InvestmentUpdate

29 December 2020

Brexit deal brings some clarity, but not without costs

A free trade agreement with the EU avoids damaging tariffs, but other barriers remain

In summary

- After nearly five years of sharing our Brexit analysis with you, we finally have some clarity. The UK will leave the European Union (EU) with a free trade agreement (FTA) in goods once the transition period ends on 31st December.
- With the backing of the Labour whip, it is highly likely to pass the UK's parliament. Approval from EU member states was provided from the EU ambassadors on 28 December and we don't expect any subsequent objections before the official signing on 30 December.
- Policy uncertainty, in and of itself, is negative for economic growth, and in this sense any news is positive. But even an FTA imparts significant short-term economic costs (and most likely long-term too), and it's unfortunately still an item in a list of reasons why the UK may emerge from the COVID-recession as an economic laggard.
- Moreover, the fog of uncertainty is yet to disperse over the UK's outsized services trade. Talks are scheduled to begin in 2021 on several important 'mini-deals' covering, for example, cross-border financial services, the transfer of data between the UK and the EU, or the portability of accreditation in other professional services.
- Our analysis suggests that UK-focused equities and the pound are already priced for a particularly adverse scenario. Valuation gaps with comparable assets overseas may begin to close, but not entirely, as there are a number of non-Brexit factors at work. Broadly speaking, we continue to favour global companies less sensitive to Brexit and UK economic growth.

Non-tariff barriers to trade

The trade deal avoids the imposition of tariffs. This is good news. In the short-run the imposition of tariffs would add an additional level of disruption and would likely further delay productivity-enhancing business investment as firms adapt to the new regime. Our favoured economic research teams, such as those at Citi, Oxford Economics or Capital Economics, concluded that "No Deal" would have seen 0.5-2.0 percentage points less GDP growth by the end of 2022 relative to what it might be under the trade deal.

Over the long-term, however, non-tariff barriers (NTBs) are likely to exert by far the greater cost and, broadly speaking, the trade deal doesn't negate these, despite what Mr Johnson tried to claim in his press conference. The Bank of England expected around 80% of the total reduction in trade as a result of "no deal" to be attributed to NTBs. Others estimated upwards of 90%. The Cabinet Office recently estimated the cost to UK companies of filling out customs declarations alone, for example, could come to £7bn. Various non-tariff barriers affect trade in services too, to which tariffs wouldn't have applied. That's concerning because for several decades UK growth has been founded upon its comparative advantage in financial and business services.

Few sectors escape NTBs such as checks at customs on compliance with rules of origin, labelling laws, and so on. An annex on medicinal products sets out an agreement on mutual recognition of inspections and manufacturing practices. That's important because medicinal and pharmaceutical goods are the third largest category of UK exports, with the second largest trade surplus among categories of goods. However, other sectors are not so fortunate. The agricultural sector faces many new checks, such as vet certification, leaving British farmers facing more barriers than New Zealand's. Non-tariff barriers to exporting electric cars get a six-year reprieve, but other consumer products will face significant red tape right away.

The UK has said that it won't impose the new customs regime on imports from the EU until at least 1 July 2021, to allow firms to acclimatise. The EU has said that it will impose full checks from day one, which may mean that the UK's exports to the EU are disrupted by more than its imports from the EU.

Of course, it has been known for some time that NTBs are going up. As has the near unanimous verdict of economists (a rarity!) that the effects will be negative for UK growth. As investors we focus on what risks may not already be compensated for by today's prices.

The successful resolution to the trade talks makes us more hopeful that we will see use of trade facilitation measures to cut down some – though by no means all – of the burden of NTBs.

The deal references a set of arrangements whereby firms that demonstrate consistent quality assurance on customs matters can be designated "Authorised Economic Operators" who benefit from the fast-tracking of consignments and fewer physical and documentary examinations. It sets out clear

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Look forward

procedures in a five page technical appendix, and this is a good sign.

Risks to trade in services remain

The trade resolution also makes us more hopeful about crucial negotiations on cross-border financial services, digital and data transfer rights between the UK and the EU, or the portability of accreditation to conduct accounting services due to take place in 2021. It is encouraging to see that the deal contains an agreement to permit lawyers to provide cross-border services. British politicians have pointed to the framework that the deal provides for establishing mutual recognition of professional qualifications. But the EU's deal with Canada also contained such a framework and yet no recognition negotiations have been successful.

In short, risk and uncertainty remain. The UK runs a large trade deficit in goods that is paid for mostly by its large trade surplus in services, which is almost entirely in financial and other professional and technical services.

The UK will leave the EU's passporting regime that permits financial institutions in one EU country to operate in any other member state without any extra authorisation. The UK has already legislated for a temporary passporting regime that allows EU firms to continue to operate in the UK while the process of obtaining full authorisation is worked out. The EU has not reciprocated, and UK firms have transferred their EU clients to EU subsidiaries to minimise the disruption. Thankfully, a series of special arrangements has minimised any risks to financial stability for the foreseeable future, according to the latest assessment in the Bank of England's Financial Stability Report.

Next year, the EU will assess whether or not to grant UK firms "equivalence" status – a de facto, albeit impermanent financial passport. There is a nominal 31 March deadline, but this is not set in stone. We think the UK should pass the test. UK and EU financial institutions currently follow the same rules, rules that tend to be decided by supranational bodies such as the G20's Financial Stability Board or the Basel Committee, and the most zealous aspects of recent financial regulation have been proposed by the UK not the EU (e.g. the ring fencing of retail banking from investment banking, the bank levy, and the ban on inducements).

The UK's pre-eminent financial services industry is about far more than London as a convenient gateway into the EU. It is the agglomeration of three centuries of global financial activity, supported by world-leading professional services in accountancy and law, safeguarded by the British legal system and made accessible by the English language and a convenient time zone. The economic benefits to locating here will not be erased if the UK breaks ties with the EU, and the sector is highly unlikely to collapse. However, if the UK failed to negotiate a substantial agreement on continued access, it is difficult not to envisage a gradual loss of financial business and investment, particularly given that legal and regulatory experts have been emphatic since before the referendum that the EU intends to clamp down on the extra-territorial provision of financial services.

Some financial service chiefs have warned that even with equivalence, some business will have to move. Passporting lasted for as long as you were in the EU, but equivalence can be withdrawn at a moment's notice. There's form here. In 2019, Switzerland had its stock market's equivalence withdrawn.

Non-EU trade deals: blue, yonder

As an EU member the UK had 40 trade deals; 29 have been replicated, but they cover less than 10% of UK trade. A new deal was signed with Japan, but the government expects it to add a mere 0.07% to GDP over the long run. Distance matters in trade, and academic trade research is clear that the UK is likely just too far away from other trading partners to make up trade foregone with EU over the next decade. Geopolitical dynamics have changed since the referendum, and trade deals with both the US and China are arguably mutually exclusive now. The UK-China relationship was also damaged by the decision to ban Huawei's kit from the UK's 5G network.

Investment and public policy

Broadly speaking, the costs of Brexit can be broken down into three: (i) short-term disruption; (ii) productivity and capital losses as changes shake themselves out in the market; (iii) long-run costs associated with being a more closed economy.

The links between trade and productivity - via competition, market size, specialization, cross-border investment and technological transfer - are well known, and we won't repeat them. The drag on productivity from Brexit could be eclipsed by a publicly backed wave of digitalisation, green energy infrastructure (increasingly important for competitiveness as we move into a world where carbon border taxes are likely), as well as initiatives to raise productivity outside of the South East. Overall public investment has been lower than in other leading economies in recent years, and investment in digital infrastructure still lags investment in transport, energy and utilities, which in turn lags the best-performing advanced countries.

Public investment and support for private business investment has been noticeably absent in UK fiscal policy during the pandemic, in contrast with the EU's Recovery Fund, for example. But it was pleasing to hear it featuring so prominently at the recent Conservative Party conference. Moreover, November's Spending Review maintained ambitious plans for public net investment, greatly increasing from £42 billion in 2019 to an average of £73 billion in the years between 2023 and 2026, targeting digital and transport infrastructure and regional "levelling-up" (see our

InvestmentUpdate for more information).

The continued uncertainty around trade facilitation, and the portability of data, financial services and professional accreditations will likely continue to hold back business investment. As will the need to divert resources to navigating and complying with the new regime. Between the referendum and the beginning of this year, UK business investment did not grow, compared to average growth of 10% in the other G7 economies.

Academic research concludes that the vote to leave has also cost billions of pounds in lost foreign direct investment (FDI), which is particularly important for the long-run productivity gains on which business profits depend. Despite its underrepresentation in the UK stock market, software technology is an important sector for FDI, often accounting for the greatest number of FDI projects in a calendar year. Business services is often the second most important sector on this basis. Future inward investment is therefore also contingent on the result of those negotiations slated for 2021.

To be clear, we do not expect FDI to collapse without them. There are many reasons why international companies invest in the UK that have little to do with unfettered access to the EU's single market. But it is imperative that a concerted public policy effort is made to ensure that the UK remains an attractive place to invest for the long term, and that a decade of stagnant productivity and low rates of firm formation are put behind it. Although these are global problems, they appear a little more chronic in the UK compared to some of its peers.

Fiscal and monetary policy

Government debt is frequently misunderstood, even by some economists. As we explained in our recent Investment*Update*, we are not concerned about this year's extraordinary increase.

In short, with the second lowest debt burden among the G7 economies, structurally low interest rates and its own currency, UK public finances are sustainable. Indeed, more money can be borrowed to invest in projects that will grow the future tax base. Discretionary fiscal spending in the Eurozone will remain significantly expansionary in 2021. The US is likely to follow suit. Despite higher debt burdens, government borrowing costs in these regions have stayed extremely low. We are relieved that the UK Chancellor has shelved plans to prematurely withdraw support. Of course, this needs to occur at some stage, but getting the timing wrong could leave lasting scars.

We expect monetary policy to support the economy should growth start to falter. Even if Brexit were to constrain supply more than demand, we believe that the disinflationary legacy of the COVID-crisis (in other words a protracted period of precautionary saving) will keep inflation in check in 2021. For more explanation, please see our recent update on inflation and the policy response to COVID here.

In another recent update we explained why we expect negative interest rates to be used only as a last resort. We have questioned Bank of England Governor Andrew Bailey and his colleagues at roundtables and conferences, and the Bank is still not confident that they are feasible, effective or appropriate. It is certainly not ruling them out and has asked financial firms to report on their ability to accommodate them operationally. But we would expect the Bank to further expand its quantitative easing (bond purchase) programmes and targeted financing of bank lending in the first instance should the economy need it.

Will the UK emerge a laggard?

Unfortunately the potential disruption from NTBs adds to an already long list of reasons why the UK may lag other major economies as the world emerges from the COVID recession.

Indeed, the UK is on track to have one of the worst outcomes this year out of the 42 developed and developing countries that we monitor. One reason for this is the UK has suffered the fourth-worst health outcome (behind only Belgium, Spain and Italy). That raises the relative risk of more stringent restrictions, which could last into 2021. Using our bottom-up model of the UK economy, we estimate that November's national lockdown, and December's Tier 4 restrictions will leave UK GDP 13% below the pre-COVID high water mark. In contrast Germany will be around 5.5% below and the US 3.5%.

The UK has a larger consumer services sector than most other countries, and therefore is more sensitive to COVID restrictions. Similarly, out of 22 advanced economies it ranks third for the proportion of its GDP produced in its cities. Key sectors were already ailing before the pandemic, and there's evidence to suggest the UK may have a greater share of so-called "zombie" companies (unprofitable enterprises propped up by extremely cheap financing). The private sector is more indebted than many countries too, which increases fragility and limits the bounce-back.

UK firms' employment intentions are notably weaker than average according to international surveys. And a Europe-wide survey of unemployment expectations shows UK households are more fearful, which correlates with a lower propensity to spend. While surveys of other countries' business investment intentions improved in the third quarter, in the UK they remain stuck at the lowest level since the survey began in 1997 – substantially worse than during the financial crisis even. The trade deal should help employment and investment bounce back, but we still expect the UK economy to underperform many peers.

To be clear, our pessimism about the UK economy over the next year or so is purely an analytical judgement. In no way do we presume to judge whether

Brexit is right or wrong for the UK in terms of its many juridical, social and political facets.

The weight of a pound
Although the pound has rallied substantially against the dollar this year, it has done little since the Brexit deal was announced. On a trade-weighted basis, the pound is still 10% below where it was on the eve of 2016's referendum.

We expect the pound to continue to appreciate, but both global and local cyclical factors may still hold it back over the next year. Ordinarily, the pound is a highly cyclical currency versus the dollar or the euro – it falls when global investor sentiment falls more broadly. That's mainly because the dollar accounts for c.60% of reserve assets, the euro c.22.5% and the pound just 5%. It's therefore not a major safe haven, and it is also tied to a lot of financial activity that moves with the business cycle. The pound could be held down if severe COVID restrictions unnerve global investor sentiment over the winter.

Thinking locally, if negotiations go poorly next year, a loss of service sector access may require the pound to remain cheap to facilitate a reallocation of resources to the less competitive manufacturing sector. The many non-Brexit reasons why the UK is a laggard in the COVID recovery could also hold back the pound.

On a range of long-term valuations frameworks – the only time horizon for which we believe currency forecasts can be made with any assuredness – the pound appears undervalued against most major currencies. That's the case if we look at simple frameworks, such as purchasing-power parity, very complex ones, such as the IMF's external balance framework, or our preferred proprietary framework, which looks at relative prices, relative productivity and relative savings. The latter suggests that the pound has been trading around a value consistent with an almost unthinkably dire long-run scenario.

UK equity implications
A basket of UK-listed companies that derive over 70% of their sales from the UK has underperformed the main UK equity benchmark (FTSE 100) by 15% since the vote to leave. While they have performed in line with each other so far in 2020, the successful conclusion of the trade talks removes some major challenges to UK growth and therefore improves the prospects of this basket.

But the FTSE 100 itself has underperformed the MSCI World equity benchmark over the last five years. This year it ranks 22nd out of the 25 developed market indices we monitor. Since the vote to leave, the gap between valuation multiples, such as price-to-book value, in the UK and overseas has widened to a degree not seen since the 1970s, when the UK had to ask the IMF for a bailout. Surveys of institutional investors have suggested global fund managers have been avoiding British companies. We expect some of this valuation gap will start to close, but by no means all of it.

A rising pound is a mechanical headwind for the multinational companies that dominate the FTSE 100. Revenues earned overseas in foreign currencies are worth less when translated back into sterling (all other things being equal). Indeed, the FTSE 100 initially rose on news of the vote to leave because of the fall in the pound, before it started its protracted period of underperformance relative to the rest of the world. However, in time overseas investors returning to UK assets could more than offset this mechanical effect.

There are other non-Brexit reasons why we expect the valuation gap to remain wide for the time being. Historically the UK has offered a high – and high-quality – dividend yield, but as we have questioned for some time (and has been proven this year), that is less the case today. The UK also has outsized exposure to financial companies and oil and gas, whose profits are held back by bigger structural forces. The exposure to resource extraction may have driven some underperformance as investors formally build environmental, social and governance (ESG) factors into their selection processes. This year, a greater weighting in sectors badly affected by the pandemic compared with Europe and the US has further detracted from relative performance too.

A global antidote to UK gloom
Of course, companies listed in the UK earn between 70-80% of their collective earnings overseas. There are many for which Brexit is 'more bark than bite' and offer good long-term investment opportunities. We are becoming more optimistic about global activity, while acknowledging short-term cyclical risks still to navigate this winter. The approval of COVID vaccines has changed the risk-reward profile of equities in 2021 too. Given everything we have discussed in this note, we believe a global mindset is needed to participate in this recovery, and UK domestic names could continue to lag.

For more of our latest analysis, please see our Brexit hub.

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