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HARD BREXIT? KEEP CALM AND CARRY ON

With several months passing since the UK referendum on EU membership, two of our senior fixed income portfolio managers in London, Simon Down and Holger Mertens, update their views, following on from previous website pieces:

Scones or Croissants?
Brexit: The Route to Exit and Key Risks

https://en.nikkoam.com/articles/2016/03/scones-or-croissants-brexit-the-route-to-exit-and-key-risks

Brexit: In or Out? The Final Run In.

https://en.nikkoam.com/articles/2016/06/brexit-in-or-out-the-final-run-in

BREXIT, BREXIT! Where's the Exit?

https://en.nikkoam.com/articles/2016/07/brexit-brexit-wheres-the-exit

Executive Summary

- UK migration laws are likely to be tightened significantly over the next few years to reduce annual migration dramatically before the 2020 election.
- A 'Hard Brexit' with the UK leaving the EU entirely, including the single market, is now the most probable scenario.
- Although perceived by many as the worst case scenario, the timescale involved could be long, limiting the market impact and reducing the economic consequences for both sides.
- With a more extended timescale for BREXIT than previously thought, the Bank of England will likely keep interest rates on hold with no further interest rate cuts until there is greater evidence of a negative economic impact from the referendum. The UK needs to attract capital to balance its high current account deficit and uncertainty will make this more difficult for some time, thus increasing volatility. Light positioning, a close to record short in futures markets and a real effective exchange rate now two standard deviations below its long term average, however, should provide some support for Sterling.

Assessing the most likely BREXIT scenario

"Brexit means Brexit" is now an oft-repeated phrase from UK government officials as they attempt to reassure voters that there will be no post-referendum backtracking. At the recent Conservative Party conference, Prime Minister May stated that Article 50 would be triggered before the end of Q1 2017 and the government is now collating its negotiating team and assessing the best way to move forward. There are a number of ongoing legal challenge that seek to force a vote by the UK Parliament or the Northern Ireland Regional Assembly to give the government the authority to trigger Article 50. These cases may have some impact on timing of events, but based on currently available information, we outline the most likely scenario that will take place:

Immigration: The UK Redline

The level of immigration was a key issue during the referendum and the government has stated that control of UK borders is a red line issue during negotiations with the EU. The Prime Minister has repeatedly stated that controlling immigration is her priority and that it should be reduced to the 'tens of thousands.' It is important for investors not to underestimate the level of commitment to this goal.

In the run up to the referendum, Exit campaigners stated that the UK would move to a point-based system to control immigration. Signals from government officials now suggest that they do not regard this as robust enough, with May instead favouring a much stricter permit-based system. During her time at the Home Office, she dismantled the rules for non-EU migration and post-election, replaced them with a hard-line new system, with many British people unaware of the strict new rules. It now looks likely that the government will simply extend this visa system to all migration, including EU migrants.

One study carried out for the Financial Times by Oxford University's Migration Observatory concluded that around 81% of current EU migrants would not meet the visa rules for non-EU migrants, rising to much higher levels in certain sectors such as hotel/restaurant services and farming. In order to accommodate seasonal workers in sectors such as farming, however, the government appears prepared to issue up to 75,000 temporary work visas that will grant access to the UK for a limited period of time.

Non-EU migration should start to fall rapidly as the new visa rules take hold and if introduced for all migrants, the government's target of net annual immigration below 100,000 looks quite achievable. This is likely to happen **before** the UK exits the EU, with the government arguing that **the EU requires free movement of labour, not free movement of people.** For the 3-3.5m EU migrants already in the UK, the government appear to be looking at ways to offer a fast tracked permanent residence visa with the Home Office stating that they will be piloting an online application for EU nationals rather than the existing 85-page form.

UK Immigration System for Non-EU migrants

- In order to work in the UK, non-EU migrants require a Tier 2 work visa. From April 6th 2016 the government introduced a minimum salary threshold of £25,000 for general visas, rising to £30,000 in April 2017. Some positions with skill shortages (for example nurses) are allowed a lower threshold. From April 2017, employers will also need to pay an annual £1,000 per person immigration levy on each non-EU worker.
- From April 2017, after five years (or nine years if earning above £120,000 pa), non-EU migrants must either leave the UK or apply for an "Indefinite Leave to Remain" visa. In order to be eligible for this visa, there is a minimum salary threshold of £35,000 (rising incrementally to £36,200 by 2020).

In addition to this, the UK government also appears to be looking at ways to put pressure on firms to recruit domestically. Some of the guidelines being considered include companies needing to provide the government with data on the makeup of their workforce and the numbers of foreign employees, as well as toughening tests to ensure that companies have actively tried to recruit within the UK before they will be allowed a visa for a foreign worker. Part of this is aimed at the manufacturing sector, and an attempt to provide more manufacturing jobs to British people rather than European migrants. Rules within the public sector are also to be changed, with plans being drawn up to train an additional 1,500 doctors each year in order to cut the use of foreign doctors. Similar schemes are now likely to be more broadly introduced across the public sector.

With this new immigration system in place or in the process of being implemented, the UK government will then trigger Article 50. Negotiations will then likely focus on maximising trade opportunities with the EU from this baseline on immigration. For most other EU states, though, free movement of people is a cornerstone of the EU and, thus, various states have already indicated that they would be unwilling to negotiate if the UK were not to accept this. If that is the case, then it looks highly likely that the UK will not be able to accept single market access and will ultimately pull out of such, with tariffs between the UK and EU being imposed at some future date.

Hard Brexit? Time to Panic?

Well actually, probably not. Firstly, the negotiations once Article 50 is triggered could take a considerable period of time. If the UK starts the process in late Q1 2017, it could take an extended time for the EU to formally respond. It is quite possible that it will be late 2017 or even 2018 before there is any real sense of where negotiations are headed. Even then, assuming that the UK and EU part ways without UK access to the single market, it is unlikely that there will be an instant cut off as both the EU and UK will want to provide time for firms to adjust and rebalance trade flows and supply chains.

Article 50 states that 'the EU shall negotiate and conclude an agreement with that state, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the union.' At this stage, much emphasis has been placed on Article 50 negotiations having a two-year timeline and that the UK would cease to be a member after this period. But the most likely scenario is that once it becomes apparent that single market access is unobtainable, negotiations would switch to agreeing how to manage a UK exit in a way that minimises the economic fallout for both parties. During this transitional period, the UK would most likely need to continue to make some contribution towards the EU budget. According to the think-tank Civitas, there are an estimated 9.4m jobs that rely on trade between the EU and UK, with 3.6m in the UK and 5.8m in the EU. Thus, although the UK is likely to exit the EU entirely, it is likely to take five to ten years to do so.

The Future of EU/UK Trade

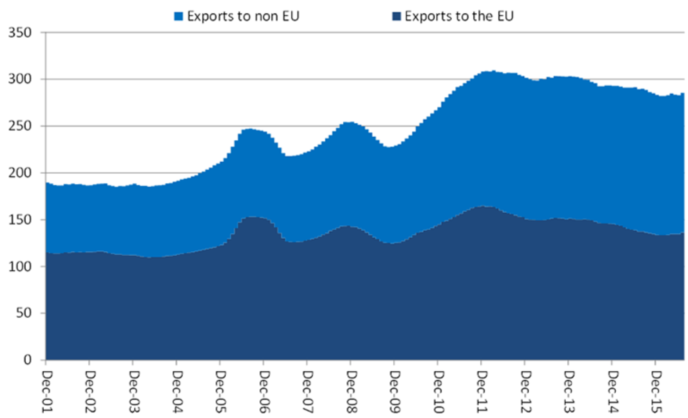
Trade between the UK and EU countries will occur regardless of whether the UK is within the single market, but once the UK is on the outside, it will certainly be more difficult for counterparties in both economies to transact with each other. Once Article 50 negotiations are concluded (and assuming that the UK exits the single market), the focus will switch to what can be agreed upon to facilitate trade.

- Mutual Recognition Agreements (MRAs): these are made so that two countries recognise each other's conformity assessments, such as quality control performed by the home countries designated assessment body. The EU currently has MRAs with a number of countries including the US, Japan and Australia.
- Free Trade Agreement: this is an agreement whereby two countries agree to remove customs tariffs and also to open up markets on services, investment, public procurement and regulatory issues. This makes trade faster because common rules on technical standards remove the need for customs checks.

If the UK exits the single market, it may be difficult for the EU to agree to a Free Trade Agreement with the UK for political reasons. However, a MRA is possible, which would at least make it easier for firms to continue to trade.

Trade between the EU and UK could well decline from current levels, but UK exports to the EU have been in decline since 2011 anyway, with exports to non-EU countries now the largest share of UK exports. This trend is likely to continue and once tariffs are in place, some production which is currently exported will likely be switched for UK consumption.

UK Goods Exports: EU & Non-EU (£bn)



Source: Bloomberg

Despite a prohibition on the UK entering trade talks whilst still a member of the EU, such does not appear to be deterring the UK from doing so.

- The UK and Australia have set up a working group to negotiate an FTA that will have its first meeting in Australia in early 2017.
- The Ministry of Commerce in China has stated that it is conducting a feasibility study for a China-UK FTA and the UK government have stated that they are studying the China-New Zealand FTA as a base for talks.
- Korea has stated that it will push for a FTA with the UK once the UK has exited the EU. Korea-UK trade has been one of the largest beneficiaries of the EU-Korea FTA agreement.

Financial Sector

The financial sector has been highlighted as one of the sectors most likely to be affected by the referendum result. The "passporting" of financial services across the EU is seen as one of the toughest issues for the UK to negotiate given that both France and Germany have long coveted the UK's role as a global financial centre. There are two factors which are likely being underestimated for this sector however:

- MIFID II: Under current rules, a bank based in any EU country has a financial passport which enables it to conduct business in any other EU country. Speculation is that by leaving the EU, banks based in the UK will lose this "passporting" access, restricting their ability to conduct business and forcing them to move to an EU country. Under MIFID II, though, the passporting system changes dramatically and allows banks from non-EU member states to access the EU market directly as long as their home state regulation is deemed "MIFID equivalent." This would allow firms operating from the UK to continue to operate within the EU, although it is also possible that foreign banks will choose to operate directly from their own domestic market rather than from any European country.

Running up to negotiations: Germany Elections and BREXIT

Germany will hold its national election next September and current polls point to a continuation of the current government coalition of the centre-right parties, CDU/CSU, and the centre-left party, SPD. Nevertheless, Chancellor Merkel has not stated if she will run for a fourth term. Even if Merkel decides not to run for a fourth time, it is very unlikely that the CDU/CSU will lose power, in our view. Merkel's decision on re-election will depend on the CSU's (the CDU's sister party) endorsement. At the moment, the relationship between both parties is tainted by different opinions about Germany's refugee policy.

It is expected that Merkel's stance toward the refugee crisis will be one of the main topics during the upcoming election campaign. In recent regional elections, her open door policy led to substantial loses for her party. In Mecklenburg-Vorpommern, one of the 16 German states, the CDU dropped behind the protest party AfD (Alternative für Deutschland) into third place. But Merkel made already clear that she doesn't plan to change her policy and only her resignation will likely allow a major shift in such. Potential candidates to succeed her could be Ursula von der Leyen, the current Defense Minister (and her close ally), as well as Horst Seehofer, the leader of the CSU. Seehofer has been one of the main critics of her refugee strategy.

Another important topic during the campaign will be the negative-interest rate strategy of the European Central Bank. Merkel's party singled the central bank's policy out as one of the main reasons for CDU/CSU's disappointing election results. Germans are traditionally more conservative investors of their money and usually stick to saving accounts rather than real estate or stock market investments. This is particularly true for the elderly, who now suffer especially from the central bank's rate policy.

It does not seem likely that BREXIT will be an important topic during the campaign. Although the trade relationship with the UK is important, given Germany's current account surplus with the UK, Merkel's position toward this topic has not been challenged by the opposition or her partners. Closely after the vote, she pointed out that no negotiation will start before Article 50 is triggered and no "cherry picking" will be possible with respect to free movement of labour and access to the single market. Also, the UK government appears keen to move forward with the triggering of Article 50 before the end of March and not wait for the elections in Germany and France to be concluded.

- English Law is regarded as one of the strongest in the world for the protection of property and business interests, as it is based on legal precedent rather than the civil law system that is used in the rest of Europe. This means that the majority of international financial contracts are written in English law, with disputes settled in UK courts.

These factors have led analysts at Moody's to suggest that the impact of BREXIT on the UK's financial system, even in the event of a hard exit, will be 'modest.' Others disagree, however, and a report by Oliver Wyman, a management consultancy, concludes that up to 75,000 jobs could be lost. Ultimately, there is likely to be an ongoing conflict between the UK and EU on this sector and, as a result, other financial centres such as Singapore and New York may end up gaining market share.

Economic Impacts

It is clear from recent economic data that the initial impact of the referendum on the UK economy has been much less than many forecasters expected. Consumer spending has remained robust, and although big-ticket items such as cars and houses witnessed some demand weakness immediately following the vote, sales of such have started to recover (helped by falling mortgage rates following the Bank of England's rate cut). Employment has been strong and so far there is no sign that the decline in business confidence has had any meaningful impact on hiring. Some business confidence indicators such as the PMI data have also staged a recovery, as the drop in Sterling has led to increased export orders. For 2016, the IMF has now upgraded its forecasts for UK growth to 1.8%, which would make the UK the fastest growing economy in the G7.

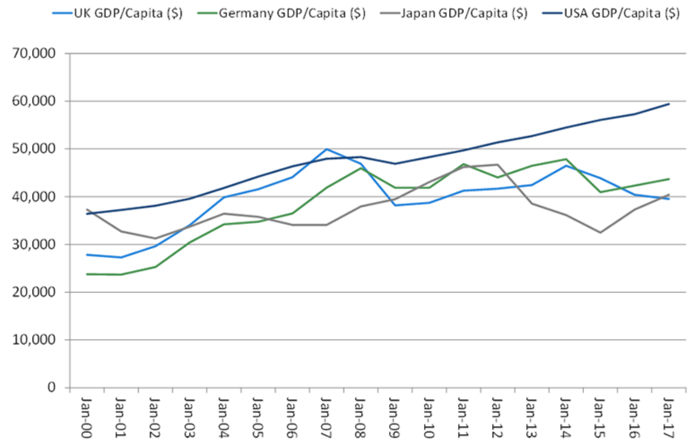
Looking further out, however, there remain concerns about business investment, a factor that leads to most forecasters' expectation of a slowing economy in 2017. The IMF, for instance, predicts growth of only 1.1%, but the reality is that these forecasts for 2017 will be very fluid depending on how the situation evolves.

Conclusion

What is becoming clearer is that the relationship between the UK and EU is now likely to change in a very meaningful way. The UK government is determined to see a dramatic reduction in immigration rates, from in excess of 300,000 to the 'tens of thousands.' This will be very difficult, if not impossible, for the EU to accept and, thus, the risks of the UK leaving the EU and single market entirely are now very high. Over time this will result in a rebalancing of trade, with UK imports and exports with the EU declining. The extent of the economic impact for both parties will depend on the timescale over which exit occurs and how successfully trade can be shifted towards other countries.

The decline in migration will also have long term consequences for UK GDP and, all other things being equal, will act as a headwind for long term growth. The UK has experienced one of the strongest growth levels in the developed world in recent years, but this has relied heavily on population growth with poor growth in GDP/Capita.

IMF GDP/Capita US Dollars



Source: Bloomberg / IMF

Although growth for the aggregate economy may be lower going forward, it is possible that in the medium term individuals may feel wealthier, especially if the labour market does not weaken and declining immigration leads to higher wages. There may be a short term inflationary cost though, as the drop in Sterling increases the prices of imported goods. The medium term view though, combined with positive voter perceptions on immigration, is what Prime Minister May calculates will keep the voters on her side in the 2020 elections, although nearly everyone agrees that there likely will be many twists and turns until then.

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