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Brexit Deal Breakthrough

After more than 40 years of UK membership in the European Union, Brexit negotiators from the UK and EU made essential concessions to avoid the disruption of a no-deal Brexit with just days to spare before the deadline. Three and a half years on from the deciding referendum vote in 2016, negotiations continued until the eleventh hour with the eventual agreement leaving both the EU and the UK better off than if no deal had resulted. The 1,000-page legal text that outlines the future relationship between the UK and the EU provides the opportunity to assess the deal and its implications, however, uncertainty still remains over key areas such as the services industry. This update seeks to provide clarity around what has been negotiated, what is still unclear, the reaction in financial markets, and what we expect to happen next.

Brexit Deal with Days to Spare

December 2020 was characterised by continually missed deadlines and stalled talks on the contentious issues of fishing rights and level-playing field legislation. After a deal was not reached by the European council's final summit of the year, discussions between Boris Johnson and Von der Leyen intensified as negotiators tried to thrash out a compromise. By December 20th, it was reported that a compromise had been made on the level-playing field, leaving only the issue on fisheries to be determined. As unofficial updates continued to make headlines, financial markets started to believe a trade deal would be agreed, with major UK equities posting gains from December 21st. On December 24th, the UK and the EU announced an agreement on a trade deal, which was soon approved by EU ambassadors and passed through the House of Commons by December 30th.

Core Components of the Brexit Deal

A core characteristic of the Brexit deal is the agreement of tariff-free and quota-free trade in goods. With good exports accounting for 58% of total UK exports (goods and services) to the EU, the UK exports £170 billion worth of goods to their largest trading partner. Having avoided tariffs being implemented on the majority of trade exports and imports, the two sides have helped to reduce the burden on businesses, whilst mitigating business frictions at a time of depressed economic activity. That being said, there are a number of other key areas that have seen changes:

- ***Fisheries***

Fisheries played a bigger role in negotiations than many individuals were expecting prior to 2020. After the UK initially demanded an 80% cut in the value of fish caught by EU boats in UK waters, the final cut was agreed to be 25%, which will be phased in over the next five and a half years. Upon the end of this phasing, the UK will have full control over its waters, providing it with the opportunity to make deeper cuts going forward. This may not be attractive to the UK, however, as the EU will have the power to retaliate through tariffs on UK fishing products and possible restrictions on UK boats in EU waters.

- ***Level-playing field***

In the agreement, the UK and EU committed to maintain common standards on workers' rights, as well as many social and environmental regulations, a key demand of the EU. As these do not have to be identical in the future, the UK does not have to follow EU law, but the UK does have to be seen to be protecting fair competition. Although the UK agreed to stick to common principles on how state aid regimes work, the UK can choose to develop a system which only makes decisions once evidence of unfair competition is presented. This differs from the EU's system, assessing the likely impact of subsidies before they are handed out.

- ***Dispute resolution***

This is expected to be the subject of tension in the coming years, as it relates to the enforcement of the agreed Brexit deal, and the appropriate responses either side can take if the other drifts from the agreements. What has been agreed so far is that if either side moves away from the common standards set, a dispute mechanism can be triggered, leading to tariffs being imposed. This is a form of a rebalancing clause, and this clause is much stricter than measures found in other EU trade deals, being a key demand of the EU.

- ***European Court of Justice***

The UK ensured that the EU had to drop its demand that the ECJ should play a direct role in policing the governance of the agreement in the future, although the European Court will remain as the highest legal authority within Northern Ireland.

- ***Data***

Both sides agreed that they would want data to flow across borders as smoothly as possible, however there is also the importance that individuals should have a right to the protection of their personal data and privacy simultaneously. Currently, the EU is still deciding on whether it recognises that UK data rules are roughly the same as its own, which is why a special period of four months has been agreed, as long as the UK does not make further changes to its rules on data protection.

- ***Product standards***

This is the area that will likely lead to delays between the UK and EU's border. With there being no agreement on a conformity assessment, trade going between the two regions may have to be checked twice to be fully certified to move across borders. Additionally, food of an animal origin will face additional checks due to there being no agreement on recognising either side's sanitary and safety standards for animals. The result of the new product standards is going to impact the daily lives of the nation as a result, with the raft of red tape and new checks at the border expected to add £3 billion in costs for food importers alone, which is expected to increase the prices paid by food customers at checkouts. This area of the agreement is likely what headlines will often refer to going forward as being a negative of the Brexit outcome.

- ***Security***

Following Brexit, the UK will lose access to some of the databases used for security purposes, meaning security co-operation will no longer be based on real time access. An agreement has been made on extradition and the UKs continued role within Europol.

Having outlined some of the key areas where complete or partial agreements have been made, the services sector is where much of the uncertainty for the UK lies. Ranging from finance companies to public sector services, the UK has a comparative advantage in the services it exports which mainly originate from financial services. The subsequent trade surplus in services helps to offset the trade deficit in goods, with services accounting for 42% of the UK's exports. Yet, the Brexit agreement did little to outline the future for the services sector, with further clarification and agreements made between the EU and the UK required. So far, the UK and the EU have agreed to continue talking about financial services regulation in the future, however, with the state of the current economic and pandemic related pressures, it is difficult to say when we may receive clarity for the services sector. For financial services, the problem of losing its 'passporting' privileges from mutual recognition of its regulation is a threat to the health of the sector. Associated with this is the seamless transition of European share transactions from UK to European hubs, which is estimated to have lost the City of London almost 45% of the volume of stock that would have gone through the City at the end of last year. Outside of the financial sector, legal services are still uncertain on the status they will receive from the EU, nor do accountants know whether their qualifications will be accepted across the EU.

Financial Market Reactions

Upon understanding the implications of the Brexit deal, speculative UK and EU markets began to fully price in the benefits of the agreement, with the negatives of a no-deal now off the table. Pound sterling has continued to appreciate against the US dollar which currently stands at $1.36, as it became apparent that the UK faced a more positive outlook with a trade deal as opposed to a no-deal. Despite the rise in the pound sterling, UK equities continued to rise as we entered the new year. The rise has come at a time where UK equities are discounted in value when compared to overseas equities, as Brexit uncertainty and volatile pandemic conditions have caused UK large caps to have a relatively stagnant 2020 after the initial march sell off when compared to US markets. Cementing a more bullish view from investors on UK equities, despite economic fundamentals expected to be weak in the first half of 2021, a UBS strategist has forecasted the UK large cap index to rise up to 9% in the year ahead.

European equities were also a strong beneficiary from the clarity provided by a Brexit deal. Both European small caps and large caps have posted strong gains since December 21st, where more muted performance was to be expected if a free trade agreement was not reached.

The equity market rises came during a time when the UK had just announced its latest lockdown restrictions which would have negative effects on the UKs economic outlook. This suggests the effects of a Brexit agreement and the UKs latest vaccine distribution efforts have improved investor sentiment, further demonstrating the continuously improving medium- and long-term outlook for the UK.

What Next?

As outlined by the inclusions and exclusions of the Brexit deal, further clarity is expected in the following year. Although we cannot yet put a date on when additional clarity will be produced, an analysis by EY on the financial services sector has outlined four key questions that need to be answered going forward: the extent to which cross-border access will be permitted, the extent to which either side's regulatory policy might become protective, the equivalence decisions that will go beyond access such as to capital and other frictional costs, and the regulatory cooperation around the supervision of large groups.

Additionally, clarity that solves the recognition of professional qualifications and a potential willingness from both sides to reduce frictions at its borders may be provided later in the year. That being said, it is likely that both sides will need activity to resume to fully understand the impact of the current trade deal on its operations, and changes may not be realised until many years to come. Pandemic-related risks are a more urgent matter, too. With the Brexit negotiations out of the way, both sides will be focusing their attention on vaccination distribution and logistics, as well as analysing the impact of restriction measures and whether additional policies must be implemented.

Our View

Towards the end of 2020 Brexit news flows became increasingly frequent as negotiations approached its eventual deadline. The 'Canada-style' deal has provided relief to financial markets and investors, with the 'Australia-style' no-deal being averted. Although further clarity is still required for certain sectors, and new frictions may be encountered as we move forward, the agreements in the majority of the key areas has improved investor sentiment and confidence in the UK. With UK equities still remaining discounted, their valuations have become increasingly attractive for domestic and overseas investors, especially now as the UK's vaccine distribution efforts are well under way which has provided a concluding end date for the current lockdown restrictions. It will now be up to the UK's subsequent decision-making and new ability to make more targeted policy decisions that will set the course for the economic recovery in the short-term, and the foundations made for the medium-to long-term UK outlook. As a whole, UK equities appear attractive and their potential to outperform other major nations supports their key involvement within the OBI portfolios.