Investment Event

10 October 2018
For Client Use

No Brexit deal (yet)

EU27 leaders have stated that not enough progress has been achieved on agreeing a withdrawal treaty for the UK's exit from the EU

Talks remain deadlocked around the issue of how to avoid a hard border in Ireland after Brexit

There is still time for an agreement to be forged, but this probably needs to happen by the 13-14 December European Council summit to be ratified in time

Our views

We believe UK equity valuations remain consistent with a neutral positioning amid downside risks to UK economic growth. Prospective returns for UK gilts also continue to look poor to us

Still no withdrawal agreement for UK exit from the EU

At a working dinner on 17 October 2018 – as part of the October European Council summit – EU27 leaders stated that despite intensive negotiations, not enough progress has been achieved on agreeing a withdrawal treaty for the UK's exit from the EU.

EU27 leaders confirmed a special summit – pencilled in for November – to finalise a deal would not be going ahead. However, they would "stand ready" to call a special meeting when warranted.

What's the likely economic impact?

Talks remain deadlocked around the issue of how to avoid a hard border in Ireland (between Northern Ireland (NI) and the Republic of Ireland) after Brexit. Departing the EU with no new trading relationship in place would create more border checks because the UK is currently part of:

- *The EU customs union*, which is an agreement that entails no tariffs on goods travelling within the union and a common external tariff on all goods entering the union
- *The EU single market*, a system of rules and regulations which allows free movement of goods, services, people and capital

The EU has suggested that a suitable "backstop" solution to avoid a hard border after Brexit would involve keeping NI in the EU customs union and aligning the country to EU (single market) goods regulation. However, this crosses a "red line" for the UK Conservative governments' ally, the Democratic Unionist Party (DUP), as it may require more border checks down the Irish Sea.

The UK government has proposed an alternative solution of keeping the whole of the UK in a temporary customs union with the EU. But the EU believes this arrangement should be on an "indefinite" basis, and not negotiated before Brexit as it might prejudge negotiations on the future EU-UK trading relationship. The UK proposal does not address the issue of regulatory alignment.

What could happen next?

Michel Barnier, European Chief Negotiator for Brexit, originally stated his intention to wrap up talks by the October summit. Nevertheless, **there still remains time** for an agreement to be forged and for it to be ratified before the UK officially leaves the EU on 29 March 2019.

It is possible that both the UK and EU sides will be more **willing to compromise on key sticking points the closer we get to the 13-14 December European Council summit**, after which the timetable for ratifying the agreement in the UK and EU parliaments becomes extremely tight.

At the October summit, an option was floated to extend the transition period after March 2019, during which time the UK continues to observe EU rules, and negotiates a new trade deal. This may help unlock a deal on the Irish backstop, by reducing the probability of it being triggered.

If talks remain deadlocked, and the Article 50 negotiating period is not extended beyond 29 March 2019, **the UK could exit the EU next March with no deal**. But If there is an extension, the UK could face a **second referendum** or a **general election** to try and break the stalemate

Market Considerations

In the event of a no-deal Brexit, the imposition of tariffs on UK-EU trade (and other non-tariff barriers) is likely to disproportionately hit UK growth. With this in mind, and given that we think the prospective reward to bearing **UK equity** risk is unattractive compared to other markets (such as Asia and the eurozone), we retain our neutral stance in this asset class.

Meanwhile, Brexit related uncertainty is a likely factor for the apparent cheapness of the **British pound** (GBP) at present. The UK's FTSE 100 index is heavily weighted to multinational firms with foreign revenue flows, making GBP weakness a positive for GBP denominated portfolios. However, the possibility of a breakthrough in talks, and the scope for a bounce in the currency, supports our view that GBP portfolios should be partially hedged against this risk.

Finally, similar to other developed market government bonds, prospective returns for **UK gilts** continue to look poor to us. In an environment of gradual policy tightening by the Bank of England, the US Federal Reserve and European Central Bank, we remain underweight in gilts. However, it is important to remember that gilts rallied in the aftermath of the June 2016 referendum vote. A similar performance is possible in the event of a "no deal" Brexit, with the Bank of England also possibly cutting interest rates to help offset the potential economic disruption in this scenario.

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