Market Update: 10th September 2020

Following the UK's official exit from the European Union, the UK and EU had only managed one round of talks before coronavirus brought a stop to negotiations. The onset of Covid-19 caused the cancellation of two negotiation rounds as nations around the globe faced the challenge of grappling with a worsening pandemic and severely deteriorating economic conditions. Any hope of further progress was also halted as both the EU and UK chief negotiators, Michael Barnier and David Frost, tested positive or demonstrated mild symptoms of the virus.

As negotiation rounds began from April onwards, media sentiment appeared positive, as both sides exhibited their willingness to come to a deal, acknowledging that each must adjust their positioning for an agreement. However, the outlook has worsened in recent weeks. Both sides remain firm in their positioning, whilst a recent decision by Boris Johnson to draw up new laws between the UK and Northern Ireland have weakened the withdrawal agreement which was reached last year between the UK and EU.

The impasse

The impasse appears to be based around two key areas: UK fisheries and state aid. Fishing has always been one of the biggest hurdles to a post-Brexit deal, and as foreign secretary Dominic Raab reiterated earlier this week, it is one of the very reasons the UK decided to leave the EU. As the UK entered the European community, the nation was forced to share its fish-rich waters with EU fisheries. Under this scheme, a 2016 report found over 58% of fish and shellfish in the UK's waters were caught by non-UK boats. The EU is seeking to maintain its access for its fishermen and women to protect jobs and coastal communities, whilst the UK wants reduced access for EU boats and to make the matter conditional on regular negotiations.

Market commentators have questioned the UK's stance on this matter. The UK fishing industry only contributes to 0.1% of UK GDP, and it employs less than 0.1% of the UK's entire workforce. Although this is true, the industry dominates many coastal communities and any changes in its fortunes could have a very noticeable impact.

The other matter, on state aid, is one which would be expected to provide the UK with a much larger economic benefit. Since the treaty of Rome in 1957, member states have been banned from giving companies or industries special help that would distort competition. Aside from times of economic need, which relaxes the regulation on state aid to support the economy, EU member states cannot support firms which could undercut their European rivals. However, on leaving the EU, the UK sees an opportunity to support its presence on the international stage. The UK technological start-up scene has lagged the likes of US and China, and towards the end of August, Apple's market capitalisation surpassed the value of the entire FTSE 100 index. Through the provision of state aid, the UK government could adopt a stronger policy stance which fosters innovation, which in turn increases international competitiveness through bringing new ideas to market.

It would be expected that this would effectively help firms overcome structural and financial hurdles, however some may argue otherwise. Sceptics argue that governments are not necessarily good at picking winning tech start-ups to invest in, and the economic benefit would not be as great as originally thought. The economic benefit may be weaker too if the pursuit of state aid comes at the expense of a worse deal with the EU, which limits the access to the European market.

What may a deal look like?

The deal outcome between the UK and EU will be dependent on the current negotiations surrounding fishing and state aid. An Australian type of deal is more likely if the two sides are unwilling to negotiate on these matters, whereas a Canadian style deal will be expected if both the UK and EU can compromise on their current positions. Under an Australian agreement, the UK and EU would not trade under a free trade agreement (FTA) but rather WTO rules. Compared to our current agreement, this would make goods and services a lot more expensive for UK customers, whilst reducing the demand for UK exports. The attractiveness which has often been highlighted in the media however is the potential points-based immigration system, which provides the UK with greater control over who can come into and reside within the UK. The attractiveness seems to stop there, however, and this would likely be the worst outcome if the UK and EU cannot come to an agreement on fishing and state aid. Financial markets could become increasingly concerned about the possibility in the short term, based on the recent comments by Boris Johnson highlighting this type of deal will be pursued if another agreement is not reached by the middle of October.

A Canada-style agreement, on the other hand, is much more favourable. Called a Comprehensive Economic and Trade Agreement (CETA), this style eliminates almost all tariffs and increases quotas, which in turn means the price of goods will not suddenly spike nor will costs increase for consumers on either side. A free trade deal of this form will help to reduce trade barriers between the region, helping to support trade continuation and support UK businesses in their forward planning and decision making. Although, the UK would likely build on this form of agreement further since the value of trade is greater and its proximity to the EU is much closer.

Market commentators have been discussing the difference between these two types of deals. The difference between the two above is reduced trade barriers and hence lower up-front costs under the FTA. The similarity is that both will increase the level of border checks and paperwork involved, as differing regulatory requirements requires greater scrutiny. As such, either scenario will increase the opportunity cost faced at borders, increase delays and produce frictions in trade which are otherwise smooth at this moment in time. The long-term effect of which deal, however, could be much more important. Under an Australian 'no-deal', the UK is estimated to miss out on 7.7% of future income over 15 years compared to a comprehensive trade deal like the one we currently have. Yet, under a basic trade deal, the UK would miss out on a lower 4.9% of future income over the same period.

Boris Johnson stands firm, EU warning on NI behaviour

Despite what may seem to be a clear decision to many, Prime Minister Boris Johnson announced he is willing to take a gamble on the outcome, after his recent comment "I will not back down" on the two main points of contention. Whilst the extent of this comment is uncertain, news outlets have speculated as to how believable this is. On the one side, Brexit is personal to Boris Johnson, as he led the campaign to exit the EU in 2016 and then won a majority last December to deliver Brexit. On the other, the severity of the recession the UK may face in the wake of the pandemic may be enough to dissuade the PM from accepting more economic disruption via an Australian-style deal than is necessary.

The UK's recent negotiation stance has angered the EU. Early this month, it was confirmed that the UK is drawing up new legislation with Northern Ireland (NI) that would dilute the effect of the withdrawal agreement on subjects ranging from state aid to customs. The purpose of the new legislation is to smooth the transition at the border, helping to clarify the Northern Ireland Protocol between the UK and NI. This goes against the legal Brexit withdrawal agreement which was put in place between the UK and EU in 2019, in which the EU insists a customs border must be in place in the Irish sea. As a result, this is likely to disrupt the Brexit negotiations and make the EU less likely to compromise on a deal, which could further increase the chances of an unfavourable deal being established. Not only is the EU unimpressed by the behaviour, but so was the head of the UK government's legal department Jonathan Jones, who quit this week. The senior civil servant resigned after being dissatisfied with the UK's move to begin overwriting parts of the NI protocol.

Market reactions

The pound has exhibited weakness over the last week as bearish bets on the currency have grown amidst the Brexit uncertainty. Markets are beginning to price in a failure of trade talks, as the prospect of a no-deal Brexit becomes increasingly real. At the last MPC meeting financial markets were reassured that there would not be rate cuts soon, however expectations are growing that the Bank of England will cut rates below zero by May 2021, forward from September 2021. If investors begin to bet on interest rate cuts and a negative Brexit outlook, bond yields could turn negative and hit new record lows.

The pound's fall could initially boost foreign demand for FTSE 100 companies and UK goods, as the investments appear cheaper and undervalued. If the worst-case scenario begins to materialise, the fundamental value of these companies may worsen, due to the regulatory and supply chain impact amongst other factors. Looking at financial markets, the scepticism has not been fully baked into equity market prices, and this may be due to Brexit fatigue of the last four years or greater expectations for central bank stimulus moving forward.

That being said, many remain optimistic for the UK's prospects. Economists from Goldman Sachs Group Inc., JPMorgan and Morgan Stanley all still anticipate a deal on commerce will be in place in time for the end of December. Others have highlighted that deadlines can be extended, and politicians can have the tendency to remain stubborn until the last moments, only for a mutually beneficial outcome to be agreed upon.

Our view

Whilst the latest developments appear to decrease hopes for a trade deal, it remains mutually beneficial for both sides to come to an agreement, whether that may be on the artificial October deadline or at a delayed deadline. The economic risk from the global pandemic has put UK and European nations in a weakened position, as GDP has severely contracted while unemployment rates remain heightened. If both sides remain hostile and pursue a tit for tat strategy, it will simply worsen each other's position and there will be no winner. The UK could compromise by reversing its pursuit of revising the Brexit withdrawal agreement at its Northern Ireland border, meanwhile the EU may be willing to accept slightly decreased access to UK waters if the UK government is willing to accept a certain level of EU fishing boats. Compromising on the two key areas could greatly boost the Brexit outlook for both regions.

Despite Boris Johnsons firm stance, a deal could still be agreed upon after the 31st December deadline. Either way, deal or no deal, greater border checks will be implemented. The UK exported £291bn of goods and services to other EU countries in 2018, which was 45% of all UK exports. In comparison, the UK imported £357bn of goods and services from the EU, which was 53% of all UK imports. Even with the current uncertainty around negotiations, the stakes are potentially greater for the EU whose export value is larger, whilst the UK would be free to negotiate stronger trade deals with global nations post Brexit. Looking ahead, we are likely to see further volatility in both the UK and Europe as news headlines on either side produce differing outlooks. We remain optimistic on a deal of some form being struck and compromise on either side, which would further support the UK's growth prospects in its pandemic recovery.