# IE

27 March 2018
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# Global investment event

## UK: Brexit transition deal agreed, but uncertainty remains

- Leaders at the European Council meeting have approved certain terms of the UK's withdrawal from the European Union (EU), including a 21-month transition period after March 2019
- This significantly reduces the risk of a 'hard-Brexit' scenario of an EU exit with no new trading relationship in place
- However, the transition period remains dependent on a final withdrawal treaty being ratified before March 2019. A key sticking point is how to avoid a hard border in Ireland
- Even with the deal, we believe the UK is likely to remain an economic underperformer. We think current valuations remain consistent with a neutral stance in **UK equities**
- We remain underweight in **UK gilts**, where prospective returns remain poor and the Bank of England is gradually tightening policy, along with other major central banks

## UK-EU agree transition deal…

Leaders at the **European Council meeting** have approved certain aspects of the UK's withdrawal from the EU. This includes the terms of a transition period following the UK's official departure from the bloc on 29 March 2019.

The **transition period will last until 31 December 2020**, during which time the UK will remain in the customs union and single market. The UK will be able to negotiate new trade deals.

Ultimately, the agreement significantly reduces the risk of a 'hard-Brexit' scenario of the UK exiting the EU with no new trading relationship in place. This is particularly important for UK/EU businesses, who have faced months of uncertainty following the Brexit vote in June 2016.



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## …but tough negotiations lie ahead

The deal gives Brexit negotiators more time to establish the terms of the new UK-EU relationship. However, there are reasons for caution.

The transition period remains dependent on the ratification of a final withdrawal treaty before March 2019. A key sticking point remains the issue of how to avoid a hard border in Ireland. The UK is pushing for a departure from the customs union, which will require customs inspections for goods entering the UK. An upcoming House of Commons vote on maintaining some form of a customs union will be important in this respect.

During the transition period, the UK will also remain under the EU Common Fisheries Policy, allowing continued EU access to UK waters. Eurosceptic politicians in the UK have raised concerns over this, and have threatened to vote against the final treaty.

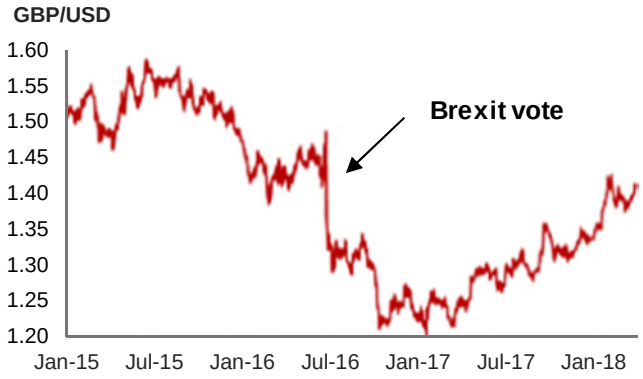
Finally, although talks on a new trade deal will begin soon, the EU is not expecting detailed negotiations to start before March 2019. Therefore, the transition period may need to be extended, although there is no extension clause in the current agreement.

## Market considerations

Although the transition deal reduces some near-term Brexit uncertainties, there is still a chance the deal could fall apart, whilst the longer-term UK-EU relationship remains fundamentally unclear. This will continue to dampen “animal spirits” in the UK economy, and likely translate to continued softness in business investment.

More positively, however, the recent recovery in sterling – in part due to progress with Brexit negotiations (Figure 1) – should help keep inflation on a gradually downward path this year. Indeed, the February CPI inflation prints saw a larger than expected fall to 2.7% yoy on the headline measure. This should relieve some of the pressure on squeezed household budgets.

**Figure 1: Sterling has gained amid progress in Brexit talks**




Source: Bloomberg, as at March 2018

Yet, overall, the UK is likely to remain a relative laggard in terms of economic growth, and we think the prospective reward to bearing **UK equity** risk remains unattractive compared to other markets (particularly the eurozone and Japan). Therefore, we retain our neutral stance in this asset class.

Meanwhile, similar to other developed market government bonds, prospective returns for **UK gilts** continue to look poor. The monetary policy backdrop is also unfavourable. With inflation above target, the lower risk of a “hard-Brexit” may keep the Bank of England on a path of gradual policy tightening.

At their meeting this week, the Monetary Policy Committee (MPC) continued to argue that a tight labour market and low levels of spare capacity will feed into greater domestically-generated inflationary pressures. This view may be supported by data released this week showing a larger than expected gain in wage growth in the three months to January. This raises the possibility of a rate hike as early as the next meeting in May. Overall, we remain underweight in in UK gilts.

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