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Economist's Weekly Market View

Tuesday, 11th December 2018

The Brexit end-game begins

The past week has seen much turbulence on financial markets. Equity markets came under severe selling pressure, with Wall Street suffering a fall of over 3% on last Tuesday alone. However, the stress has not just been confined to stocks. Oil prices experienced further falls, while credit spreads widened sharply. At the same time, sovereign bonds benefitted from safe haven appeal, resulting in marked declines in yields as funds flowed in to this market.

The yield on 10 year US Treasury bonds has fallen by over 20bps in the past week, declining to below 2.85%. Even more noteworthy, the US yield curve has started to invert, with 5 year yields dropping below 2 year yield levels.

An inverted yield curve has tended to be a forerunner to a downturn in the US economy. However, underlying economic fundamentals, including the labour market, remain strong in the US. While the economy is likely to slow next year as the impact of the Trump fiscal stimulus fades, there are no signs that a US recession is imminent.

Overall, what could be happening is that markets may be in the process of re-pricing valuations and risk to more realistic levels in light of the vast array of threats hovering on the horizon for 2019. These include slower global growth, escalating trade tensions, geopolitical risks, tightening in global monetary conditions and Brexit. However, if the global economy holds up, then investors may return to riskier assets in the New Year given more attractive valuations following the recent sell-off.

Brexit risk is now very much to the front and centre of market attention. The vote in the UK Parliament on the Withdrawal Agreement was pulled yesterday as it was heading for defeat by a large margin. This week's EU Leaders' Summit is unlikely to see any significant changes to the Brexit deal.

Uncertainty will thus continue about Brexit, with Parliament very much in a logjam and unable to agree on a way forward. Given the turmoil in Parliament, a General Election cannot be ruled out. There is also the growing possibility of a second referendum.

UK markets have been relatively calm up to now, despite all the political turmoil over Brexit. Sterling has so far remained within the 87-91p trading range that it has occupied against the euro since September 2017. However, the currency has weakened in recent days, with the euro rising above 90p yesterday.

Markets may be taking some solace that a large majority in Parliament are strongly opposed to a hard Brexit and thus, in the end, will find some way of preventing the UK from crashing out of the EU without a deal in March.

The coming days and weeks, though, could well test market patience if politicians cannot get their act together on Brexit. Markets may start to worry that a hard Brexit could be on the cards as this is the default position if an exit deal is not ratified by the UK.

The Bank of England recently warned that a hard Brexit could have dire consequences for the UK economy. Thus, we expect serious pressure to come on UK politicians to avoid such an outcome. The Brexit end-game has just begun and sterling looks to be in for a volatile ride.

Oliver Mangan
Chief Economist
AIB

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