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Despite tough Brexit talks, UK yields to rise slowly

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- The UK is under huge pressure to break the recent deadlock in the Brexit negotiations by stepping up its offer.
- Most recent UK signals to markedly increase its exit payments might convince the EU Council (Dec. 14/15) to acknowledge "sufficient progress" in the divorce talks, thereby opening up the door for trade negotiations. However, a further delay is still possible.
- Moreover, given the so far extremely sticky negotiations, high uncertainty over the final trade deal and the transition period will likely extend far into 2018. This will weigh on UK investment on top of already weak private consumption.
- The current market pricing of a cautious tightening cycle by the Bank of England appears appropriate given the prevailing uncertainties. Having said this, while UK gilts are unlikely to disconnect in full from the international yield environment, the scope for 10-year UK yields to rise appears more limited than for their counterparts.

Brexit negotiations have been extremely bumpy so far, with periods of thawing quickly turning back into another standstill. The latest EU-UK talks even ended on November 10 with Michel Barnier, the EU chief negotiator, setting Britain a two-week deadline to make sufficient progress. Otherwise the EU Council on December 14/15 would be unable to open the door for trade talks. The stickiness of the negotiations looks like a built-in problem, as the UK aims to preserve as much leeway for the final "package" (including the trade access) as possible while having had to succumb to the EU negotiation sequencing. By contrast, the EU clearly intends to frustrate this approach, in order to draw a line between members and non-members (to preserve its attractiveness). This implies to not allowing the UK to remain in the Single Market without insisting on fulfilling its obligations (esp. the free movement of labor).

On top, the UK government's room for maneuver has been limited by the fight between Brexiteers and non-Brexitieers within both the Cabinet and the Conservative Party itself. PM Theresa May's leadership has been substantially damaged by the loss of the majority in the Lower House of Parliament in June. Moreover, several cabinet members had to step down of late for different reasons, and reports over MPs aiming to oust May of Downing Street are frequent. In addition to this party intern-fighting, the government is also under pressure from business federations, demanding more clarity on the post-Brexit trade terms and outlook for the transitions period. The December EU Council meeting is considered especially crucial as it would be the last opportunity before many firms decide on their 2018 investment budgets. Time for trade negotiations is running out. Finally, polls are showing that public disapproval is rising (ORB International found 66% of UK people disapprove the government's negotiations conduct).

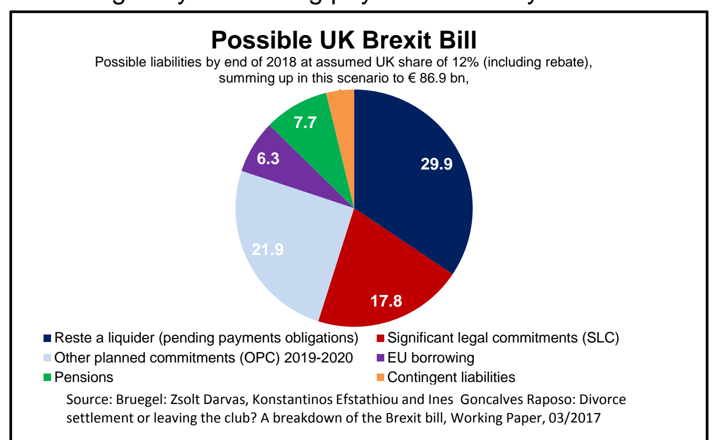
Press reports a breakthrough in the Brexit bill

The EU demands "sufficient progress" on three issues, i.e. the Brexit bill, Ireland/North Ireland border and expatriates citizens' rights, before the second phase of negotiations about the future EU-UK relationship can be launched:

Regarding the Brexit bill, Theresa May made a first move in her Florence speech (promising about € 20 bn), by large not matching EU calculations between € 60-100 bn. Most recently, the press reported that Britain had bowed to the EU's demands and agreed to fully honor its financial obligations as identified by Brussels. However, for the sake of "face-saving", no final figure will be presented but a method for regularly calculating payments in the years to come.

Possible UK Brexit Bill

Possible liabilities by end of 2018 at assumed UK share of 12% (including rebate), summing up in this scenario to € 86.9 bn,



Source: Bruegel: Zsolt Darvas, Konstantinos Efstathiou and Ines Goncalves Raposo: Divorce settlement or leaving the club? A breakdown of the Brexit bill, Working Paper, 03/2017

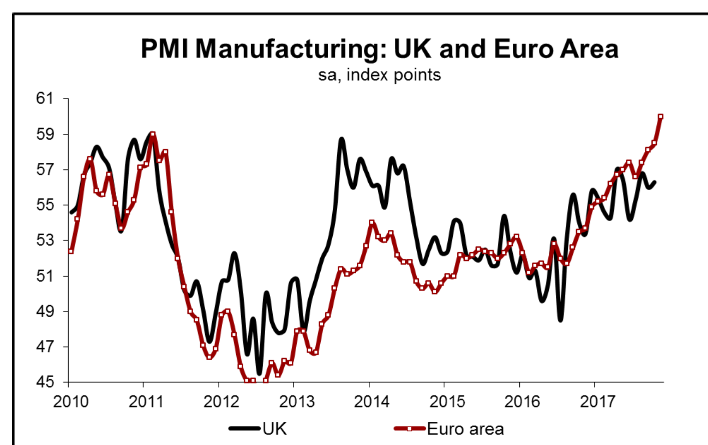
Moreover, the UK seems to be pressing that an implied net figure, taking into account UK receipts and other deductions, will not be higher than € 40-45 bn. PM May seems to have won a ministerial backing (i.e. a compromise between the two factions in her cabinet), conditional on securing a transition deal and a good trade agreement. The new offer is likely to remove the biggest stumbling block in the negotiations and will likely be presented next week as a package deal.

With regard to the citizens' rights, Brexit will end the EU law regarding the legal status of EU citizens in the UK and vice versa. The main point of disagreement is about who should ultimately arbitrate disputes. While the EU wants it to be the European Court of Justice, the UK is unwilling to accept its supremacy. However, both sides believe that they are quite close to an agreement.

By contrast, the Irish border issue seems far from settled. Both sides agree that no physical border controls should be reinstalled between Northern Ireland and Ireland in order to not jeopardize the hard-won peace process. However, after Brexit Ireland will have an external Community frontier to the Northern Ireland/UK, thus being obliged to uphold the legal order of the Single Market and the Customs Union. The UK initially proposed sophisticated technical tracking systems, which the EU rejected as largely unworkable. Instead, the EU proposed a continued customs union with North Ireland, which in turn UK disapproved on the ground of having then a border inside the UK. While this topic seems far from solved, diplomats consider it less likely that Ireland would veto a decision to enter the phase two of the talks, because this topic is inherently also very much dependent on the specifics of the final trade agreement. Moreover, after the Irish government crisis seems settled for now, it has again become less likely of the Ireland issue to become a final stumbling block.

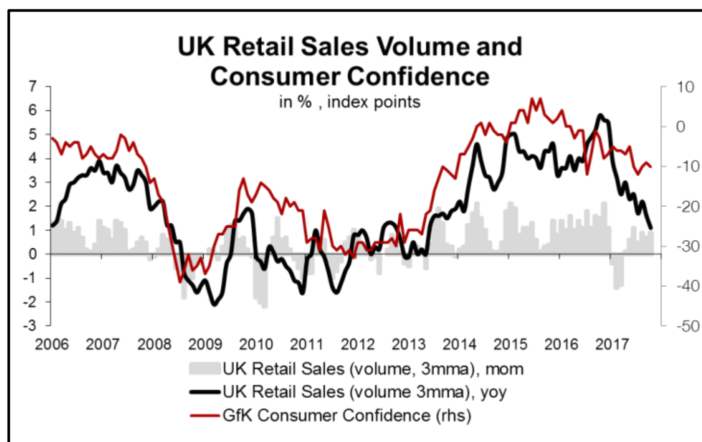
Tough negotiations to go on in phase two

In sum, if the press reports come true, there is a good chance that the EU will enter into trade negotiations. However, any of these issues above could also cause progress to break down again. Moreover, entering into the stage two will not solve all problems. Brexit Minister Davis recently said that Britain wants the freest possible trade in goods and services with the EU that goes further than the bloc's trade agreement with Canada. Theresa May has proposed delaying a full Brexit until 2021 by asking EU countries to agree to a two-year transition period during which the UK would continue to enjoy unfettered access to the single market. By contrast, Brussels stressed so far that it sees its free trade agreement with Canada as the only realistic model for post-Brexit trade relations (given the UK to exit the Single Market and customs union, demanding regulatory autonomy and independence of the European Court of Justice). Thus, any bespoke deal will face significant hurdles while negotiation time is only very limited. Consequently, we expect negotiations to remain tough and uncertainty to remain high.



Ongoing uncertainty to weigh on investment

This high uncertainty in turn will likely continue to contribute to relatively low investment, on top of private consumption suffering from high inflation. Currently, UK is in a situation of relative (not absolute) weakness, as the euro area – which is UK's most important export destination with around 40% – powers ahead but the UK remains confined in a relative mild expansion. In Q3, real GDP growth sped up moderately to 0.4% qoq while business investment rose only reluctantly by 0.2% qoq. This relative underperformance is most visible in the PMIs, which clearly increased with the upturn of the international business cycle, but the UK lost its long-standing, historical outperformance. Looking ahead, we do not expect this situation to fundamentally change in the first half of 2018, while more visibility on the final Brexit deal could improve sentiment again later next year (provided a deal will be in sight). Of late, finance minister Hammond slashed the growth outlook, underlying the budget outlook, to 1.5%/1.4% in 2017/18. Therefore, the forecasts are now very much in line with market views.

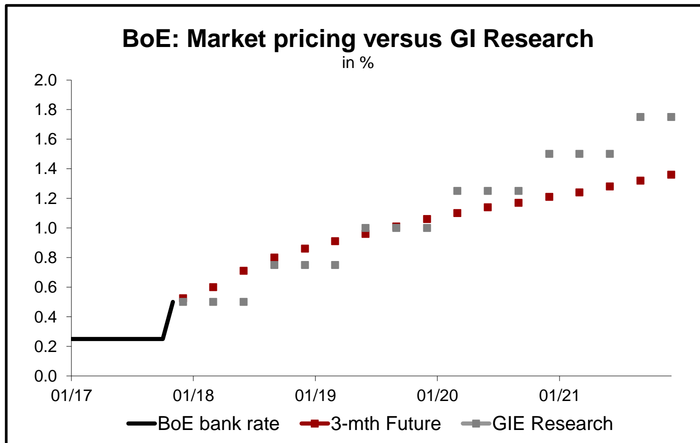


BoE has started the cycle, but is in no rush

Despite the weaker growth outlook and the political uncertainties, the Bank of England (BoE) has for the first time in more than 10 years increased the bank rate by 25 bps to 0.5% on November, 2. We consider the move to be primarily driven to prevent further imported inflation, given that the BoE violated its inflation target of 2% by a full percentage point. However, the hike was accompanied by dovish remarks and the Monetary Policy Committee signaled a slow policy tightening. Forwards imply only two further hikes (each 25 bps) until the end of 2019. It should be noted that the deteriorating growth environment, the high current account deficit and the difficult Brexit negotiations point to a somewhat weaker British pound going forward.

The forecast slower growth amid a more modest outlook for labor market conditions will give the BoE scope for a cautious approach. Under these assumptions, it expects the headline inflation to trend back towards the 2% target (from a current level of 3.0% in October) until 2020. Taking into account the political uncertainties which are very un-

likely to abate in the months to come, the BoE will probably be most reluctant and rather err on the side of caution. Hence, the dovish tightening cycle currently priced by financial markets appears appropriate. This stands in opposition to the pricing of Fed (and to a lesser extent to ECB) key rate hikes. While only three Fed hikes are priced until the end of 2019, we forecast five steps and the Fed dots even imply six additional hikes in the period.

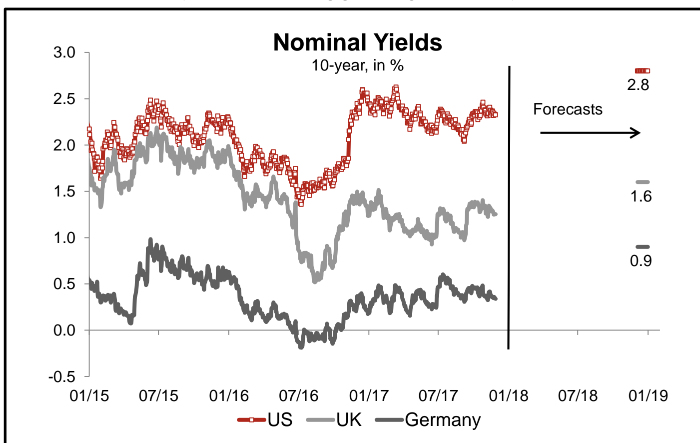


This is expected to limit any increase at the short end of the UK yield curve. In contrast, future Fed hikes have the potential to trigger a further increase in 2-year US yields and the forthcoming QE tapering by the ECB in combination with first key rate steps in 2019 are seen to lift 2-year German Bund yields back in positive territory (from -0.70% currently). The leeway for short-dated UK yields is more limited. Taking into account the expected cautious tightening, 2-year UK yields are not seen to increase substantially above the 1% threshold over the next 24 months.

This applies all the more as there is a non-negligible risk that the Brexit negotiations fail and a hard Brexit becomes the base scenario (see above). In this case, the BoE is forecast to become more dovish again, accept the spike in inflation and a depreciation of the British pound and would end the cycle (if not reverse it). Accounting for this uncertainty, short-dated UK yields are likely to be capped at around 1% in the foreseeable future.

Limited leeway for higher UK yields

Longer-dated UK yields are to a greater extent influenced by the international bond markets. While the Brexit vote triggered a downward shift in the yield level, the correlation since then remained high (0.85 for 10-year UK and US yields). Hence, the expected upward drift of long-dated US and euro area yields will trigger higher UK yields as well.



However, the scope for higher UK yields appears more limited as UK real yields have fallen to a historical low. Immediately after the Brexit decision the UK real 10-year yield fell by 60 bps to -2.10% and has not recovered from this shock (current level -2.20%). In contrast, US real yields have increased by around 35 bps and German real yields have remained stable (although at a low level of around -1.1%). As estimates for a higher UK trend growth are unlikely to rise going forward – which would trigger a higher real yield in the UK – UK yields will follow an international upward movement in yields only to a limited extent. As financial markets are not convinced that the growth impact of the Brexit remains contained (and this is very unlikely to change in the months to come), UK Gilts are expected to perform better than Bunds or Treasuries. Not surprisingly, this applies all the more in case of increasing signs that a hard Brexit could materialize.

Imprint

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