BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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May will launch divorce proceedings from the EU in… March 2017

Sufficient time to negotiate. Smooth transition and risks associated with a hard Brexit. Limited political options. Confidence returns, the economy is resilient, but the FTSE100 is flagging.

Key points

- Prime Minister Theresa May announces the initiation of divorce proceedings for March 2017
- Is a smooth transition possible?
- A divorce under the spotlights begging the question: will it be a hard or soft Brexit?
- Limited political options
- The BoE seems unruffled for now
- Resilient economy thanks to consumers
- Confidence returning swiftly
- The manufacturing sector is on a roll
- Financing the British deficits
- Residential real estate is resilient, prices are rising
- Bond market euphoria is temporary
- Imported inflation jumps +7%
- The FTSE100 will no longer benefit from a depreciating pound Sterling

Prime Minister Theresa May announces the initiation of divorce proceedings for March 2107

Three months after the historic British vote, the UK's Prime Minister announced the date of the first step in the process of separation to be negotiated with the EU.

She addressed the British people, emphasising the recovery of independence and sovereignty after having been subjected to EU authority since the implementation of the 1972 European Communities Act, which will have to be repealed.

The British government will take its time preparing new legislation terminating the act of accession to the EU.

Naturally, May claims she hopes to obtain the best possible agreement in order to achieve a smooth transition. Brexit supporters and the EU were both ardently hoping article 50 would be triggered as soon as possible. First anticipated for September, this step will likely not occur before the first or even the second quarter of 2017. At that point the UK will still have two years to negotiate the terms of its exit. A further postponement of negotiations could then be granted, but would have to be determined in concert with the EU.

The coming spring will thus be busy in Europe with the initiation of Brexit negotiations just as the presidential election is taking place in France and prior to the German elections. Theresa May responded to voters' impatience by setting a date, though rather distant from the June vote. The advantages of European integration no longer appeared evident to the British, who felt their circumstances had deteriorated over the past decade and thus voted to exit the EU. It did not matter, moreover, that the UK posted stronger economic results that the EU over the past several years, thanks in particular to a decrease in unemployment and an increase in consumer spending. A first point of uncertainty is thus lifted, alleviating the impatience of those who will certainly be satisfied to have obtained a response to the timing question.

This being settled, new questions will fast arise regarding the terms of the UK's exit from the EU. Many uncertainties thus remain and will not be swiftly resolved.

At this stage it is difficult to determine with certainty whether this divorce between historical partners of over 45 years will be friendly or acrimonious.

A divorce under the spotlights begging the question: will it be a hard or soft Brexit?

The business community is insisting on the need to obtain more visibility with regard to future relations between the UK and the EU as soon as possible. Beyond visibility, economic circles are mainly and rightfully concerned with the actual terms of separation. The Prime Minister will have to formulate a subtle strategy responding to Brexit supporters' expectations while attempting to assure the business community that the separation will be accomplished without causing a major destabilizing impact on the UK economy, third largest in the EU, which is running the risk of cutting itself off from the second largest economy in the world, representing close to a quarter of world GDP. Economic interests are pushing for the least amount of change possible on the regulatory front and in terms of trade with the EU. Above all they want to identify expeditiously the future conditions determining their survival and development. The immigration issue was a key factor in the Brexit win, and it will thus remain central to how Theresa May approaches negotiations with the EU.

Limited political options

Pressure could thus intensify to manage immigration more strictly at the cost of giving up access to the single market. By announcing the drafting of a law that would convert EU laws into British legislation, May is attempting to reassure businesses concerned with the risks of a legal void. However, beyond the announcement effect, the risks of a hard Brexit should not be neglected. Indeed, three months after the vote, no strategy seems to have been put in place by the British government, which has not yet figured out in what direction to initiate the negotiations.

As we mentioned already in June, the British negotiators' political options following Brexit are in fact fairly limited. Existing models are probably not optimal. In the Norwegian model, EFTA members contribute to the EU budget and are bound by the directives governing the free movement of persons. In the Swiss model, bilateral agreements exclude the financial sector. A distinctive and likely complex path will thus have to be charted, while the Brexit camp aims to dispense with budgetary contributions and free movement.

From the EU's standpoint, the aim will thus be not to set too favourable a precedent to avoid eliciting new inclinations toward independence among other Member States.

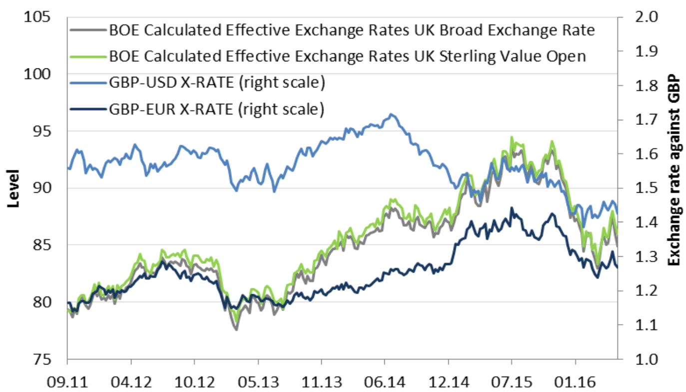
The BoE seems unruffled… for now

No changes noted in September. The BoE acted in August, announcing a large-scale stimulus plan aimed at reassuring business managers and households worried by the possible consequences of Brexit. The central bank was restrained at first, doubtless to avoid giving the impression of hastiness. Post Brexit, the BoE thus decreased its target rate from 0.5% to 0.25% to boost the borrowing capacity of households and businesses. It also initiated a more competitive bank financing programme to expedite the transmission of its policy. Its asset purchase programme was expanded to allow further monetary injections. The BoE thus acted without haste and seemed to provide the expected solutions to boost confidence. It should maintain the status quo until the end of the year, particularly if the economy demonstrates sufficient resilience over the next several months. The pound stabilised after its June tumble to relatively low levels against the main currencies. The British currency may have already reached a valuation level enabling a more lasting consolidation pending greater visibility with regard to the country's economic outlook.

The pound's tumble should constitute the most important factor bolstering GDP growth in the second half of the year.

Increasingly competitive exports have had a swift positive impact on the markedly expanding manufacturing sector.

<u>**Effective, dollar, and euro exchange rates**</u>



Sources: Bloomberg, BBGI Group SA

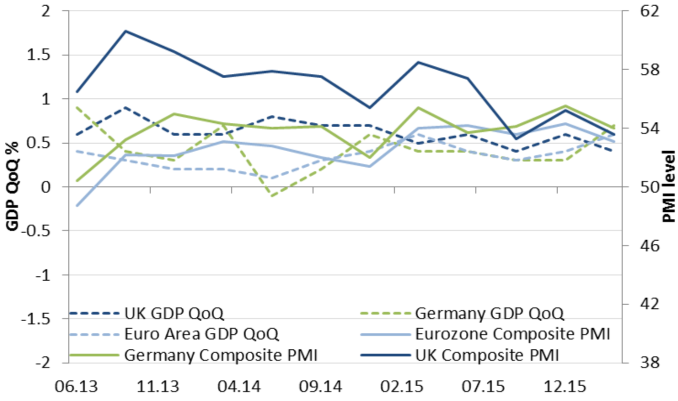
Resilient economy thanks to consumers

British consumers and the manufacturing sector are boosting GDP growth. Confidence has returned, and consumer spending is holding up well. Business and consumer confidence has improved since the June vote. In September, the household confidence index regained ground lost after the Brexit announcement, even reaching its second highest level since 2016. Wages continue to rise more quickly than prices, enabling an increase in purchasing power, just as interest rates and unemployment are decreasing. Business managers are also somewhat more optimistic. The index published by Lloyds Bank jumped 8 points and has reached its highest level since the Brexit vote.

Brexit's initial impact is already visible in the British manufacturing sector. The fall of the pound has boosted exports.

The manufacturing PMI index jumped from 53.4 to 55.4 in August, its highest level since 2014. September export orders surged, partially tempering fears of an economic collapse. Nevertheless, the sector remains a minor contributor (10%) to GDP overall. However, the manufacturing index is highly correlated with the services index; the latter should thus confirm the former's strong results.

Quarterly GDP and PMI – UK, Eurozone, Germany



Sources: Bloomberg, BBGI Group SA

British consumers are spending and, moreover, are not hesitating to purchase on credit despite continuing uncertainty. Indeed, consumer credit expanded +10.3% year-on-year in August, suggesting an improvement in consumer spending in the third quarter, a key factor in terms of post-Brexit economic growth expectations.

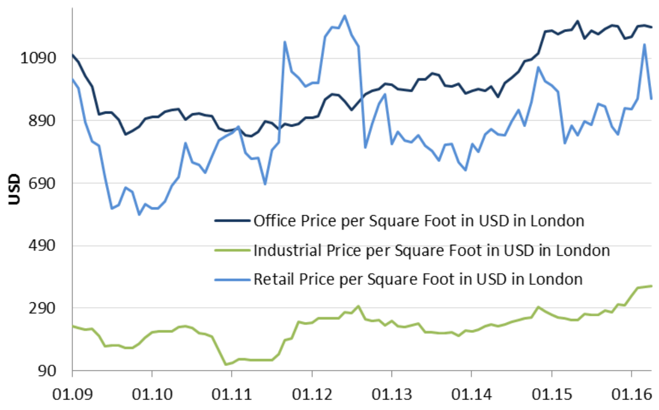
Financing the British deficits

The UK depends on foreign investment to finance its dual fiscal and current deficits. Its current account deficit is the highest among the G7 countries, and its fiscal deficit is also among the largest. Capital inflows have been significant in the past several years, allowing the UK to finance its deficits. A negative outlook for the pound should be offset by higher yields, justifying the risk. Decreasing yields and the BoE's monetary policy are not currently moving in this direction, however. It is thus far from certain that Brexit will give rise to conditions favourable to maintaining a high level of foreign investment in the UK, thus making it more difficult to finance these deficits. On the trade front, the UK has a deficit with many EU countries. For now, the trade balance is benefiting from the manufacturing sector's resurgent competitiveness. Ultimately, losing access to the single market would impact a large portion of the UK's trade. Imports and exports of goods and services represent 60% of GDP, half of which are conducted with the EU. Therefore, make no mistake – the current recovery may well only be temporary and dependent upon future economic conditions. An effective renegotiation of trade agreements is essential to supporting the country's economic prospects, even if confidence prevails for now.

Residential real estate is resilient

Residential real estate prices rose another +5.3% due to a permanent imbalance between supply and demand. Temporarily weaker demand was offset by a decrease in supply before they jointly rallied in August. The year-on-year price increase in September was even larger than in June (+5.1%). Nevertheless, growth has slowed compared with 2014 valuations.

Real estate prices



Sources: Bloomberg, BBGI Group SA

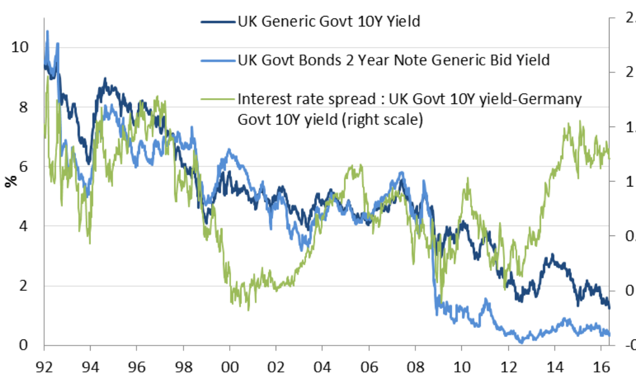
The wealth effect generated by rising real estate prices will continue to boost the confidence of households and their propensity to consume or invest. The real estate sector, which had a lot to lose from Brexit's anticipated effects, has remained resilient in terms of the residential segment. Leading indicators remain rather favourable to continuing growth in domestic demand and restricting new construction. However, the number of mortgage approvals continues to consolidate. A depreciating pound could bolster residential demand, as many private international investors could be tempted by this opportunity and by persistently favourable borrowing rates. In contrast, the commercial segment is more risky. International investors had favoured this market for their

European activities. Brexit diminishes London's appeal as an operational base for these firms, thus increasing risk in this segment.

Bond market euphoria is temporary

In spite of the pound's tumble and rising inflation in August (+0.3%), price indices have not expanded significantly to date, namely, +0.6% year-on-year and +1.3% for the index excluding food and energy. However, the +7.6% year-on-year rise in imported prices following the fall of the pound and the increase in oil prices should transfer to general price indices. In this context, 10-year rates reached new historic lows, dropping below their January 2015 floor to a mere 0.5%, before gradually coming back up since mid-August.

10- and 2-year UK government yields



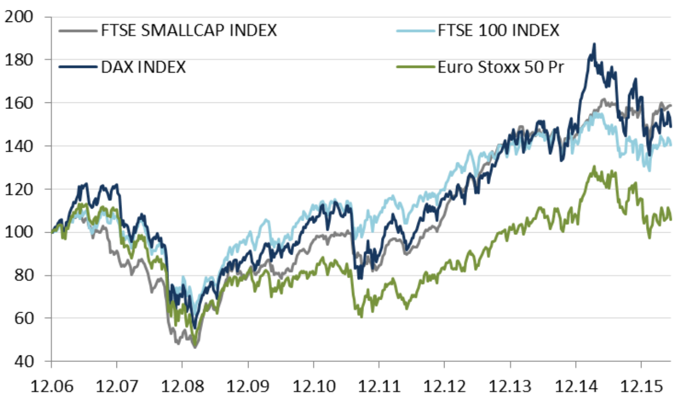
Sources: Bloomberg, BBGI Group SA

This situation is extraordinary, as it does not appear to be taking into account the significant risks of an increase in interest rates and risk premiums, which are logically linked to Brexit and the immediate downgrade of UK government debt from AAA by the rating agencies. Nevertheless, said situation is a key element bolstering the economy, even though the current euphoria is unlikely to last.

The FTSE100 will no longer benefit from a depreciating pound Sterling

As we mentioned at the time of the referendum, the fact that close to 70% of the revenues of the FTSE100's large stocks are generated abroad will have a positive impact on earnings in the context of a depreciating pound. While the British equity index rose +11.3% since Brexit, it finally fell -0.44% in CHF. At approximately 15x 2017 earnings, the British market is more expensive than most European markets for similar yields (4%). Since June 22, small caps (+10.4%) have slightly underperformed the large cap index (+11.3%). The stabilisation of the pound should moderate the rise of British shares.

UK (small & large cap), Eurozone, German equities



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