FIXED INCOME

The UK Has Left the EU. What's Next Post-Brexit?

January 31, 2020

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It’s been 3-1/2 years since the United Kingdom voted to leave the European Union, and the process known as Brexit has been far from smooth. Now that the deadline to leave has passed, what’s next for the United Kingdom, and for Europe? Our Head of European Fixed Income David Zahn says that while there’s no turning back, there are still quite a few kinks to be worked out, including the all-important trade agreements.

On June 23, 2016, a referendum was put forth to citizens of the United Kingdom with a profound choice: remain in the European Union (EU) or leave. It was a close vote, but the choice was leave, and the process known then forward as Brexit has been fraught with controversy, confusion and many delays.

But, here we are at the end of the Brexit deadline—and there’s no turning back. Now that the United Kingdom has officially left the EU, many fixed income investors are wondering what comes next for both regions—and what it may mean for their portfolios.

Trade Negotiations: So Much to Do, So Little Time

Trade negotiations are arguably the most significant piece of unresolved work. The EU has allowed for the unfettered movement of people and goods within its 28-member countries. Now, the remaining 27 countries and the European Parliament must figure out how the goods and services relationship progresses with the United Kingdom outside the bloc.

The early worst-case fears were tied to border gridlock preventing the movement of goods into and out of the United Kingdom, along with the potential for a massive departure of UK-headquartered multinational companies to other countries. While there have been a few hiccups, the worst-case fears largely haven’t materialized.

We have seen some UK companies leave the country, and business and consumer confidence have been negatively affected throughout the Brexit process. But, on the flip side, some domestic companies have benefited from the weaker British pound as exports become cheaper to foreign buyers.

The Brexit deal negotiated with the EU calls for the United Kingdom to leave the customs union. Still, Northern Ireland will continue to follow and enforce many EU rules, making for some potential sticking points at the border or in the middle of the Irish sea.

That’s just one localized border issue. The UK faces a transition period until December 31, 2020, to work out new trading relationships with other countries. Until then, it will follow EU rules and existing trading relationships. We are not the only ones who think 11 months is a very aggressive deadline for such a monumental task. Some countries have taken over 10 years to work through trade agreements.

So, we would anticipate a lot of noise around trade this year, but UK Prime Minister Boris Johnson seems keen to start trade deals sooner rather than later.

There is still a chance that the United Kingdom could crash out with no trade deal at the end of the year, but that would represent a systemic event that could result in a default to World Trade Organization rules. It is possible for the United Kingdom to ask for an extension on trade with the EU, but it would have to do so in June or July.

European trade will be hit if there's no trade deal in place because it runs a big surplus with the United Kingdom. That all said, in the end, we are optimistic that the UK can get a deal done with the EU.

Budget and Monetary Policy Matters

Aside from trade deals, our next notable event to watch will be the UK budget on March 11. This will be important because Johnson will lay out his framework in terms of how he plans to run the country over the term of parliament and possibly longer.

Going forward, we will be watching the government's attempts to spur some of the economic growth lost amid the prolonged Brexit uncertainty. We anticipate we will probably see increased fiscal spending in the north of England, where Johnson has seen strong support, and in Scotland and Wales. Fiscal spending will likely have an impact on the demand for gilts as the United Kingdom grows its debt to finance it.

From the monetary policy side, the Bank of England (BoE) will have a new governor on March 15, Andrew Bailey, and we don't really know yet if he's a hawk or a dove. The BoE could have scope to keep interest rates on hold when it sees the budget in March, if it contains a big spending push. But since there are still a number of unknowns, we believe the BoE should likely remain somewhat accommodative.

With support from the monetary and fiscal sides, the UK economy should have enough support to make it through its post-Brexit transition period.

On the continent, the European Central Bank (ECB) is likely to remain incredibly accommodative—particularly amid a broad policy review that is currently taking place. ECB President Christine Lagarde has announced a review of the entire organization, including how it targets inflation, measures growth, incorporates climate change into its policy and communicates with the public, among other things.

The market is still getting used to Lagarde and how she communicates; she did well in her first conference not to rock the boat. As such, interest rates will likely stay where they are for now. The ECB will likely continue to do quantitative easing for the foreseeable future, but will probably look for other levers to stimulate the economy.

Investment Implications

As noted, if there's no trade deal on the table with the EU by year-end, then some investors will use gilts again as a hedge for a hard Brexit. The pound will also remain in focus because some of the removal of uncertainty should help bring back some strength to the currency.

Some of the uncertainty should also be removed for UK corporate bonds, which we think are relatively cheap versus others globally. So, we think they should perform reasonably well over the coming year.

Once the United Kingdom is no longer under a transition agreement, it basically has no trade deals with anyone. We think the commonwealth nations will be the first target for new trade deals, because they already have existing relationships with the UK. But there's a lot of work to be done, and we reckon we'll see the government push quite hard and be aggressive, which should create opportunities for investors, particularly active managers.

There are a lot of things that have to happen and there will likely still be some bumps in the road.

As noted, the risks now are tied mainly to trade issues in the United Kingdom as well as greater Europe. However, now that US President Trump has done his "phase-one" trade deal with China, will he turn his attention to Europe?

In addition, the US presidential election in November could have implications for the European bond markets. Once we have the US Democratic candidate for president, we'll have to see how things play out in terms of potential fiscal policy.

In summary, the removal of some of the Brexit-related uncertainty we've faced over the past few years should help investor confidence. Growth in the UK and in Europe broadly may see slight improvement amid accommodative fiscal and monetary policy, but still looks slow. We expect European bond yields to remain low in 2020, and UK gilts to likely underperform European bonds.

While the United Kingdom has now officially left the EU, this is just the end of the beginning. Now, the hard work actually begins.

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