Market Bulletin

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How will the Brexit negotiations conclude?

We believe the Brexit negotiations will conclude with a relatively "soft" Brexit. But, as current media headlines show, there are still a number of compromises that need to be made on both sides to seal the deal.

Sealing the deal

To understand those concessions that still need to be made, let's recap on what the UK actually wants from Brexit. This in itself isn't entirely straightforward because the nation, parliament, and the Conservative government is divided over what we should be seeking to achieve. As a result, the Prime Minister's initial wish list essentially tried to please everyone.

The UK wanted to leave the European Union (EU), but it didn't want a border on the island of Ireland. It still wanted goods, services and capital to flow freely, but it wanted the power to control immigration. The UK wanted British rules set by British courts, and it wanted to stop sending "substantial" sums to the EU. And finally, the UK wanted to be able to trade more freely with other parts of the world.

This wish list was unacceptable to the EU. EU negotiators understandably argued that without a border on the island of Ireland, then they could not guarantee that goods travelling into the UK would stay out of the EU. And if the UK establishes its own rules, that could give it a competitive advantage over companies in the EU. So the UK will have to prioritise and accept a series of concessions.

In fact, that process is under way. The "Chequers" agreement—reached by the UK government—has prioritised the Irish border. Not having a physical border requires a customs agreement in goods. The Prime Minister has already conceded that this would require the UK to abide by the EU rules set for goods. It may also mean the UK is more limited in its ability to strike trade deals with the rest of the world.

The next priority for the Prime Minister is likely to be some control of migration. I believe there is compromise to be reached here if the UK agrees that any EU resident can come from the EU to work if they have a pre-agreed job. In my mind, this would be acceptable to the UK population, but would also not defy the EU's principles.

The UK has conceded that without full access to the single market, this will limit its ability to trade in services. But ultimately it seems likely that there will be an agreement on regulatory co-operation that will largely preserve the UK's dominance in the provision of financial services. Many commercial banks have indicated that if forced to move they would focus relocation efforts on the city of Frankfurt to be close to the regulator. Given the strength of the German economy, it isn't obvious why Chancellor Merkel would find such a relocation desirable, particularly given the inherent risks that come with a large financial system.

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It is in the interests of both sides to make compromises towards a deal, and there would be economic pain on both sides of the Channel if one cannot be struck. It would certainly be most keenly felt in the UK given that 8% of UK GDP is exported to the remaining EU states. But 3% of EU GDP is exported to the UK and supply chains are highly integrated. Given the fragility of the eurozone recovery, such a shock could be enough to halt the recovery in both regions.

Ratifying the deal

Once the UK and EU negotiators agree on a deal, it then needs to be ratified in the parliaments of the UK and all 27 EU member states. This is why the negotiations need to conclude in the coming weeks to allow time for the legal processes that follow before the final deadline of March 2019.

There is considerable scepticism that the UK Prime Minster will receive support from enough members of her party to pass the Withdrawal Bill in UK parliament. While it is true that a deal like the one above will not please all members of the Conservative Party, it is worth remembering the consequences of blocking the bill. The resulting political deadlock could only be resolved in one of two ways: another referendum on the EU (which could result in no Brexit at all), or a general election, in which the Conservatives could lose office. Both seem a significant risk to take and ultimately I believe will ensure that the Prime Minister has enough support from her party to pass the Withdrawal Bill.

There will then be a period of transition between March 2019 when the UK formally leaves the EU and December 2020, which will allow businesses time to adapt to the new framework.

A soft Brexit would likely lead to higher sterling and UK interest rates

If this analysis proves correct and the negotiations conclude with a relatively soft Brexit, there are likely to be significant implications for the UK economy and markets going into 2019. We believe there is still a significant Brexit risk premium in UK rates, currency, and equity markets. As a result, a satisfactory resolution would likely see sterling rise, which would bring down UK inflation and help lift consumer and business spending.

We may then see a significant re-pricing of expectations for UK interest rates. Remember that before the referendum in 2014, the Bank of England (BoE) was expected to be the first central bank to start taking interest rates back to “normal”—ahead of the US Federal Reserve. That’s because unemployment was low and the recovery well advanced.

Post Brexit, with unemployment now even lower, it seems likely that the BoE would deem it necessary to raise interest rates at a faster pace than the 25 basis points per year that is currently priced.

EXHIBIT 1: IMPACT OF BREXIT NEGOTIATION ON TRADE AND STERLING

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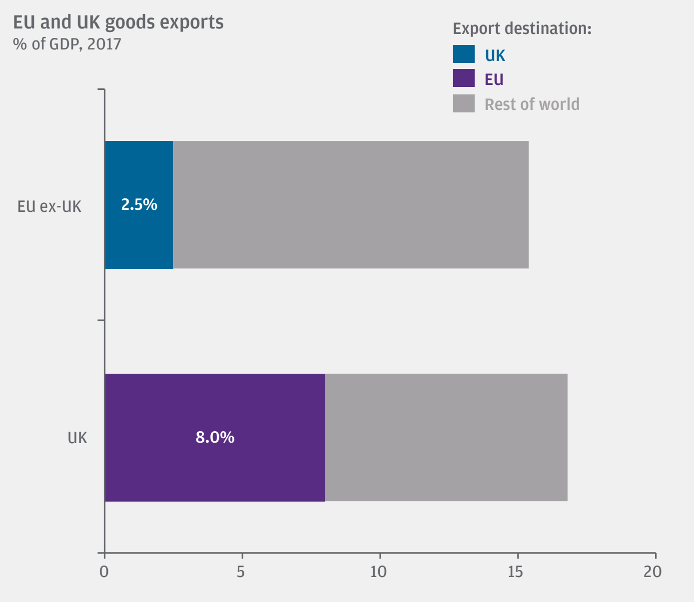

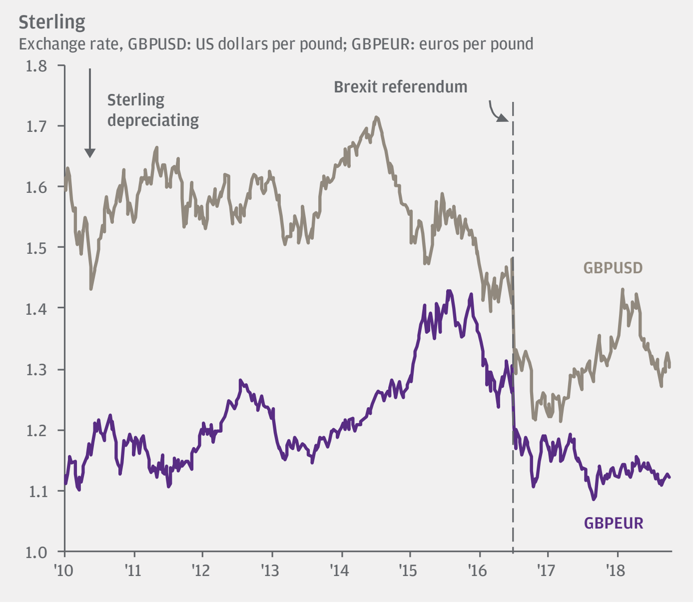

Source: (Left) IMF Direction of Trade, IMF World Economic Outlook, J.P. Morgan Asset Management. EU data is EU ex-UK exports as a % of EU ex-UK GDP. Rest of world also excludes intra-EU trade. (Right) Thomson Reuters Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Guide to the Markets - UK. Data as of 30 September 2018.

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