GENERALI INVESTMENTS

Focal Point

High noon in Brexit negotiations

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- The UK is scheduled to leave the EU on March 29, 2019. For an orderly exit, a withdrawal agreement shall be reached by October in order to give both parliaments time for ratification.
- However, a recently published White Paper laid bare the fundamental clash concerning UK's future access to the EU Single Market, with the Irish border issue a major stumbling block. A deal could also fail in the UK parliament.
- Thus, a "no-deal" scenario looks well possible. However, considering the damages entailed, we deem a last minute solution still our base case. This could involve a postponement of fundamental differences into future trade negotiations.
- Against this background, uncertainty will probably remain high and markets volatile over the next months with regards to Brexit news. However, given our eventually positive expectations, we see a market relief in the end.

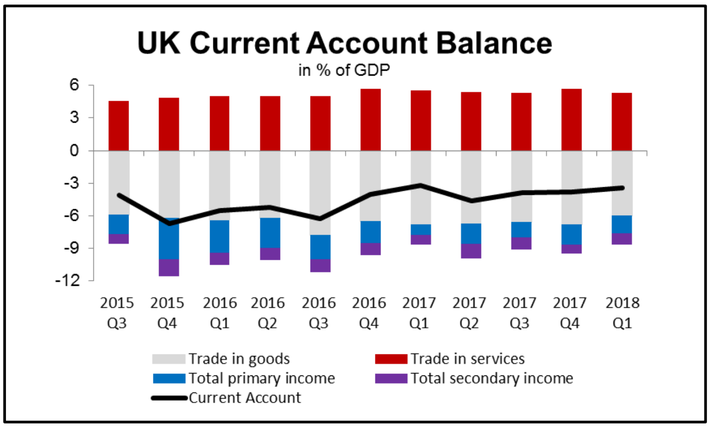
A kind of "high noon" mood currently surrounds the Brexit negotiations between the EU and the UK. The UK is scheduled to leave the EU on March 29, 2019. For a (smooth) orderly exit, a withdrawal agreement would be needed by mid-October, so that both parliaments will still have time for the ratification process, before Brexit legally takes place. Without a deal, economic relations between both economies would fall back to WTO rules only. However, key differences regarding the future trade relationship, implying the Irish border issue, have still to be overcome. Hence, pressures will likely rise in the months to come. Recently, both sides have already warned to prepare for a hard Brexit. In what follows we lay out the key obstacles for a Brexit agreement and try to assess the chances for an agreement. This makes a look into the UK political situation necessary as well as into the EU negotiation principles.

Hard Brexiteers driven out of May's cabinet

In the UK, Prime Minister (PM) May not only has to negotiate with the EU but also be aware of the hard Brexiteers within her own party. Her recently published White Paper drove representatives of this faction out of her cabinet and from other party posts – among them Brexit Secretary David Davis and Foreign Secretary Boris Johnson. Consequently, her leadership was questioned as well as her backing in the lower house of Parliament, as the important bill on customs passed only with a tiny majority of just three votes. Most recently, she took personal control of Brexit talks, thereby downgrading the role of the new Brexit secretary Dominic Raab. While May looks safe amid the parliament's summer recess, her leadership might still be challenged in autumn. The influence of the hard Brexiteers should not be underestimated. A major reason for May to be still in place is that no other person looks much better placed to overcome the deep rift within the Conservative Party. In addition, recent opinion polls see Labour about 5pp ahead of the Conservatives. Thus, a general election would likely result in a significant drop in the number of Conservative Members of Parliament (MPs).

UK's vision for a "New Economic Partnership"

The political turmoil in Britain reflects the need to come to terms with fundamental choices about the future level of integration with the EU. PM May detailed her views in a long-awaited, 98-page government White Paper, published on July 12. Economically, the paper makes clear the UK will leave the EU Single Market and the Customs Union,



relying on a free-trade area. At the same time, it proposes complex rules to keep Britain inside the bloc's customs territory (called Facilitated Customs Arrangement). This will be true for trade of goods including agri-food, but much less so for services. The framework has been named "New Economic Partnership". Brussels will most likely qualify it as a proposal for an "association agreement" (based on Article 217 Lisbon Treaty) which allows for special arrangements. However, the UK proposal has elements of different levels of integration. In more detail (all quotes from the White Paper):

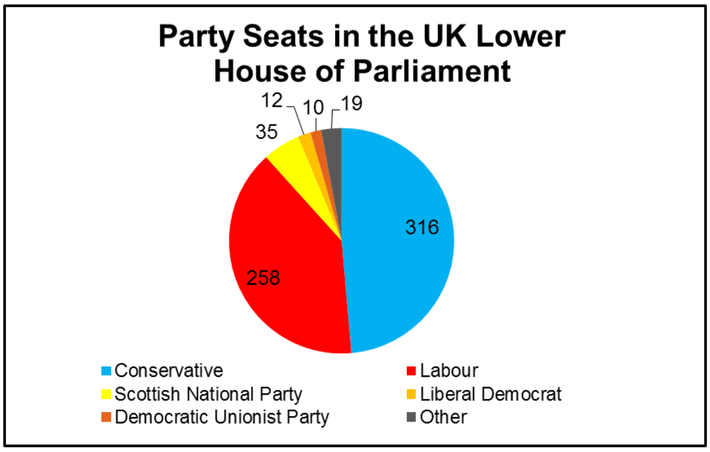
- Regarding goods trade, the UK proposes a free trade area, in order to "*protect the uniquely integrated supply chains and 'just-in-time' processes" while at the same time "avoid friction at the border and ensure both sides meet their commitments to Northern Ireland and Ireland through the overall future relationship*".
- The latter can obviously only be reached by proposing a phased introduction of a "Facilitated Customs Arrangement". This is in fact a customs union including the removal "*for customs checks and controls between the UK and the EU as if in a combined customs territory, while enabling the UK to control tariffs for its own trade with the rest of the world and ensure businesses pay the right tariff*". It also eliminates quotas and routine requirements for rules of origin for goods traded between the UK and the EU. Technically, the handling is supposed to rely on a system of "trusted traders" On top, the UK wants to be at the cutting edge in technology to streamline the process.
- Moreover, the White Paper proposes common rulebooks, i.e. a continued convergence (with or without reciprocity) on standards, which the UK sees as underpinning the free trade area, but is in fact typical for the regulatory framework of a Single Market. "*The UK would also seek participation – as an active participant, albeit without voting rights – in EU technical committees that have a role in designing and implementing rules that form part of the common rulebook.*" This is intended to cover also food and agriculture. The UK would seek participation in EU agencies for chemicals, aviation, medicines, accepting the rules and contributing to their cost. This part has provoked hard Brexiteers, seeing the UK as simple "rule-taker".
- Regarding services, Britain would leave the Single Market. The White Paper does not call for mutual recognition of each other's regulation, but seeks equivalence (a procedure that is already available for third party countries, and would be bilaterally-agreed and treaty-based). That means, the EU and UK will not have the same market access as before. Recently both sides cleared issues of an independent arbitrator.

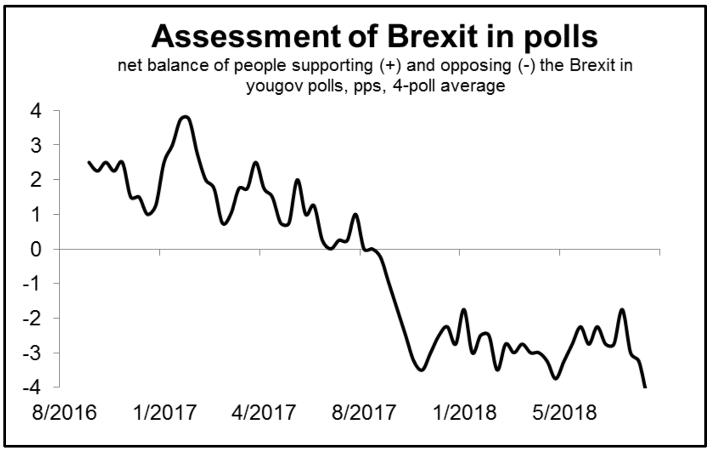
White Paper "dead upon arrival"?

The White Paper has faced a lot of criticism in the UK itself. Not surprisingly, hard Brexiteers called it "Brexit in name only" (Brino). Accordingly, they forced PM May to harden her stance via amendments to the customs and trade bills (which lay the regulatory framework for post-Brexit international trade esp. setting out powers to collect tariffs). One amendment made it illegal for the UK to collect EU tariffs unless the EU acts on a reciprocal basis, which the EU already excluded. The second amendment covers the VAT issue. To properly apply the VAT, the customs authority needs information on goods crossing the border. This information can be either obtained by remaining member of the EU's VAT administrative system (with the Eurosceptic amendment killing this option) or by a hard borders which goes against the heart of the new customs arrangement. However, No 10 insists the amendments are still consistent with the White Paper. In fact, these concessions to the party hardliners served PM May to politically survive.

EU to prevent "cherry picking"

While the snares set by the hard Brexiteers might complicate the process, the EU response is of much higher importance. In fact, the UK White Paper seeks to be "in and out" of the Single Market at the same time. The EU has consistently rejected such an approach. Accordingly, the White Paper has been only welcomed in part. Principally, the basis of the EU appraisal is its negotiation guidelines for the future relationship as agreed at the European Council in mid-March 2018. The paper stresses that the four freedoms are indivisible and that there can be no "cherry picking" through participation in the Single Market based on a sector-by-sector approach. Consequently, the UK White Paper crosses EU red lines, as it seeks a de-facto single market access for goods while not for services (EU chief negotiator Barnier also challenged that goods and services can easily be separated e.g. in case of a smart phone) while at the same time principally ends the free movement of labour and the jurisdiction of the European Court of Justice. Accordingly, the proposal has been rejected in the current form. The EU Parliament recently also recalled that there will be "*no space for outsourcing the EU's customs competences*". Barnier also said that the EU will not jeopardize the integrity of the Single Market.



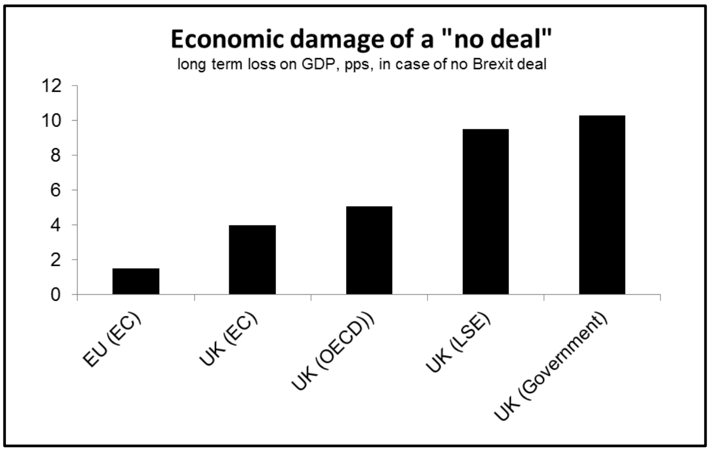


"Deal" or "No-deal"?

However, it is less clear what this will really imply. Two basic scenarios are feasible:

First, a no-deal scenario can rely on two strands of argumentation. 1) In order to preserve the integrity of the Single Market and to keep its independent decision making, the EU would reject the de-facto UK's Single Market access for goods. Instead, Brussels would demand from the UK to remain in the customs union and offer a Canada-style trade agreement afterwards. The UK instead would value the possibility for its own third-party free trade agreements higher than the access to the EU, i.e. not give in. In this scenario both sides clash, reaching no withdrawal agreement which implies no transition period and both sides to drop back to WTO rules on March 29, 2019. The Irish border issue would be unresolved. 2) A no deal scenario, however, can also be the outcome of UK parliamentary process. PM May looks unlikely to be able to rely on the hard Brexiteers within her own party. Thus, Labour MPs would be needed to secure a majority. But Labour developed its own six tests for agreeing in Parliament, which the White Paper currently does not meet. A clash in the UK parliament could well end up with PM May stepping down and new general elections.

In a **second scenario**, a withdrawal agreement would guarantee an orderly Brexit. Significant incentives for such an outcome exist as economic studies clearly show a lose-lose situation for both sides. A recent IMF study suggests a "no deal" would cost the EU on average the equivalent 1.5 pp of GDP over the long-run in a WTO scenario, while the damage for the UK (similarly to Ireland) could reach about 4 pp. Basically, the exit agreement (Article 50 Lisbon Treaty) and the future relationship are two different things. They are interconnected as the March guidelines demand an "[…] *overall understanding of the framework for the future relationship that will be elaborated in a political declaration accompanying and referred to in the Withdrawal Agreement*". Thus the "Future Framework" has the quality of a political declaration only. While the UK put forward that "*Nothing is agreed until everything is agreed*", in reality a complete alignment of ideas is not needed - only a framework is. Details can be postponed to a future trade deal, with negotiations to start only after the Brexit date on March 29, 2019. This opens up the possibility of a dilatory solution, provided urgent matters (i.e. the Ireland issue, see below) can be fixed. Given an exit agreement can be reached, there will be a transition period until the end of 2020 (at least) during which the UK will continue to be a de-facto member of the bloc, albeit without voting rights.



Ireland border issue a big stumbling bloc

The Ireland/Northern Ireland border issue remains a big stumbling block. Both, the UK and the EU are determined to avoid a hard border, in order not to challenge the Irish peace process. A free trade deal alone will not do the trick, while Britain's solutions to collect the import duties on the behalf of the EU or the high-tech maximum facilitation "max-fac" alternative have been rejected by the EU as not workable. Back in December 2017, the UK signed up to a binding "backstop" clause, i.e. that Northern Ireland would remain in full alignment with the EU's single market and customs union rules in all relevant sectors. However, this would create a customs border within the Irish Sea, which PM May upon interventions of the coalition partner DUP called unacceptable. May reiterated her stance that no British PM could ever accept such a border, calling instead on the EU to welcome her White Paper plans. Of late, the UK also toughened its stance by putting its financial contribution again into question, in case an exit agreement would not be reached.

In sum, given the economic costs involved, the high price to be paid from a cliff-edge, the importance of the decision in the "face of history" and the "low hanging fruit" to just postpone the dilemma into the future, we think that a typical last-minute deal could still be reached. At the same time, we expect a lot of "drama" to be involved in autumn. In fact, the decision could be postponed into December or even the negotiation period be extended (via agreement by all states as recently suggested by Ireland).

Markets could see a relief in the end

Accordingly, we expect a "hot" autumn. This is likely to contribute to market volatility during this period. Difficult negotiations will imply no clear direction for markets from the Brexit issue, while the ultimate outlook clearly depends on the realized scenario. However, as we consider a positive final outcome as slightly more likely than not, markets could ultimately respond with relief.

The British pound is likely most sensitive regarding negotiations. EUR/GBP has fluctuated since October last year predominantly in a band between 0.87 and 0.90. Recently, the pound depreciated towards the upper bound. The IMF stated in its last Article IV consultations that the REER is 0%-15% above the level consistent with fundamentals and desirable policy setting, which also reflects UK's current account deficit. While speculative positions are significantly short GBP, positioning is not extreme. Given the fundamental depreciations pressures from the CA deficit, we see the currency relief in case of a deal as smaller than the possible depreciation in a no-deal scenario.

With regard to 10-year Gilts, even in case of no-deal safe haven flows, FX hedging cost of 1.3% per year render a Gilts investment fairly unattractive in our view.

UK equities currently look attractive from a valuation perspective. In case of a deal eventually struck, this potential is likely to unfold. That said, the FTSE tends to be negatively correlated with pound strength which would dent some gains. All in, we recommend maintaining a selected UK equity exposure.

Imprint

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