Weekly Update

C0 | EXTERNAL PUBLICATION

Breaking the Brexit deadlock

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More than two years after the referendum on leaving the European Union (EU), more than 15 months after triggering Article 50 and less than 9 months before Brexit day, there remains little clarity on the United Kingdom's future relationship with its most important political and economic partner.

In large part, the lack of progress reflects profound divisions. The Brexit vote almost split the country in half – 48.1% voted to remain, as did Scotland and Northern Ireland. 2017's snap election yielded a hung parliament, with the Conservative party only able to govern with the support of Northern Ireland's DUP. And both major parties are themselves deeply split on the issue. This has made it difficult for Theresa May's government to fix clear objectives and hence develop a coherent negotiating strategy.

In recent weeks however, the UK government has begun to make some progress. On July 6, the cabinet agreed on a "soft" version of Brexit. This brought divisions within the cabinet to a head, forcing the resignation of those members – such as Foreign Secretary Johnson and Brexit minister Davis – who felt unable to support the plan. The meeting was followed by the publication of a white paper setting out Britain's proposal for future relations with the EU and which will form the new basis of the UK's negotiating stance.

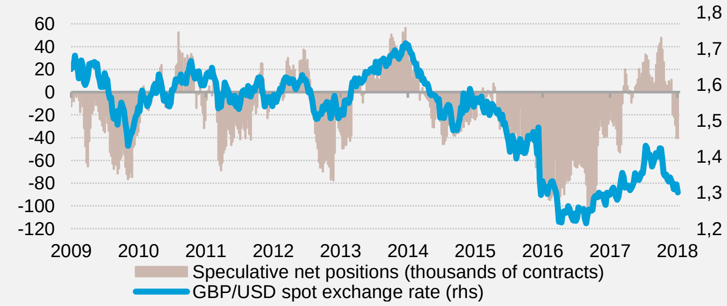
However, many stumbling blocks remain. The EU is likely to judge that the proposal amounts to cherry picking, i.e. splitting the single market's "four freedoms" (movement in goods, services, capital and people). Many pro-Brexit MPs are likely to judge that it amounts to "Brexit-in-name-only", a betrayal of the referendum result. But it commits the UK to clear choices, accepting that trade in services will be excluded from the final agreement, as well as accepting EU rules and European Court of Justice jurisdiction are necessary to ensure frictionless trade in goods (see p.3 for **Brexit terms decoded**).

The run-up to October's EU summit will see negotiations intensify in an attempt to reach a common position. The result then has to be ratified at December's European Council, before the government seeks parliamentary approval in early 2019. That leaves little time for ratification by a supermajority of EU-27 states before Brexit day on March 29.

An additional stumbling block is the lack of consensus in Westminster – Mrs May's white paper satisfies neither the Leave nor the Remain camps in parliament, raising the risk she could be ousted. However, it is unclear who might want to replace her at such a critical juncture and with so little time left.

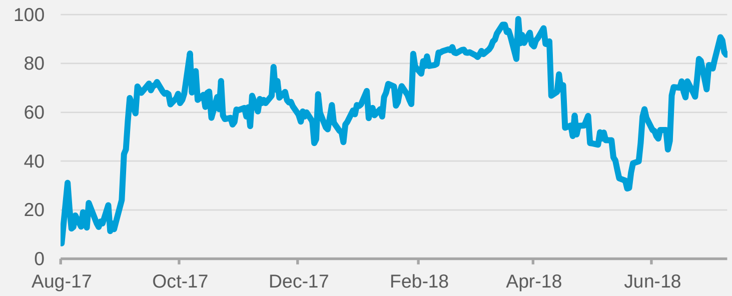
Bottom line. Given the myriad uncertainties, traders will focus on **sterling**. Recent fears that no agreement would be reached have sent GBP/USD back below 1.30. Hopes that a soft Brexit might ensue would see the currency trade back towards our 1.35 medium-term target. The consensus still expects **rates** to rise at the August 2 Bank of England meeting. However, this week's lower-than-expected inflation figures and the risks to growth could encourage them to wait. And recent weakness in sterling should bolster profit growth expectations for **UK equities** given the 70% proportion of turnover in foreign currencies, providing support for the market.

Speculators rebuild short positions on GBP



Sources: SGPB, DataStream, 19/07/2018.

Probability (%) of BoE hike still elevated



Sources: SGPB, Bloomberg, 19/07/2018.

This week and next

EUROZONE

- Headline inflation was confirmed at 2% YoY for June, up from 1.9% in May whereas core inflation softened to 0.9% YoY (May 1.1%).
- Trade surplus (SA) fell below expectations from €18bn in April to €16.9bn in May – slackening global demand weighed on exports, down 0.8% YoY.
- Despite political worries, industrial orders in Italy bounced back +3.6% MoM in May (from -0.6% in April).

Next week's key events		Per.	Prev.	Cons.
23 Jul	Consumer confidence	Jul P	-0.5	--
24 Jul	Comp. purchasing managers conf.	Jul	54.9	--
25 Jul	Money-M3 annual growth	Jun	4%	--

UNITED KINGDOM

- Consumer prices rose 2.4% YoY in June, unchanged from May and lower than expected. Ex volatile items, prices increased 1.9% YoY in June, down from 2.1%.
- Retail sales (ex. petrol) decelerated from 4.5% to +3% YoY in June.
- Average weekly earnings rose 2.5% YoY in the three months to May, the weakest growth in 6 months. Meanwhile, the jobless rate remained at 4.2%, its 43-year low.

Next week's key events		Per.	Prev.	Cons.
24 Jul	Total order books, CBI	Jul	13	--
25 Jul	Mortgage approvals SA	Jun	39k	--

UNITED STATES

- Industrial production rose 0.6% MoM in June, above expectations. Meanwhile, capacity utilization increased from 77.7% to 78.0%.
- Retail sales were up 0.5% MoM in June, down from 1.3% in May.
- Import prices dipped -0.4% MoM in June but rose 4.3% YoY.
- University of Michigan consumer sentiment printed at 97.1 in July, down from 98.2 on trade war concerns.
- While the NAHB housing was unchanged at 68 in July, building permits weakened to 1.27mln in June on rising mortgage rates.

Next week's key events		Per.	Prev.	Cons.
24 Jul	Manufacturing confidence	Jul P	55.4	55.5
26 Jul	Durable goods MoM	Jun	-0.4%	2.5%

ASIA & EMERGING COUNTRIES

- In Japan, headline CPI rose 0.7% YOY, below expectations (0.8%YoY), whereas core CPI rose 0.8% YoY in line with forecasts.
- As expected, the Chinese economy grew 6.7% YoY in Q2, the 12th quarter in the 6.7-6.9% range. Growth in total social financing slowed to 9.8% YoY from 10.3% in June although bank lending beat expectations (+12.7% YoY).
- Retail sales in China were up 9% YoY in June, an improvement on the 15-year low observed in May.

Next week's key events		Per	Prev.	Cons.
24 Jul	Japan: Manufacturing confidence	Jul P	53	--
27 Jul	Japan: Core inflation YoY	Jul	0.7%	--

Sources: DataStream, Bloomberg, 20 July 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.16	1.20
GBP/USD	1.30	1.35
EUR/CHF	1.16	1.18
USD/JPY	112	110
Brent	$73.3	$75
Gold	$1217	$1250

Forecast figures are not a reliable indicator of future performance

No change to our 6-month targets this week.

Question time

Past performance should not been seen as a guarantee of future returns.

BREXIT TERMS DECODED

The moving parts:

- **Single Market** (SM) – No tariffs, quotas or taxes. Enshrines the four freedoms (of goods, services, capital and people). Includes all EU members. Requires common standards. Has been extended, with exceptions, to Norway, Iceland and Liechtenstein via the EEA. Governed by the European Court of Justice (ECJ).
- **Customs Union** (CU) – Covers goods but not services, agriculture or fishing. Includes all EU members, along with Monaco, Jersey and Guernsey, and Turkey via a separate agreement. Requires that rules of origin be respected, and that common external tariffs be applied. Subject to EU standards and ECJ jurisdiction. Difficult to sign free trade deals with non-EU parties.
- **European Free Trade Area** (EFTA) – No common external tariffs so not a customs union. No regulatory alignment with EU. Includes Norway, Iceland, Liechtenstein and Switzerland.
- **European Economic Area** (EEA) – Enables three of EFTA's members, but not Switzerland, to participate in the SM.

The possible models:

- **Canada** – The CETA provides for preferential access to SM. Requires that rules of origin be respected. Excludes some foodstuffs. Includes some services and access to public procurement.
- **Norway** – Under EEA, provides full access to SM, except for agriculture and fishing. Requires financial contribution to EU budget, acceptance of EU laws and ECJ jurisdictions, acceptance of freedom of movement.
- **Turkey** – Provides for CU with EU for goods, not foodstuffs or services. Requires that Turkey applies EU's external tariffs on its imports
- **Switzerland** – Access to SM is governed by numerous bilateral agreements and EFTA membership. Requires a financial contribution. Acceptance of free movement.
- **Jersey** – In the CU for goods and also agriculture, not for services. Common external tariffs applied.

A possible solution:

As outlined on page 1, the divergences and divisions within the UK have slowed progress on deciding what type of Brexit to aim for. The government initially set out a number of red lines which proved incompatible with its attempts to negotiate a deal with the EU. One of the most intractable has been the commitment to avoid a physical border between Ireland and Northern Ireland. This makes models such as Canada or Turkey problematic in that they would entail continued customs controls. The Norway model crosses a different red line as it requires continued financial contributions and acceptance of freedom of movement. The Swiss model involves over 180 separate bilateral agreements and would be virtually impossible to implement – even if the EU were to be open for discussions, it also involves financial payments.

That could leave Jersey, as suggested by the Centre for European Reform in January. A physical border in Ireland would be avoided, but no freedom of movement for people is involved. The UK would take rules from the EU on goods and foodstuffs and would find it difficult to negotiate trade deals on these with third parties. But services – around 80% of UK GDP – would be excluded, enabling the UK to strike international deals in this area.

WORLD TRADE

What impact on global trade after the EU / Japan free-trade deal?

Last Tuesday, the European Union and Japan signed the biggest bilateral trade agreement in history, removing almost all tariffs. This deal had been under negotiation for some years but America's declaration of trade war probably encouraged both parties to finalize discussions. The EU-Japan Economic Partnership Agreement is set to create an open trade area covering more than 600m consumers and almost a third of the world's GDP. The pact now needs legislative approval.

The agreement will eliminate 99% of tariffs applied on EU exports to Japan, according to Reuters, and save European importers up to 1bn euros in annual duties, according to the European Commission. In addition to goods and services, the deal also covers data protection, with Japan agreeing to align with the EU's General Data Protection Regulation (GDPR).

On one hand, the EU will be able to access Japan's 127m consumers with its services (financial services, e-commerce, telecommunications and transport) and also its agricultural produce (cheeses, meat, etc.). On the other, Japan will be see tariffs on car and car part exports to the EU gradually removed over 7 years. The overall impact could lead to a 0.8% boost to EU economic output and 0.3% for Japan.

Although the EU and Japan have clearly committed to free and open markets, they will continue to engage with the US administration – indeed, European Commission president Jean-Claude Juncker will visit Trump in Washington next week.

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-37 bp	0 bp	➡	0 bp	-2 bp	0 bp
3mth Euribor (EUR)	-32 bp	0 bp	➡	1 bp	1 bp	1 bp
3mth Libor (USD)	235 bp	1 bp	➡	-1 bp	65 bp	104 bp
3mth Libor (GBP)	76 bp	3 bp	⬆	-3 bp	24 bp	47 bp
10-year US Treasury bond	285 bp	-1 bp	➡	-7 bp	43 bp	58 bp
10-year German bond	27 bp	-2 bp	⬇	-33 bp	-15 bp	-21 bp
10-year French bond	57 bp	0 bp	➡	-25 bp	-9 bp	-22 bp
10-year UK bond	124 bp	-9 bp	⬇	-32 bp	1 bp	0 bp

Credit

	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0,1%	⬆	0,3 %	-0,1 %	1,1 %
BAML EURO Corp HY	0,2%	⬆	-0,6 %	-0,4 %	1,7 %
BAML GBP Corp IG	0,6%	⬆	1,2 %	-0,8 %	0,8 %
BAML US IG	0,2%	⬆	0,5 %	-2,3 %	-0,6 %
BAML US HY	0,1%	⬆	0,4 %	0,7 %	2,3 %
JPM Global EM Sov. Plus	0,2%	⬆	-2,8 %	-4,3 %	-0,7 %

Exchange rates

	Last	1wk		3mth	YTD	12mth
EUR/USD	1,16	-0,3 %	⬇	-5,7 %	-3,1 %	1,1%
EUR/CHF	1,16	-0,6 %	⬇	-3,0 %	-0,6 %	5,7%
GBP/USD	1,30	-1,5 %	⬇	-7,6 %	-3,6 %	0,0%
USD/JPY	112	-0,1 %	➡	4,7 %	-0,2 %	0,4%
USD/BRL	3,83	-1,4 %	⬇	13,0 %	15,6 %	21,6%
USD/CNY	6,78	1,6 %	⬆	7,9 %	4,1 %	0,3%
USD/RUB	63,6	2,2 %	⬆	4,4 %	10,3 %	7,8%

Government bonds*

	1wk		3mth	YTD	12mth
United States (3-7yr)	0,1 %	⬆	0,8 %	-0,9 %	-1,4 %
United Kingdom (3-7yr)	0,3 %	⬆	1,4 %	0,0 %	-0,3 %
Germany (3-7yr)	0,0 %	➡	1,2 %	0,7 %	0,8 %
Japan (3-7yr)	0,0 %	➡	0,0 %	0,0 %	0,2 %

Equities*

	Last	1wk		3mth	YTD	12mth
MSCI AC World	514	0,1 %	➡	0,3 %	1,8 %	10,6 %
Eurostoxx 50	3 472	0,8 %	⬆	1,8 %	2,0 %	2,7 %
DAX	12 686	1,6 %	⬆	1,0 %	-1,8 %	1,9 %
CAC 40	5 417	0,2 %	⬆	2,9 %	4,8 %	7,2 %
S&P 500	2 804	0,2 %	⬆	4,6 %	6,0 %	15,6 %
FTSE 100	7 684	0,4 %	⬆	5,9 %	2,3 %	7,7 %
SMI	8 934	1,3 %	⬆	1,9 %	-1,6 %	2,4 %
Topix	1 750	2,3 %	⬆	0,2 %	-2,6 %	10,2 %
IBOV Brazil	77 487	2,2 %	⬆	-9,7 %	1,4 %	18,9 %
MICEX Russia *	2 269	-2,3 %	⬇	1,7 %	7,6 %	16,3 %
MSCI EM	1 061	-0,8 %	⬇	-9,3 %	-6,7 %	2,7 %
SENSEX 30 India	36 351	-0,4 %	⬇	6,3 %	8,4 %	15,1 %
Hang Seng (H-K)	28 011	-1,7 %	⬇	-6,9 %	-4,1 %	9,0 %
Shanghaï Composite	2 773	-2,3 %	⬇	-11,1 %	-16,2 %	-14,2 %

Commodities

	Last	1wk		3mth	YTD	12mth
Brent	$73	-0,1 %	⬇	-2,0 %	10,0 %	47,8 %
Gold	$1 217	-2,4 %	⬇	-9,5 %	-6,6 %	-2,0 %
Silver	$15,3	-4,4 %	⬇	-11,1 %	-10,1 %	-6,1 %

Source: DataStream, on 19 July 2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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