FLASH UPDATE

Brexit Day – What Happens Now?

The Summary

After almost 42 months of uncertainty with repeated speculation about a second Brexit referendum, the Conservative party’s resounding election victory on December 12 finally resolved the debate, paving the way for formal departure from the European Union tonight, January 31st. The result was met with relief by UK businesses, with a rally back into expansion territory in this month’s confidence surveys of purchasing managers in manufacturing and services. What happens next? And what is the likely impact on business and markets?

On Wednesday January 29, the European Parliament voted overwhelmingly in favour of the Withdrawal Agreement (WA) negotiated late last year, removing the last remaining obstacle to tonight’s departure. The WA covers three main areas: it confirms that the UK will pay a €39bn divorce bill, some of which has already been settled; it protects the rights of UK expatriates in the EU and EU workers in the UK; and it removes the need for physical border checks between Northern Ireland and the Republic of Ireland.

During the transition period – which commences tomorrow February 1 and is due to run until year-end – the UK will retain many of the advantages of EU membership but much will begin to change. In the “Deep Dive” section of this report, we cover areas such as travel and residency, legal status and representation, trade, the regulatory context and the forthcoming negotiations.

Business confidence has bounced in the wake of the December election and mortgage approvals jumped in January, leading the Bank of England (BoE) to keep interest rates on hold yesterday. Nonetheless, the market still assigns a 48% probability to a 25bp rate cut in May. This reflects the slowdown in the UK economy in 2019, with GDP growth slipping below 1% on slow business investment and sluggish productivity growth.

However, the job market has been robust – unemployment currently stands at its lowest point since the 1970s – and wage growth has been strong. Moreover, the election was won on a platform of fiscal stimulus, in addition to the promise to deliver Brexit. This additional spending should combine with improving business confidence to foster a pick-up in activity this year, suggesting that the BoE may not need to cut rates after all. All in all, the consensus expects 2020 GDP growth at 1.1%.

Bottom line. With no change in key rates this year, we expect 10-year UK sovereign yields to rise and suggest focusing on short-maturity bonds which are much less sensitive to moves in rates. Corporate bonds should continue to outperform UK sovereigns. Sterling remains sharply undervalued against the US dollar, as illustrated on the chart below. As negotiations advance throughout the year, we expect the pound to strengthen somewhat, reaching $1.35 to $1.40. Sterling strength tends to act as a brake on large UK companies’ profits which are mostly earned overseas, meaning that mid-sized, more domestic stocks should outperform.
The Deep Dive

Travel and residency. Although no longer EU citizens, UK passport holders will still be able to travel freely within the EU. However, UK citizens living in EU member states will have to complete administrative requirements imposed by those states in order to obtain resident rights there. Moreover, they will no longer be able to move from one EU member state to another, given the loss of entitlement to freedom of movement.

EU citizens who have lived in the UK for more than 5 years have until June next year to apply for settled status. If they have lived in Britain for less than 5 years, they can try to obtain pre-settled status, which would entitle them to live and work in UK for up to 5 years (this is only available to EU citizens who moved to the UK before December 2019).

After transition period ends, there may be a need for visas for UK workers who wish to settle in an EU member state, and vice versa. However, both sides have said they plan visa-waiver schemes for visits of less than 90 days.

Legal status and representation. Until transition ends, the UK will still be bound by EU laws, directives and regulations but will no longer be represented on EU institutions. Its MEPs will leave the European Parliament and the UK government will no longer sit on European Council, on inter-government meetings of ministers and no longer has a representative on the European Commission. During transition, the UK will continue to contribute to EU budget, the European Commission can still investigate potential breaches of its directives and the European Court of Justice can still impose fines.

Trade. The UK will still be a member of customs union and single market, ensuring continuing friction-free, two-way trade in goods and services until the transition period ends. However, the UK will lose representation on EU bodies which are responsible for setting standards for various industries.

After the transition ends, the UK will regain a “hard” border with the EU (i.e., one with clearly-defined and strictly-controlled crossing points for customs and identity checks). The sole exception to this rule will be the specific case of Northern Ireland. This was a bone of contention throughout the negotiations and indeed still remains so. The EU is insisting that border checks on goods moving from Great Britain to Northern Ireland are part of the Withdrawal Agreement and as such will be mandatory. Prime Minister Johnson, however, has gone on record as saying that there will be none. Clearly, agreement must be reached rapidly on this point to avoid unwelcome delays in the negotiations.

Last year’s Political Declaration, which accompanied the Withdrawal Agreement, stated that fishing and financial services were priorities to be dealt with by July. This looks rather ambitious.

Fishing, although a tiny sector, is highly politically sensitive. The sector generated only 0.04% of UK economic output in 2018 whereas financial services added 7.1% (according to the Office of National Statistics). At present, territorial waters, (where the UK retains exclusive fishing rights) reach 12 nautical miles from shore. After Brexit, the exclusive zone will be extended to 200 nautical miles, with a median line drawn between UK and EU shores where territorial waters overlap. Given that EU boats land 700,000 tonnes of fish in UK waters each year, this represents a touchy subject for fishing communities on both sides. Moreover, between half and 70% of the UK’s catch is exported to the EU.

Financial services are a key sector in the UK economy and are scheduled to be excluded from the future trade deal. Their “passporting”, which enables firms from one member state to sell across the others, will end after the transition period. However, both parties have declared their intention to work on an “equivalence” basis. This means that the UK will develop a separate regulatory regime, which will diverge from the EU’s framework but ensuring equivalent levels of customer protection for example in order to avoid regulatory dumping. Nonetheless, Switzerland’s loss last year of access rights to EU stock exchanges for Zurich-listed companies suggests that the EU will remain very vigilant on these issues.

Level Playing Field. As a precondition for a favourable deal on trade, the EU is insisting on a level playing field for rules and regulations, with dynamic realignment to changes in key EU standards. For example, it wants EU rules on state aid to continue to apply so as to avoid unfair competition from state-backed businesses. The new UK government on the other hand has declared its intention to become more interventionist in propping up failing industries, as witnessed by the recent bailout of the regional airline, Flybe. It should be noted however that the Withdrawal Agreement already stipulates that Northern Ireland will remain covered by EU state aid rules, meaning that plans which affect the province might have to be shared with EU.

Rules for public procurement will be another battlefield, as shown by the EU’s insistence on opening access to tenders in its free-trade negotiations with Canada. The recent trade agreement with Mercosur highlighted yet another zone of friction, this time on environmental protection. And some EU governments are pushing for provisions on labour market standards to avoid dumping.

The UK government has given mixed signals in recent weeks on regulatory divergence. The Chancellor and Home Secretary have told business to prepare for divergence whereas the Brexit Secretary has said there will be no divergence for divergence’s sake. For the EU, there will be some red lines on areas, such as carbon taxes, where standards must remain in lockstep. In others, the EU might tolerate some divergence under “non-regression” agreements, i.e., where the UK would keep existing standards in place but without the need to update regulations when the EU does so.
It will require deft negotiation by the UK to reach a favourable deal without sacrificing its avowed intention to break free from EU red tape.

**The negotiations.** At present, the EU has no completely free-trade agreements (with zero tariffs and zero quotas on all products and services), reserving that advantage for EU members. The UK looks to be aiming for a “super-Canada” trade deal, that is to say a more favourable deal than achieved by Ottawa, removing tariffs and quotas on goods. However, such a deal is likely to come with strict conditions as outlined above.

Moreover, the government has left little time for negotiations. There will be less than 9 months between the kick-off on March 3 and the deal’s presentation to the European Parliament in late November. In addition, previous EU tree-trade agreements have taken years to finalise – 6 years with Japan, almost 8 with Canada. Given that the UK is much more intertwined with the EU, there is a clear imperative to advance quickly, but it would be imprudent to underestimate the complexity of the task.

Of course, the UK aims to use its new-found freedom to sign new free-trade deals globally, so as to benefit from trade with dynamic high-growth markets. However, EU remains the UK’s major trading partner, as suggested by academic studies which demonstrate that most trade is carried out with close neighbours. For example, 34% of US exports go to Canada and Mexico whereas the European Union and China, both much larger markets, receive only 19% and 7% respectively. Fully 47 per cent of UK exports go to the EU, against 13 per cent to the US and 6 per cent to China.

What might be the economic impact of a “super-Canada” free trade deal? According to the government’s own estimates (published in EU Exit, Long-term economic analysis in November 2018), it might reduce aggregate gross domestic product by around 4.9% over the long-term. While such estimates are subject to a high degree of uncertainty (the government estimated a range between -6.4% and -3.4%), it is clear that the government’s negotiators will have to work very hard on other free trade agreements to begin to compensate for the drag from reduced access to such an enormous neighbouring market. Moreover, it will need a successful conclusion to trade talks to avoid exiting after the transition period to trade on World Trade Organisation terms, an even more damaging scenario for long-term growth. It may still prove necessary to request an extension of the transition period.

**Timetable**

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<th>Date</th>
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<tr>
<td>January 31 2020</td>
<td>Formal departure from EU at midnight CET.</td>
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<td>February 1</td>
<td>Transition period commences.</td>
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<td>March 1</td>
<td>Deadline for the EU to finalise its negotiating terms.</td>
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<tr>
<td>March 3</td>
<td>Negotiations on future relationship kick off.</td>
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<td>June</td>
<td>EU-UK summit to be held to review progress. This is the last chance for the UK to request an extension to the transition period.</td>
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<tr>
<td>July</td>
<td>Deadline for agreement on fishing and financial services.</td>
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<tr>
<td>End November</td>
<td>Finalised trade deal to be presented to EU parliament to enable ratification by year-end.</td>
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<td>December 31</td>
<td>Effective Brexit. If no extension and no deal, then WTO terms will apply to EU-UK trade, including tariffs.</td>
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<tr>
<td>End June 2021</td>
<td>Deadline for EU citizens living in the UK to apply for settled status.</td>
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CA26/JAN2020
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