would then be crucial. As the chart below shows, the House of Commons is largely pro-Remain. However, Conservative MPs are expected to support their leader and regard the 51.8% referendum vote for Leave as expressing “the will of the people.”

<table>
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<th>Party</th>
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Conservative MPs are expected to view the Leave win as expressing “the will of the people.”

However, a confidence vote and potentially a new general election are possible should a small number of Conservative MPs rebel against their leader and vote according to their own personal preferences, on the grounds that the vote was won by too narrow a majority. Observers assign a low probability to this outcome.

Once Article 50 has been triggered, negotiations regarding the exit would ensue shortly after. These should take two years, though an extension is likely. With general elections in France and Germany in 2017, European leaders may want to stall the negotiations.

While the U.K. may be willing to start negotiating the terms of the new relationship once a new prime minister has been installed in September, the EU has ruled out even soft negotiations until Article 50 has been formally activated. The U.K. does not have a strong negotiating position given it loses several trading relationships representing half its exports in one go, while the EU loses only one. The EU sends a mere 10% of its exports to the U.K.

Brexiters currently aim to maintain access to the single market while restricting the free movement of labour, a key pillar of the EU, and without contributing to the EU budget. There is no precedent for such an arrangement, and it is difficult to see how this may be agreed to early or quickly, if at all. The EU will not wish to set a precedent which could encourage other EU members to seek changes to existing agreements.

A compromise will eventually have to be forged. The longer the delay in triggering Article 50, the more the reality of an untethered Britain may sink in, possibly making a compromise easier to reach. The U.K. could opt for membership of the European Economic Area (EEA), the so-called Norway model, retaining access to the single market in exchange for a contribution to the EU budget and free movement of labour. It would have no say in EU politics. Many question the
advantage of that arrangement over the previous model, though it would be the least damaging to the U.K. economy.

Alternatively, the U.K. could be adamant about rejecting the free movement of labour and accept restricted access to the single market (i.e., excluding some services or some goods).

Once negotiations with the EU are concluded, all remaining 27 EU nations and the U.K. will have to ratify the outcome, either through their respective parliaments or by referendum. This will be a challenge.

Whatever path is taken, a time limit could be imposed, perhaps five to 10 years, after which the U.K. could decide to continue with the arrangement or opt out of the EEA and seek a complete exit through bilateral agreements. Other options may be available then.

The negotiation process with the EU, due to its opacity, will create deep uncertainty. We expect the negotiations to be lengthy, tricky, and to weigh on economic activity.

Moreover, other negotiations will need to take place. The U.K. will have to negotiate trade arrangements with over 50 countries that the EU has trading relationships with as they will no longer apply once the U.K. exits the EU. The government no longer has a deep pool of expertise to deal with trade issues.

Brexit timeline

Key scheduled elections in Europe

- **Election of a new prime minister**
- **Triggering of Article 50** or **Seek parliamentary approval to trigger**
- **Negotiations for terms of exit**
- **Negotiations for new relationship**
- **Member of the EEA; i.e., Norway model**
- **Restricted access to the single market**
- **Once negotiations are over, 27 nations and the U.K. must legislate the change; parliamentary majority or referenda needed.**
- **Continue arrangement or not?**

Source - RBC Wealth Management
given the EU has long handled these matters. The newly established Brexit Unit of the U.K. government will have its work cut out.

**Slippery slope economy**

Given the lack of clarity on the path ahead, there is an unusual amount of risk attending any economic forecast. Nevertheless, one can surmise that this level of uncertainty will dampen growth.

A mild recession in the U.K. should begin in the second half of this year, in our view. Business investment, already weakening prior to the vote, is likely to deteriorate even more. The most recent construction PMI fell further than anyone had expected (to 46 from 52). Hiring decisions are likely to be postponed, while households may hold back on purchases. Upcoming data will be closely scrutinised.

**U.K. CFOs are growing more cautious**

Sam Hill, RBC Capital Markets, LLC’s senior U.K. economist, has lowered his 2016 GDP growth forecast to 1.4% from 1.8%. For 2017, he expects GDP growth of 0%, down from 2.1% previously. Forecasts are likely to be revised as the Brexit process becomes clearer.

**GDP growth grinds to a halt**

A mild recession is likely in the second half of 2016.
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With the growth background threatened, the Bank of England (BoE) has been quick to say it will step in, as widely expected. RBC Capital Markets expects the Bank Rate to be cut to 0.25% in July and an additional cut to 0.10% in August, accompanied by a £50B increase in asset purchases, bringing the quantitative easing (QE) programme to £425B.

With the currency weakening—GBP/USD has plunged more than 12% since the vote, hitting a 31-year low—inflation would be expected to increase. In the 2007–08 financial crisis when the pound fell 30% against its trade-weighted average, inflation rose to 5%. In the current environment Hill expects U.K. inflation to climb to 3%. Any increase may prove transient as the deflationary effects of the economic slowdown take root.

Despite a weaker pound boosting exports, lower business investment could lead to a sharp deterioration of the balance of payments. The U.K. runs a current account deficit of over 5% of GDP, the largest in the developed world. This has been financed largely by foreign direct investment (FDI), for which the U.K. has been a prime destination thanks to the lure of unrestricted access to the EU market of 500 million people, the country’s flexible labour laws, and a well-functioning judiciary system.

Should FDI dry up, the currency will have to weaken further to redress the balance. The impact of exchange rate depreciation should boost the U.K.’s net trade position, but this is unlikely to fully offset the drop in business spending.

In the longer term, the effect on the economy could be more moderate though not insignificant. Eric Lascelles, chief economist at RBC Global Asset Management, expects higher tariffs, less immigration, and the slight diminishment of London as a financial hub could shave as much as a quarter percentage point off growth annually over the coming decade. Potential savings on transfers to Brussels and greater regulatory sovereignty may help but are unlikely to compensate for these factors completely.

Any assessment significantly depends on the new relationship the U.K. is able to negotiate with the EU.
A number of other factors could further weigh on growth:

- Scotland holding another referendum on independence, as First Minister Nicola Sturgeon seems to intend, would add further uncertainty.
- A negative feedback loop, as slower growth in Europe due to Brexit feeds back into the U.K. economy.
- Whether the new PM appoints a new chancellor of the exchequer with a more stimulative approach.

**Financial markets**

Due to the uncertainty regarding the U.K.’s extrication from the EU, we are now adopting a more cautious stance regarding fixed income and equities in the region. We have also lowered our expectations for the pound. Concerted central bank action could play against this view and rallies in oversold markets are possible.

**Currency**

We have moved to a negative outlook for sterling. Discussions on the shape of the U.K.’s position on issues, such as trade, will greatly affect the degree to which sterling declines further from here. Our base case is for GBP/USD to reach 1.20, though a full-blown balance of payment crisis could drag the currency down further, perhaps to as low as 1.10–1.15.

We expect EUR/GBP to move higher as the euro should weaken, though not to the same extent as the pound. While economic activity in the EU has been stronger than in the U.K. recently, investors are concerned that given its links to the U.K., European economic activity will not escape unscathed. We expect EUR/GBP to peak somewhere near 0.8600 over the next year or so.

**Fixed Income**

The 10-year Gilt now trades with a yield of 0.74% (as of July 6)—almost 60 basis points lower than pre-Brexit. With the U.K. growth outlook weakening, BoE Governor Mark Carney was swift to reassure markets that monetary policy will be accommodative during this period.

Credit rating agencies S&P, Moody’s, and Fitch have all made downward adjustments, with S&P removing the U.K.’s AAA rating. Questioning the stability and effectiveness of policymaking, S&P is concerned over external financing conditions and retains a negative outlook. A further downgrade could be on the table.

U.K. corporate bonds have suffered. Domestic banking names have been the most affected along with those corporate issuers with a heavy U.K. focus. Corporate bond exposure should be re-evaluated across currencies, specifically around U.K. banks and retail-focused companies where the outlook for U.K. growth looks unclear.

**Equities**

We are retaining our Underweight position for U.K. equities while also adopting a more defensive stance in our equity selection.

The weaker pound will benefit USD earners and exporters, such as Pharmaceutical companies and Consumer Staples.

Investors may seek refuge in commodity plays. However, we would note that while the weak pound may be a tailwind, unless commodities markets fully
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The weaker pound will benefit USD earners and exporters; we are cautious on U.K. domestic cycicals. reassert themselves, many in this sector are likely to continue to endure cash flow difficulties which may imperil dividends.

We are more cautious on domestic cycicals, particularly those facing weaker demand as well as a higher cost of raw materials if paid for in USD. However, a great deal may already be discounted. Sharp price movements may present opportunities for investors who can withstand heightened volatility over a longer-term horizon.

Our approach towards banks is guarded. Margins will likely be suppressed by lower for longer interest rates. A recessionary environment may lead to an increase in nonperforming loans and provisions. As a result, less capital generation could endanger banks’ capital adequacy position, which in turn would limit their ability to remunerate shareholders.

Adapting ... again

The Brexit vote has changed the course of history for the U.K. But the country is no stranger to these abrupt changes. The loss of the thirteen colonies in the 18th century heralded a period of instability for the U.K. before it recuperated. As politicians begin to unravel the current relationship with the U.K.’s largest export market, the domestic economy will bear the brunt of the change and ensuing uncertainty. It will take several years before a new relationship is established. For now, we adopt a more cautious view of sterling, U.K. domestic fixed income, and equities.
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