Brexit Brief:

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No Deal or New Deal, Plus COVID Compression?

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No-Deal Brexit risk rising as deadlines fast approach

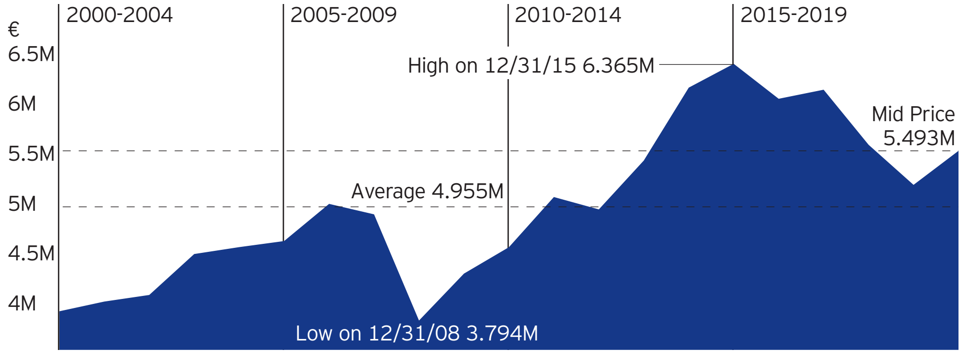
Market fears of a No-Deal Brexit have been rising as an informal mid-October deadline for a new trade deal and the end-2020 expiry of the transition period loom, reducing hopes that the crushing economic impact of the COVID-19 pandemic would soften negotiations or encourage an extension. EU deals are often struck at the last minute and we do expect progress in the run up to the deadlines, but we would not bank on a comprehensive deal at this time. The signals point to moderate progress towards a "skinny" Free Trade Agreement (FTA) and a number of sectoral deals that help avert severe disruption but do not resolve key challenges, including for the UK's large financial and professional services sectors.

Political rather than economic or financial rationales remain in the Brexit driver's seat. Plus, already weak EU trust in the UK has been damaged by the UK's "Internal Market Bill" (IMB), which in effect reverses treaty commitments under the EU Withdrawal Agreement, signed less than a year ago, to avoid restrictions on free movement of goods or people on the island of Ireland.

We suspect a joint political and economic calculus underpins UK PM Boris Johnson's ("BoJo") new UK Internal Market Bill – to distract public attention from the fumbled response to COVID, and to achieve greater flexibility in industrial policy while still securing an EU trade deal. State aid to encourage private investment in high-tech or other sectors in which the UK might catch up with world-leading firms could conceivably help narrow the skills and productivity gap, to "level-up" regions that have lagged London and the South East, where world-beating finance and professional services are concentrated. We fear that such a policy of picking winners could easily end up protecting losers, given past experience in the UK itself and elsewhere.

Be that as it may, as a result of the commitments made in the Withdrawal Agreement, and Brussels' red lines on the FTA, EU state aid rules could be invoked to limit the UK's ability to support select sectors and firms under the guise of ensuring a level playing field for post-Brexit trade between the UK and EU. The Johnson Government is seeking to limit the reach of EU state aid rules into Great Britain, threatening to reopen the Withdrawal Agreement through controversial clauses in the UK Internal Market Bill. However, invoking such powers could result in the need for a hard border on the island of Ireland, endangering the Good Friday Agreement that ended sectarian violence in Northern Ireland and of which the EU and US are both guarantors. Senior US politicians have ruled out a US-UK FTA in this event, although BoJo himself has claimed that no such threat to the Good Friday Agreement exists. The best hope is that a Free Trade Agreement includes a state aid framework, rendering the offending clauses in the IMB unnecessary, and forgotten as negotiating tactics.

Figure 1: UK imports from Germany fell significantly between Brexit and COVID



Source: Bloomberg, Destatis German Federal Statistics Office, Invesco. Annual data as at Sept. 29, 2020

On the domestic political front, the Bill is presented as a bulwark against an alleged EU intent to carve up the UK by erecting trade barriers between Northern Ireland and the UK mainland – generating political heat under the banner of standing up for UK sovereignty while distracting from accusations of mismanagement of the pandemic. Johnson may have hoped that Sir Keir Starmer, the new, opposition Labour Party leader (who is far more of a threat as centrist, credible and electable than far-left predecessor Jeremy Corbyn), would have waded into the debate against the Government. But so far, Sir Keir has resisted the bait, knowing that if Johnson fails to reach a deal with the EU, he will soon have a much bigger weapon with which to attack the Government – namely, a botched Brexit.

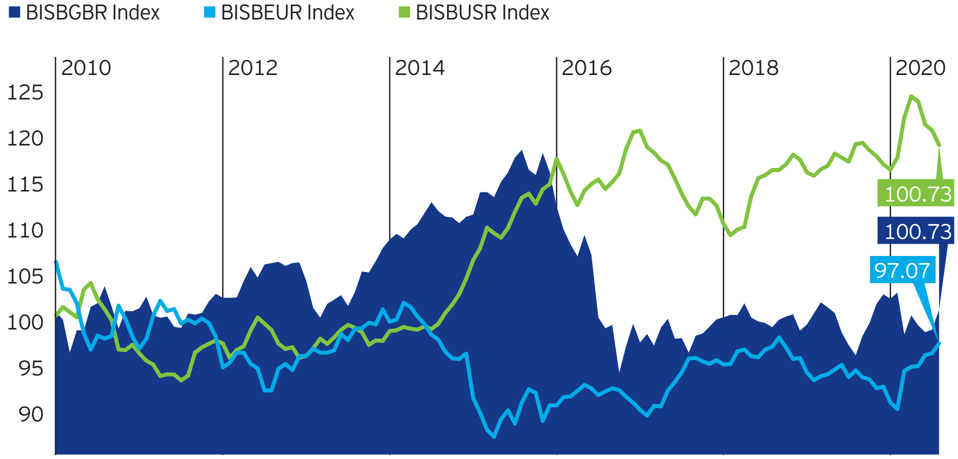
For its part, the EU seems unlikely to yield too much. Germany's exports to the UK have fallen significantly since the referendum, sharply since the pandemic, undermining BoJo's long-standing hope that EU members will fold in order to protect their tariff-free goods exports to the UK. The reality is likely to continue to be a good bit more balanced than that, given the relative bargaining power and the stakes.

United Kingdom of four nations to Disunited Kingdom of two-to-three?

A risk crystallized by Brexit, reflecting the rise of nationalism and the desire to "take back control" within parts of the UK, mirroring the wider rise of nationalism around the world, is of a disunited Kingdom. Political pressures are rising for Scottish independence and for the eventual reunification of Ireland, reflecting diverging preferences among large parts of the electorates of the nations that comprise the UK – Scotland, Northern Ireland, Wales and England.

Of course, no British government or PM would want to preside over the dismemberment of the UK. Indeed, BoJo has indicated that there won't be a second Scottish independence referendum after the last one, a once-a-generation event in 2014. However, refusing to allow a referendum is unlikely to suffice if, as currently expected, the Nationalists romp to victory in the Scottish Parliamentary elections in May. Instead, the risk of UK breakup may temper the speed and extent of divergence and separation from the EU – as should the fact that EU members and other partners are pulling together to manage both Brexit and COVID; indeed, Switzerland has just voted in a referendum to maintain freedom of movement with the EU, as part of its relationship and trading arrangements with the EU.

Figure 2: Sterling real effective exchange rate has fallen sharply since Brexit



Source: Bloomberg, BIS, Invesco. Data as at Sept. 29, 2020

Immediate hard Brexit hit difficult to disentangle from COVID

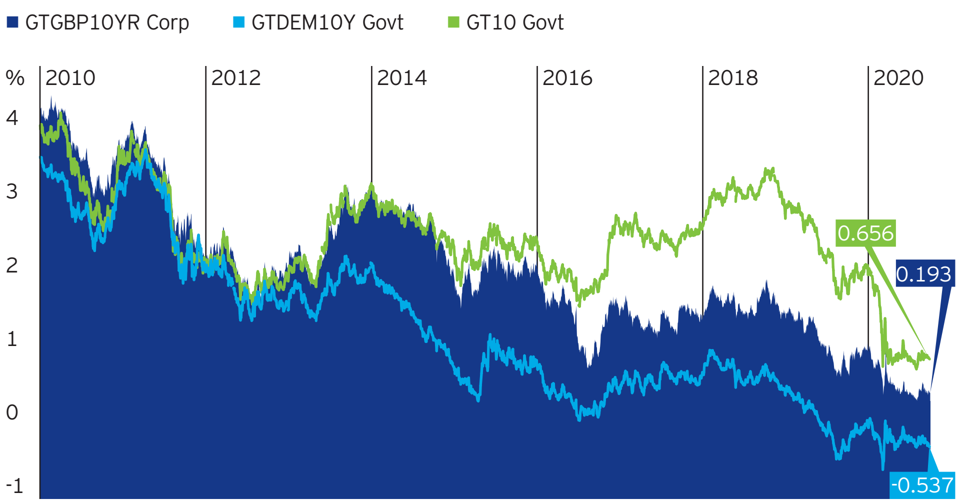
Even so, we tend to agree with the government's apparent belief that it will be difficult to distinguish the near-term effects of a hard Brexit from the great compression in economic activity imposed by first-wave national lockdowns in Q1-2. Furthermore, the virus is resurgent in both the UK and EU, targeted lockdowns are already in place and the risk of new national lockdowns has resurfaced. As a result, much economic activity including UK-EU trade is likely to remain well below normal. Even so, disruption in goods or agricultural trade in the event of a hard Brexit would damage the economy, as well as cause political problems on both sides of the Channel. Put all this together, and the real threat of a no-deal Brexit implies a significantly greater double-dip recession risk for the UK than most other major Western economies – in addition to a full-blown second wave of the pandemic and any new national lockdowns. These downside risks are likely to sustain some hope in the markets that there will be a last-minute deal, even as the political pressures prevent a comprehensive and rapid solution.

Brexit economic effects hinge on policies, over the long term

The Brexit saga from campaign to referendum, via the political theatre of Tory succession struggles into the twists and turns of the negotiation, has been running for almost half a decade. Throughout, it's been all too easy to get caught up in the noise of the moment. And with good reason, for the news often pointed to sharp shifts in political preferences and by extension in economic policies. But while the shorter-term implications of Brexit have been well-studied since 2016, the longer-term trajectory has been partially obscured by the political and public focus on COVID since the UK left the EU.

The Johnson Government's policy decisions in coming months will drive the UK's long-term trajectory and success or failure, beyond both Brexit and COVID. Freed from the guard rails of the EU's regulatory framework in many areas, focus will shift to the Johnson Government's economic, financial, tax and industrial strategies as it returns to the "levelling up" agenda – and above all, whether the UK's traditional strength as an open, predictable, free market economy is enhanced or weakened. All are likely to determine perceptions of the UK as an investment destination. Whether foreign and domestic prefer to participate or invest elsewhere, can enhance or undermine UK productivity and growth prospects, in line with concerns reflected in valuations in UK financial markets against other countries.

Figure 3: Since Brexit, UK Gilt yields have de-coupled, moving half-way from US Treasuries to Bunds



Source: Bloomberg, BIS, Invesco. Data as at Sept. 29, 2020. Past performance is not a guide to future returns.

Brexit runes, UK policies may be a global leading indicator

Country risk, as it used to be called, is clearly back with a vengeance, and has spread like wildfire around the Western world. But it is not by any means a new or recent phenomenon. Presidents Putin of Russia and Erdogan of Turkey – both in power since the turn of the century; AMLO of Mexico and Bolsonaro of Brazil and Trump of the United States since Brexit; and Prime Minister Modi of India just before – all are pursuing policies that put national political, security and cultural elements ahead of more pure economic and financial interests.

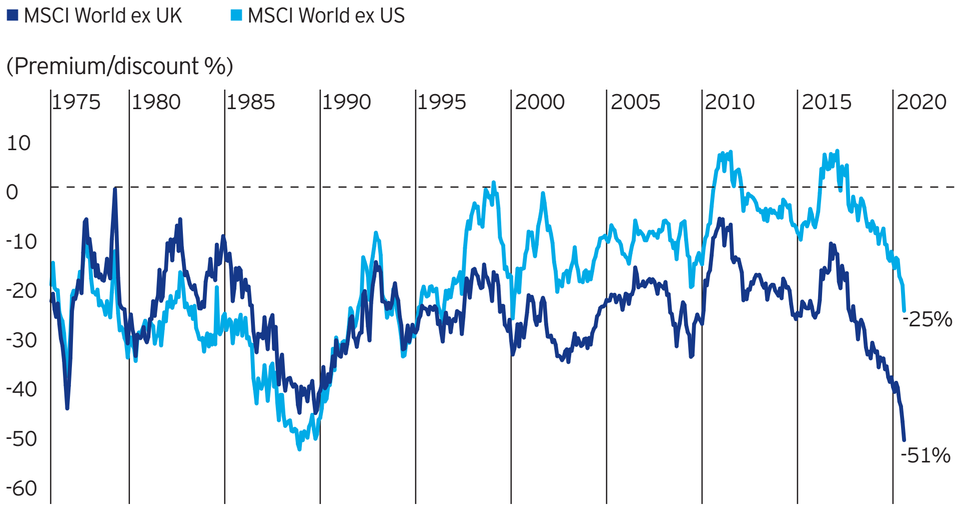
For centuries, where UK politics and policies have explored, many other countries have eventually followed. We expect this historical tendency to continue in some parts of the world, given the partly shared challenges of regional inequality and in socio-economic mobility. Indeed, the UK seems to be willing to experiment with major policy initiatives in trying to find its way to a new social contract, perhaps with a somewhat more deregulated corporate and small business sector, but with greater support and training for labour, for the "left behind" and the un- or underemployed.

Conclusion: Skinny, mini-deals likely to keep the show on the road

Tensions in EU trade negotiations reflected in English nationalism, Scottish nationalism and Irish republicanism all suggest that economic growth and investment in particular will be low; and that high financial market volatility will continue; that UK risk assets and sterling will remain at depressed valuations but that bond yields will remain low. All these issues pose a bit of a value trap in the short term with politics standing in the way of depressed UK valuations relative to other major markets.

In the longer term, however we would expect the UK government to gradually find its way through fits and starts to decent policy choices, unlocking some of that value and restoring a bit of lift to growth. For both UK and global investors, this backdrop calls for keeping a watchful eye on the UK and being diversified across countries and asset classes, because diverging and shifting policies will probably yield diversification benefits instead of the generalized, macro shifts of repeated opposite moves in sterling as against gilts and domestic vs. globally equities that have dominated the Brexit era, pointing to significantly weaker UK trend growth ahead.

Figure 4: UK has been persistently cheap relative to global equity markets, post Brexit Referendum



Source: Bloomberg, MSCI, Invesco. Data as at Sept. 29, 2020. Past performance is not a guide to future returns.
Note: Valuation based on simple average of Trailing Price/Earnings Ratio, Price-to-Book Value; and Dividend Yield.

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Arnab has 28 years of investment industry experience. He is a member of Invesco's Global Investor Forum Advisory Council with a focus on global macro and emerging markets, and previously served as Head of emerging markets macro research for Invesco Fixed Income. Prior to joining Invesco, he served as Co-head of Economic Research & Strategy at Roubini Global Economics; Co-head of Global Economics & Strategy, Head of Global FX Research, and Head of EM Economics & Strategy at Dresdner Kleinwort; and Head of EMEA Research at JP Morgan. He has also been a private consultant in global and emerging markets, as well as consulting with Trusted Sources, a specialist EM research boutique. Arnab's studies were in macroeconomics, economic history and international political economy. He received an AB from Princeton University and completed his postgraduate and doctoral work at the London School of Economics.

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