GENERALI INVESTMENTS

Focal Point

The fall-out of a Crash Brexit

October 12, 2018

Authors: GIAM Macro & Market Research

- The latest encouraging signals from Brexit negotiations support our base case of an orderly EU departure of the UK. Risks of a no-deal divorce remain non-negligible, though, especially when it comes to UK parliament ratification.
- In this risk case, the UK would fall into recession, while euro area growth would fall below potential. Barring policy responses, GDP would be down by 4.2 pp in the UK and 0.9 pp in the euro area by end-2020 vs an orderly Brexit.
- The BoE may ease again, though Carney has warned that this time around rising inflation would be hard to ignore. The ECB would postpone its first key rate hike to end-2020.
- The gloomier economic outlook and risk-off mode would induce a drop in Gilt yields and a bull-flattening of the Bund yield curve. Spreads on credit and Southern European sovereign debt would widen.
- Rising uncertainty would drive equity risk premiums higher causing share prices to drop sharply. The British pound would slide, with the EUR/GPB likely reaching parity, while the USD would strengthen.

The Brexit negotiations have reached their endgame which increasingly resembles a roller-coaster ride. The rebuff of May's "Chequers" proposals at the informal EU summit in Salzburg in late September raised fears of a no-deal Brexit, while more recent signals of an impending compromise regarding the Irish border has fueled optimism that a Brexit deal can ultimately be reached.

There are still various roads toward a deal by possibly reverting to an existing free-trade deal, fresh elections (Labour also supports a second referendum) or an extension of the negotiation period (which would require an unanimous EC approval).

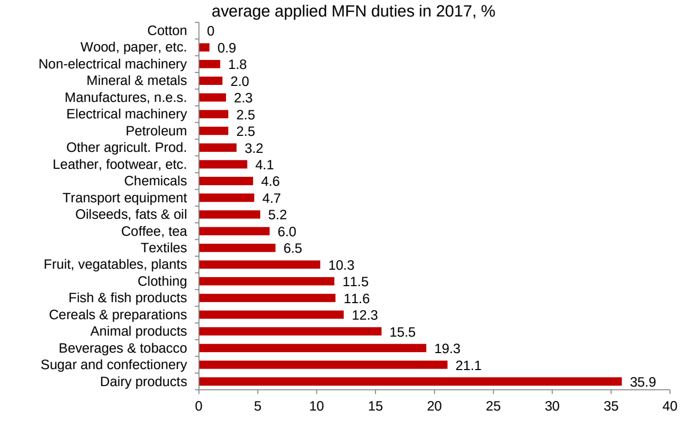
However, big stumbling blocks threaten to derail a deal. Press reports suggest that after the rejection of the Chequers plan, a majority of UK cabinet members would now only agree to a (very loose) Canada-style free-trade agreement. Given the 80+ hard Brexiteers among Conservative MPs, a government majority for an agreement in the Lower House of Parliament looks shaky. The recent UK's Labour Party Congress deemed any deal unlikely to fulfill its key criteria, adding to doubts about parliamentary approval. The macro and market consequences of a no-deal divorce would be substantial indeed, and we devote this note to summarize key elements of this risk case.

A crash Brexit to push UK into recession

A crash Brexit would lead to major disruptions in trade for a wide range of goods and services, but also involve legal issues like aircraft landing rights and EU funding programs. The EU Brexit preparedness notices and similarly the UK Brexit guidance give a more detailed impression. In a no-deal Brexit, the EU-UK trade relations would fall back to WTO rules. For a start, the UK will adopt current EU's most-favored nation tariffs, which average 5.1% but vary widely across products (see graph).

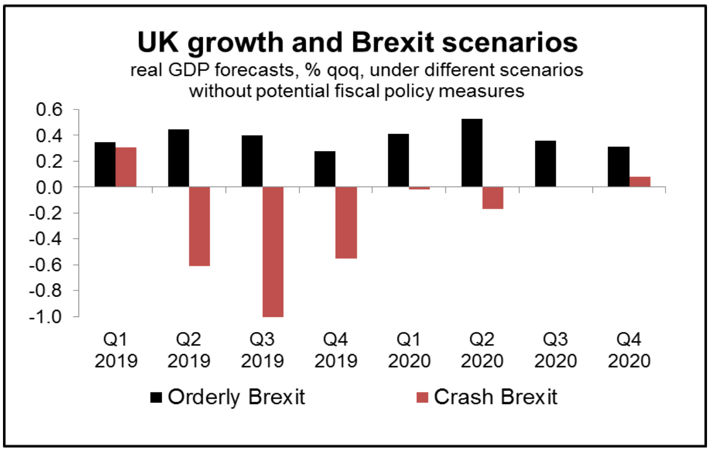
EU Most-favoured Nation Tariffs

average applied MFN duties in 2017, %



The UK economy would suffer most, with 44% of UK exports directdd to the EU 27 in 2017. They amounted to 30.2% of nominal GDP (goods 16.6%, services 13.6%), while imports accounted for 31.4% (goods 23.3, services 8.1%). 3% of total service exports (of GDP, incl. non-EU) were due to financial services, for which the required 'passporting' rights will end in case no deal is found. All in, we see British exports to recede by about 6% of GDP cumulated over 2019/20, while imports could diminish even more by about 7.5%.

The repercussions of this intial shock are plentiful. Import prices will increase due to the tariffs applied the additional border transactions costs (which are estimated to be substantial) and the depreciation of the British pound. We expect inflation to accelerate to more than 3.5% yoy in late 2019. This, in turn will lead to lower real incomes, exacerbated by a fall in consumer confidence and possibly a rise in the unemployment rate by about 3pp. Lower exports, weak consumption, higher costs for intermediate goods and a reduced attractiveness of the UK as a hub for international FDI will also weigh significantly on business investment. Real estate prices will likely see a stong drop, weighing additionally on consumption via a negative wealth effect. Taken together, we see a crash Brexit to result in a severe UK recession, with annual GDP growth at -0.1% in 2019 and -1.2% in 2020. Cumulated, this implies about a loss of GDP by 4.2 pps compared to our baseline scenario. Looking into other forecasts, they show a wide variety, ranging fom -2.6 pp to –7.8 pp compared to baseline. Looking into history, in the peak Great Financial Crisis (GFC) year 2009, UK GDP shrank by 4.2%.



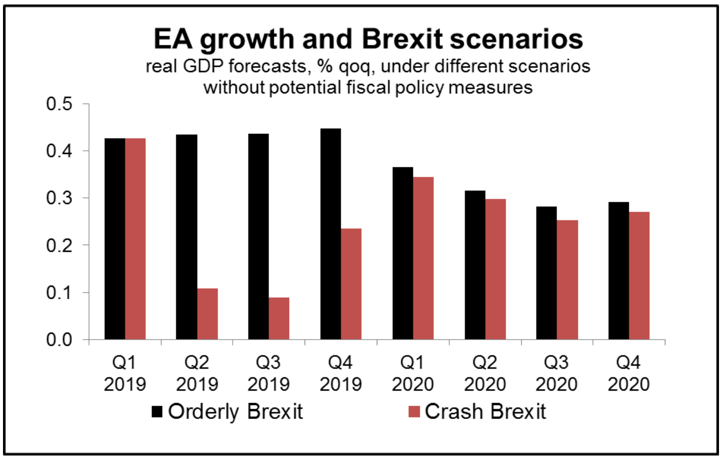
The main difference to the GFC crisis is that a broadly forced deleveraging is unlikely. BoE stress tests find the UK's banking sector to be able to "*support the real economy through a disorderly Brexit*." Moreover, the above results do not include a policy response yet. However, the anticipation of the monetary policy response is not straightforward. Whereas the BoE had embarked on rate cuts and QE following the Brexit vote in 2016, tariffs amid a weaker GBP would temporarily push inflation well above 3% and a supply-side shock cannot be healed by means of monetary policy. BoE Governor Carney has even warned recently that rates may have to rise in case of a crash Brexit. This warning might have also been made in order to communicate to the government that the BoE would not automatically try to compensate for the political failure to reach a Brexit deal. In the end we think that the BoE would react by adopting a more expansionary stance but not replicate the 2016 behavior. In case of a crash Brexiot we expect rate cuts between 25 bps and 50 bps but do not look for another round of QE this time.

Anticipating fiscal policy is also complicated as a crash Brexit could well lead to general elections. Current polls are inconclusive. While we expect a Tory-led government to be reluctant to a fiscal boost, the 2017 Labour Party Manifesto indicates willingness to spend additional 1.1% of GDP per year, mostly on infrastructure. Given the time-lags involved, we see the main impact in 2020. All in, monetary and fiscal policy could lift GDP growth slightly above 0% in 2019 and 2020.

Euro area growth to fall below potential

An unorderly Brexit would be the materialization of a key euro area downside risk. With tariffs being imposed for goods trade with the second largest euro area export market and trade in services being strongly disturbed, economic activity would get a hit. Moreover, a UK recession would additionally dampen demand for exports. For firms as well as at financial markets uncertainty will increase causing investment decisions to be postponed. However, new supply chains inside the EU will have to be built up thereby supporting investments.

All in all, euro area growth would slow down sharply in mid-2019, with growth averaging 1.2% in 2019 and 1.1% in 2020, compared to our base case of 1.7%/1.5%. This would imply quarterly growth falling below potential in 2019 while negative growth rates could likely be avoided.



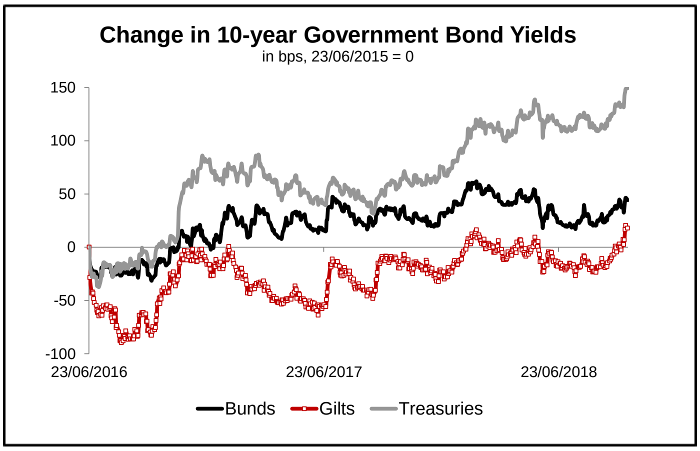
The ECB would likely react in a knee jerk reaction with liquidity injections and make use of the swap lines it has established with other central banks, if needed. Looking further ahead, an unorderly Brexit would induce a weakening in the output gap thereby constituting some headwind to the shaky uptrend of underlying inflation. The ECB would reduce its core inflation projections for 2019/20 (of currently 1.5%/1.8%) and adopt a more accommodative policy stance than it would otherwise be the case. While we see a resumption of QE (that was implemented in the presence of deflation risks) not on the cards, we would expect the start of the key rate normalization path to be postponed further. Instead of a first deposit rate hike in September 2019, the ECB would wait until the dust surrounding the crash Brexit has settled so that a first rate hike before end-2020 seems unrealistic. Moreover, the ECB could pledge to maintain its stock of APP purchases constant for an even longer period of time.

The case for a fiscal policy response seems less clear given the temporary nature of the event. The European Commission would be willing to accept higher deficits and additional spending but we do not see a coordinated fiscal stimulus imminent. Anyway, policy responses mitigate the drag on growth once they become effective and could lift growth to 1.3% in 2020 in our view.

Downturn to trigger lower bond yields

The negative economic impact of a crash Brexit will drive down nominal core sovereign yields across the board.

Real yields are seen to show the same pattern as slightly lower inflation expectations (outside the UK) will not balance the drop in nominal yields. In the UK, the resulting sharp increase in inflation expectations will even trigger a sharp decrease in real yields. As central banks are expected to shift to a more dovish policy stance, the short end of the curve will be affected as well. However, the effect is seen to be less pronounced as ECB and Fed key rate hikes will only be postponed and not cancelled for good. Moreover, the BoE's easing is likely to be constrained by the rising inflation. Accordingly, yield curves will flatten moderately. In addition, the resulting higher risk aversion will cause more safe haven flows which add to the downward trend in yields. Overall, the sovereign bond market most affected will be the British one. But – compared to our base scenario – euro area yields will fall considerably as well, whereas US yields will drop only moderately.



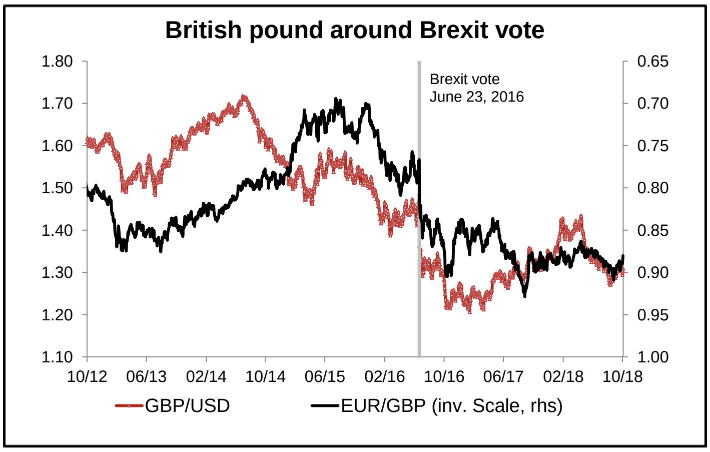
In Southern Europea, this push towards lower yield levels would be largely offset by higher risk aversion. This is all the more true in case an unorderly Brexit triggers new concerns about the viability of the EMU. What is more, the negative impact on growth has the potential to create worries about debt sustainability. Particularly Italian BTPs appear vulnerable in this respect. Therefore, compared to our base case of an orderly Brexit, Italian risk premia are seen to rise and the yield level of BTPs is unlikely to fall from current levels.

Euro area corporate bond spreads will be hit by a crash Brexit as well. Despite the current sound fundamental situation, spreads will not emerge unscathed as the weakening economic environment will ultimately trigger a deterioration of firms' balance sheets. Most of all, non-investment grade corporates will come under pressure. In addition, financial corporates will be squeezed more than non-financials as the drop in core yields and higher risk premiums for Southern European bonds are burdening particularly the former. Regarding corporate yield levels, higher spreads are more than balanced by lower underlying yields. Hence, compared to the base scenario, corporate yield levels tend to be somewhat lower.

GBP/EUR to approach parity

Sterling is the canary in the coalmine for Brexit trouble. Over a fortnight after the surprise Brexit vote in June 2016, the GBP plummeted by more than 10% against EUR and 13% vs. USD. Our quantitative approaches suggest that this risk premium vs. EUR has been maintained since then and even risen a bit further since spring. A no-deal Brexit may raise the political premium by a similar amount as in 2016. Unlike in 2016, markets would not be taken by complete surprise; but the implications for the British economy and the risk of financial market disruptions would be more severe. On these grounds, EUR/GBP may well hit parity (and temporarily even exceed it).

The move against the USD would be even stronger. The Greenback would be underpinned by safe haven flows, while the risk premium on the EUR would rise. The EUR would also be pressured by the deteriorating growth outlook vs. the US and a postponement of ECB rate hikes. While in the base case, we see the EUR/USD at levels close to 1.20 in mid 2019, a no-deal Brexit may imply a much lower level at around 1.13, followed by a mild recovery thereafter.



FTSE 100 risk premium to spike with uncertainty

The FTSE 100 is currently the cheapest European index, together with Italy. It shows a discount to history of around 8% in terms of market multiples, while the EMU index appears fairly valued. UK earnings (12-month forward) increased 11% vs. 7% for EMU year-to-date.

A crash Brexit would certainly represent quite a negative trigger for the UK as well as the EMU index. This would happen through an escalation of the policy uncertainty, translating into a higher equity risk premium and thus into lower PE levels.

Taking the 2016 Brexit referendum outcome as a reference, similar risk premium spikes would easily ignite a -9% and -12% price retracement in the short term (6 months) for the UK and EMU index, respectively. The FTSE100 would tend to outperform thanks to a weaker pound (with the majority of income earned overseas), a more defensive sector composition and a more favorable valuation. The expected market setbacks are also fed by earnings downgrade by the consensus triggered by a significant cumulated real GDP decline compared to baseline. Such a GDP drop would be indeed rapidly anticipated by the market.

Longer term (one year), positive offsetting factors would tend to contain the market setback to a milder -5% and -8% (UK and EMU respectively). Apart from lower 10-year rates, monetary policy would become more expansionary and, in case of the UK, the weaker pound would benefit the FTSE earnings momentum.

Financial market assessment of a crash Brexit

	Current value (Oct 8)	mid-2019		YE-2019	
		baseline	crash Brexit	baseline	crash Brexit
Government bond yields, in %					
2Y Gilts	0.88	1.10	0.50	1.30	0.60
2Y UST	2.89	3.15	2.95	3.30	3.15
2Y Bunds	-0.54	-0.35	-0.65	0.00	-0.40
2Y BTP	1.56	1.30	1.70	1.35	1.30
10Y Gilts	1.67	1.75	1.20	1.90	1.30
10Y UST	3.23	3.30	2.95	3.40	3.20
10Y Bunds	0.53	0.80	0.30	1.20	0.70
10Y BTP	3.57	3.50	3.60	3.70	3.60
Corporate bond yields, in %					
EUR IG	1.11	1.45	1.25	1.85	1.60
EUR HY	3.38	3.85	4.10	4.40	4.30
FX					
GBP/EUR	0.88	0.93	1.00	0.92	0.98
USD/EUR	1.15	1.20	1.12	1.25	1.17
Equity markets					
FTSE100	7233	2.0%	-9.0%	4.0%	-5.0%
MSCI EMU	120.1	2.0%	-12.0%	4.5%	-8.0%

Imprint

Head of Research	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
Head of Macro & Market Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

Issued by:	Generali Insurance Asset Management Research Department Cologne, Germany · Trieste, Italy Tunisstraße 19-23, D-50667 Cologne
Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany