

Market Bulletin

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What are the implications of the Brexit deal for the economy and markets?

It is hard to remember a time when Brexit was not dominating British headlines, but at the midnight hour, UK and EU negotiators finally reached agreement on a new trade deal. This piece addresses the key questions surrounding the deal: what is covered, how does it impact the outlook for the UK economy, and what are the market implications?

What does the Brexit deal cover?

The EU-UK Trade and Cooperation Agreement is a patchwork of compromises that enables both sides to claim victories, with the EU preserving the integrity of the single market and the UK ensuring tariff-free and quota-free goods trade. For goods sectors, the deal is far better than the alternative of World Trade Organisation (WTO) terms, although trade will still face significant non-tariff barriers. For example, a lack of mutual recognition of conformity assessments - whereby each side agrees to recognise the other's product standards without requiring its own checks - increases the likelihood of delays at the border. The deal is less comprehensive on services sectors (which make up about 80% of the UK economy), with only loose commitments on market access and no equivalence for financial services. Both sides are aiming to agree a Memorandum of Understanding for the financial sector by March, but it is unclear whether this will substantially change the existing deal.

What are the implications for the UK economy?

Compared to the alternative of the transition period ending with no deal being reached, the deal is a clear positive for the UK economy. For context, the UK Office for Budget Responsibility's November forecast pencilled in a 2-percentage point reduction in UK real GDP for 2021 in the event of no deal. The government will hope a reduction in Brexit-related uncertainty will boost UK business investment, which has stagnated alarmingly in recent years. Over the medium term, the economic impact will in part be determined by the extent to which the UK government decides to diverge from EU regulation. The more that the UK looks to forge its own regulatory path, the greater the reduction in EU market access that will likely follow. The deal may also evolve going forward, with a review of the full agreement scheduled every five years (which incidentally ensures that Brexit will be back on the agenda when the next UK general election comes around).

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How might the deal impact the Bank of England (BoE)?

As political uncertainty dissipates, the BoE will be focused on ensuring that sufficient support is in place to shepherd the UK economy through a difficult few months. While the outlook has deteriorated in light of new lockdowns, the BoE acted pre-emptively in November to expand asset purchases by £150 billion, creating ample room to ramp up the pace of Gilt purchases, if required, without announcing a major policy change. A move to negative interest rates cannot be ruled out later in the year if inflation remains below target, but views across the Monetary Policy Committee currently appear split on the efficacy of further rate cuts.

What is the outlook for sterling?

We expect the importance of domestic politics as a driver of the pound to diminish as global forces take hold. The Brexit deal has clearly played a role in the sterling rally over recent months, but this move has also been driven by vaccine approvals, given the disproportionate hit to the UK economy from the pandemic last year. Our base case of a robust rebound in activity in the second half of this year should support modest further weakening of the US dollar vs. most major currencies, including the British pound. While forecasting currency moves is always challenging, we would view somewhere in the region of 5% upside for the pound vs. the US dollar by year end as a reasonable estimate in our central scenario.

What is the outlook for UK equities?

In our view, Brexit is only one piece of the puzzle for UK equities. Of greater consequence is the relative performance of the UK with regards to the handling of the virus and reopening of the economy. And the prospect for a rally in global financials, energy and material given the relatively high

weighting of these three sectors in the UK index (42% of the FTSE 100 vs. 16% of the S&P 500). An acceleration in the global economy driven by the release of pent-up demand later in the year should bode well for UK stocks on a relative basis, particularly if we see a steepening in global yield curves. Valuations are also supportive: 12-month forward price-to-earnings valuations began this year close to two standard deviations below their long-term average vs. MSCI World.

Another factor that stands in the UK market's favour is the relatively high level of income that it offers. The dividend yield on the FTSE All-Share stands at around 3.5%, close to double that of the global stock market and particularly attractive in the context of near-record low bond yields. 2020 was a tough year for income investors as dividends were cut alongside interest rates, but analyst expectations for future payouts from UK companies are now bouncing back sharply. The resumption of UK bank dividends in 2021 is particularly notable given that the sector has historically been one of the largest dividend payers.

In summary, following almost five years of steady outflows from UK equity funds at an industry level, investor appetite may now be set to improve as the political clouds clear.

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