

Focal Point

Brexit negotiations to start tough

March 31, 2017

- UK's PM Theresa May invoked Article 50 of the EU Treaty on March 29, thereby finally starting the Brexit process.
- Brexit talks will likely begin with a clash about priorities. Given the UK opted for a "hard" Brexit, a trade deal ranges among UK's top priorities, while the EU governments seem to insist on an "orderly divorce" before trade talks can begin.
- The structural conflict between UK's full control over immigration and the EU's free factor movement underlying the Single Market do not allow for an easy agreement. The process is further complicated by upcoming elections in member states.
- We expect the way towards a new agreement to be characterized by arm twisting and horse trading. The high uncertainty about the final negotiation outcome will likely weigh on business sentiment, mostly so in the UK.
- In addition, it may well be a source of repeated market volatility including temporary flows into safe haven government bonds, while weighing on the British pound.

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After Britain had voted to leave the European Union on June 23, 2016, UK PM Theresa May eventually invoked Article 50 of the EU Treaty on March 29 to leave the bloc. This triggers negotiations about an exit deal, for which the Treaty allows a period of two years (except the Council decides unanimously to extend this period). The EU will try to finalize negotiations by October 2018, in order to give the European Parliament time to discuss. Also the UK will present its parliament the final deal, while it will depend on the topics covered whether also other member states' parliaments will be involved.

UK government announced "hard" Brexit

In mid-January 2017, PM May announced UK's broad objectives for a "clean break", followed by a white paper which set out these goals in more detail. The government basically wants to repatriate the control of borders and laws. Economically, this implies leaving the EU Single Market and not seeking to remain fully in the Customs Union either. This is exactly what has been previously dubbed as "hard" Brexit. The reasons for these decisions are straightforward: The Single Market relies crucially on four freedoms, of which the freedom of labor is incompatible with getting full control over immigration. At the same time, the British government aims at negotiating free trade deals, first of all a "bold" one with the EU, aiming at the best possible, tariff-free access to the Single Market, including for financial services. This also involves a phased implementation to avoid a "cliff edge". Moreover, the UK also target free trade with partners around the world, which would be impossible while having to stick to the EU's

Common External Tariff. However, May will seek a customs agreement with the EU. Outside these more narrow trade issues, but politically not less important, the UK wants to secure the rights for UK nationals within the EU and vice versa, to appropriately contribute to the EU budget while continuing to cooperate in the fight against crime and terrorism. Judged by the white paper and how extensively trade topics were covered, securing a trade deal ranges at the top of UK's strategy. But May also sought to show some limitation to this priority by saying that "No deal is better than a bad deal". Of late, May toured different

Topics of UK Government White Paper on Brexit:

1. Providing certainty and clarity;
2. Taking control of our own laws;
3. Strengthening the Union;
4. Protecting our strong historic ties with Ireland and maintaining the Common Travel Area;
5. Controlling immigration;
6. Securing rights for EU nationals in the UK and UK nationals in the EU;
7. Protecting workers' rights;
8. Ensuring free trade with European markets;
9. Securing new trade agreements with other countries;
10. Ensuring the United Kingdom remains the best place for science and innovation;
11. Cooperating in the fight against crime and terrorism; and
12. Delivering a smooth, orderly exit from the EU.

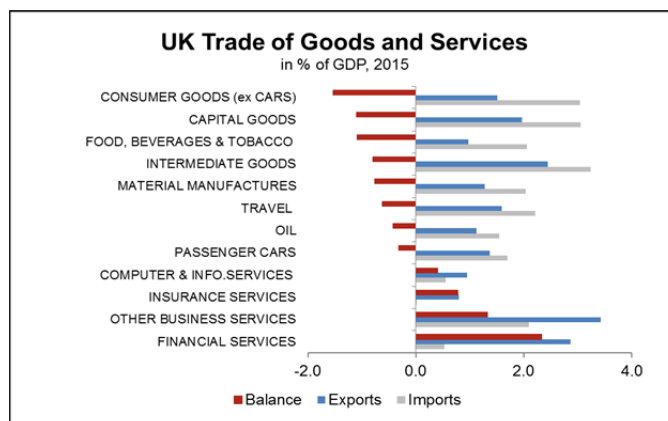
parts of the UK. Especially talks to Scottish First Minister Nicola Sturgeon, who was authorized by the Scottish Parliament to push for a fresh independence vote, could severely complicate May's Brexit plans.

First clash about order of negotiation topics

Only a few details are known about the EU's negotiation strategy. According to press reports, both sides will likely have a first clash at the start of the talks. Michel Barnier, EU's top Brexit negotiator, seems to insist that an orderly divorce must come before any trade talks. He tweeted: "Agreement on an orderly Brexit is prerequisite for future partnership". Accordingly, in a first phase until this summer, Brussels seems to want to limit talks to the "Brexit bill" and the rights of British people in the EU and vice versa. Between September 2017 and March 2019, more detailed negotiations would take place as well as preparations for a transitional agreement. Deeper conversations about a comprehensive EU free trade deal could easily extend over March 2019, i.e. beyond the two-years negotiation period. Figures for the "Brexit bill" could amount to € 40-60 bn, including consented payments for the EU budget, the UK's share of outstanding pension liabilities, loan guarantees and spending on UK-based projects. Most importantly, the EU will show strong commitment to the principle that Single Market access is conditional on acceptance of the EU four freedoms, ruling out "cherry-picking".

Current announcements from both sides are clearly part of the "positioning" at the outset of the negotiations, and therefore still very fluid. However, agreements will likely be not that easy. With regard to the exit bill, the UK government called payments up to € 60 "absurd". With regard to the British top priority, PM May needs to begin trade talks immediately in order to have a deal by 2019. On the other hand, from an EU perspective, any "frictionless" trade deal is granted only on the condition of accepting the four freedoms. In addition, the EU needs to maintain a difference between members and non-members in order to not undermine its own attractiveness. For any transitional or implementation period, the EU will insist that this phase will be governed by EU rules and courts, avoiding any "cherry picking". But, with British elections in 2020, this will likely be politically unacceptable for PM May as she would look like having failed to unwind EU obligations (budget contributions, EU court ruling, no immigration control) and thus not delivered on a factual Brexit. A similar issue pertains to the citizenships. Guaranteeing the rights of expatriates (including families?) in the UK clearly raises the question of which rights (British or EU ones)? Again, it looks controversial of granting EU citizens living in the UK still the right to recourse to EU courts, while explicitly stating to get independent of the European Court of Justice. The EU 27 will discuss its stance on an extra Council meeting on April 29. However, much more clarity on the strategy is unlikely to emerge.

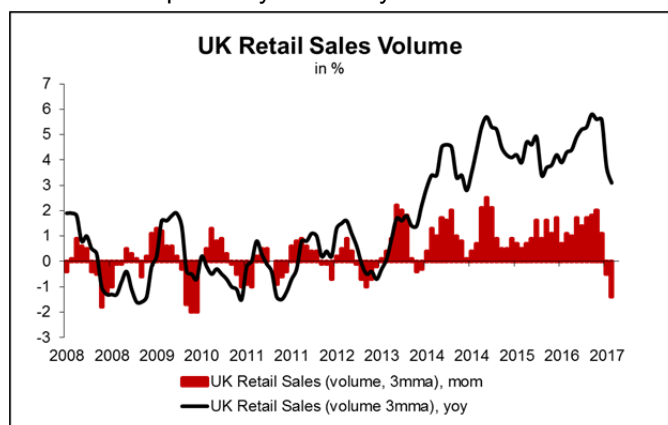
This all suggests that the start of the Brexit talks could be rough and markets could experience some more volatility. We see Gilts to temporarily benefit from safe-haven flows and renewed concerns about the economic damage to the UK economy and thus to decouple a bit from the expected rise of US long-term yields. Despite the 13% fall of the trade-weighted pound since the Brexit vote, sterling is likely to weaken somewhat further, also given its vulnerability arising from the UK's still sizeable C/A deficit.



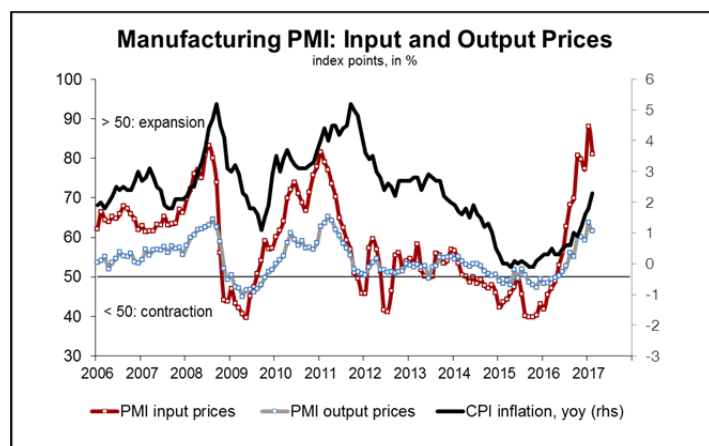
Despite these differences, we see also the need for both sides to preserving favorable trade relations. This might look for the UK to be more urgent than for the EU. According to press reports, banks and insurers have already started to move jobs to the continent as they fear to lose their so-called pass-porting rights in the EU. Also the food sector is among the most timid sectors of falling victim to rather high EU MFN tariffs (20%-36%), which is also true for the car sector (10%). In 2015 (latest year of detailed breakdown in the ONS Pink Book), the UK had a total goods trade deficit of 6.4% of GDP, of which 4.8 pp were due to trade with EU. The deficit was mitigated by a service trade surplus of 4.8% of GDP, of which a quarter stems from EU. For the negotiation outlook this implies that the UK will try to gain access for its service exports by threatening to limit good imports. This bargaining process will be rather complicated. Service exports would still have to comply with all EU rules and regulations, while the UK will lose its influence on the EU's legal process. Accordingly, important parts of the service sector would want to guarantee its Single Market access by building legal subsidiaries in EU-27.

UK growth to soften over the year

We expect also repercussion of the Brexit decision on the business cycle. So far, UK's economy proved astonishingly resilient. In the two quarters after the Brexit vote, the economy maintained a swift rate of expansion with GDP growth rates of 0.6% resp. 0.7% qoq, essentially driven by private consumption. Investment, exports and imports fluctuated, giving no clear-cut trend indication. Of late, however, retail sales growth started to soften from high levels. Until recently, private consumption was supported by a multi-year low unemployment rate and a substantial improvement in real wage growth. Nominal wage growth rose to 2.8% yoy in Q4 2016 increasing from 1.3% in 2014. The effect was amplified by a virtually flat CPI in 2015 and a



very modest rise in inflation to 0.7% in 2016. On top, consumer credit increased amid a further drop in the household savings rate (5.5% of GDP in 2016, after 6.5% in 2015 and a long-term average of 8.4%). Looking ahead, we expect inflation to substantially eat into real wage growth, thereby generating a negative feed-back on private consumption. CPI inflation already accelerated to 2.3% yoy in February 2017. We see inflation to rise further, mainly as an effect of the strong depreciation of the British pound, averaging about 3% this year and the next.



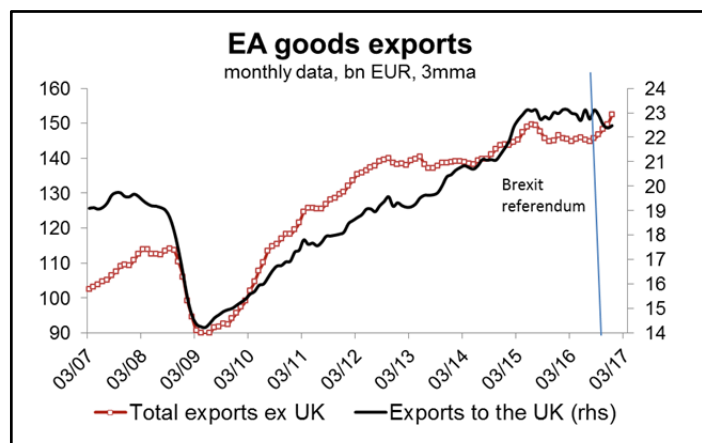
Compared to private consumption, the current investment situation is much more diffuse. Gross fixed capital formation fluctuated in qoq term, giving no special direction so far. However, in yoy terms especially business investments shrank since Q1 2016. With regard to the production side, indicators recently pointed in different directions. However, overall the depreciation of the pound supports industrial production. Going forward, we expect the uncertainty driven by the Brexit negotiations to soften investment over time. To some extent the government can provide a fiscal policy buffer, as it has reduced its mid-term deficit consolidation goals by about 1.1% of GDP. The BoE will also likely look through the rising inflation within certain limits. All in, we expect the UK GDP to grow by 1.5% this year, after 2.0% in 2016.

Brexit a headwind to euro area activity

Like in the UK, the Brexit decision has barely impacted the business-cycle in the EU so far. Despite various concerns, euro area sentiment soared in early 2017 to the highest level since April 2011.

Euro area exports to the UK had traditionally been moving in lockstep with exports to other destinations. In the months following the Brexit referendum, however, euro area exports to the UK slowed despite a rise to other destinations (see graph below). Looking ahead, we expect the Brexit fallout to drag on euro area exports more meaningfully. Against the backdrop of a moderating activity in the UK, a further depreciation of the GBP together with the political uncertainties described above, UK's import demand is likely to soften. As clearly not all value-chains can be adjusted swiftly, the process will impact the more negatively the UK-EU-27 trade, the more the Brexit negotiations will look to end in no agreement. According to our calculations euro area goods exports to the UK as the second-biggest export market (2015: 13.5% of all extra-EMU exports) could start suffering already more meaningfully in 2017. In 2016, the goods trade surplus likely was € 118 bn (with exports of about € 270 bn). According to some rough cal-

culations the surplus could be reduced by about € 20 bn (or 0.2% of euro area GDP) in 2017. However, firms' preparations to open up subsidiaries in the EU-27 could work in an opposite direction by supporting euro area investment to some extent. The countries most exposed to the UK in terms of goods exports in relation to GDP are Belgium (7.7%), Ireland (7.1%), the Netherlands (7.0%) and Germany (2.9%).



Imprint

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