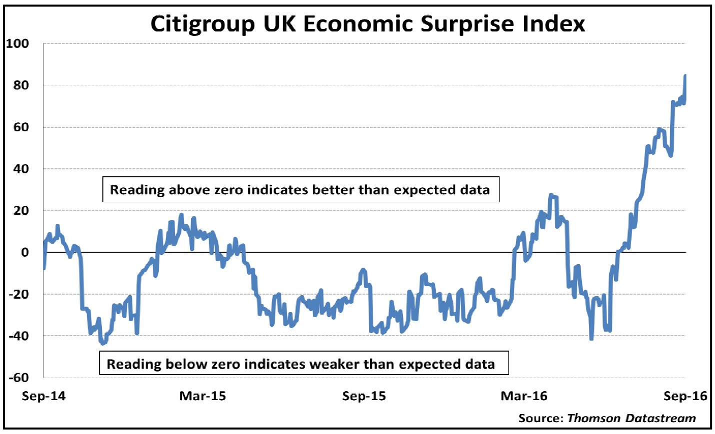
The Rocky Road to Brexit

With the summer recess now well behind us, UK and EU policymakers are refocusing on the key issue at hand, namely Brexit. The topic was discussed at the recent G20 meeting in China and is also the basis of the upcoming informal EU leaders' meeting in Slovenia, to which the UK is not invited.

Markets have taken a more sanguine view of Brexit recently. This is on the back of UK economic data tending to surprise to the upside of expectations, showing only a limited impact from the June referendum vote in favour of leaving the EU. This has helped ease market concerns of an immediate economic downturn. Last month's policy easing from the Bank of England, which included both a rate cut, an expansion of its asset purchase programme, as well as a willingness to ease policy again, if required, has also helped provide a more supportive backdrop for investor sentiment.



This is evident in UK stock markets rebounding strongly from their post referendum vote falls. Meanwhile, sterling has recovered some ground in the past month. In level terms, EUR/GBP has edged back from its three year high up near 87p to trade back down closer to 85p. Meantime, the GBP/USD pair has managed to regain some ground, rising up into a $1.31-1.34 range, after having traded as low as $1.28 in the weeks following the referendum outcome.

Markets need to understand, though, that the Brexit process is only getting started. Indeed, in reality, the official process has not even commenced. This will not happen until the UK triggers Article 50, thereby officially notifying the EU of its intention to leave and allowing formal negotiations between the UK and EU to get underway. Current indications are that this will not happen until early in 2017. On this basis, it is likely to be 2019 at the earliest before the UK exits the EU.

There seems to be a lack of understanding in the UK that some very difficult decisions lie ahead on Brexit. Indeed, some recent commentary would point to a belief that the key event for the economy was the referendum vote, rather than Brexit itself when the UK actually leaves the EU. This is despite the fact that the UK's trading relationships have not been impacted by the referendum vote and the institutional arrangements with the EU remain in place for now. **The UK's departure from the EU, though, will be a different ball game entirely.**

There appears to be a widespread expectation in the UK that because it is a large economy and an important export market for many other EU counties it will be able to secure a favourable trade deal on exiting the EU which will see it retain access to the Single Market.

The indications from the EU are that talks on a new trade deal can only begin after the UK leaves the EU. This could mean that any exit deal may only contain an interim trade arrangement, which could well be a diluted version of the Single Market.

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Key EU policymakers have also stressed that access to the Single Market requires freedom of movement of people. The UK will have to make a trade–off at some stage between its desire to maintain access to the Single Market while regaining control over migration policy.

It is also important to bear in mind that **EU leaders will not want to create a precedent of an easy Brexit** that other countries might be tempted to follow. Nationalism is on the rise in many European countries, which could undermine the whole basis of the EU.

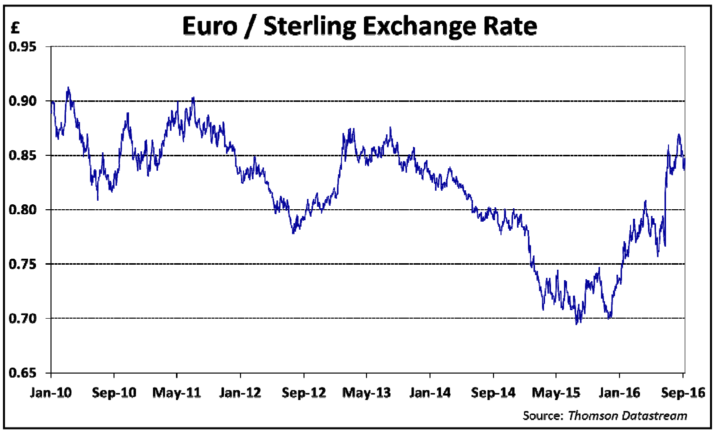
Meantime, based on recent comments from members of the UK Cabinet, there seems to be some disagreement on the strategy for the exit talks and what type of Brexit the Government wants. It is unclear if the UK wants to remain in a Customs Union, the extent of inward migration that it feels is appropriate and what shape any new trading relationship with the EU should take.

There is also a belief in the UK that it can negotiate new and preferential trade deals with other non-EU countries. The reality though may prove quite different. The UK has not negotiated trade deals since it joined the EU back in 1973. While some countries such as Australia have given positive soundings on negotiating a trade deal with the UK, they have also stressed that they will not enter into formal trade talks until the future of the UK's trading relationship with the EU is determined. There is also the issue that the UK would have to apply to join the WTO in its own right (current membership is as part of the EU) before it can negotiate any trade deal under WTO rules. This could take quite some time.

What is clear is that Brexit is likely to prove a long and difficult process with considerable downside risks for the UK economy. Some 45% of UK exports go to the rest of the EU, while the UK is heavily reliant on imports of intermediate goods from the EU for use by industry. The Single Market has been a key factor in fostering strong growth in these trading relationships. It should be noted in this context that **the EU is a much more important market for UK exports than the UK is for the EU.**

The UK is also the biggest recipient of foreign direct investment in the EU, with much of it coming from mainland Europe. London is the centre of the financial services industry in Europe. Both will clearly be impacted by Brexit. Meanwhile, large inward migration has played an important role in the strong performance of the UK economy in recent years.

We will not see the full impact Brexit has on all these factors until the UK leaves the EU. **In our view, the current complacency about Brexit, including in financial markets, is likely to prove misplaced.**



This could lead to further bouts of volatility in financial markets and bring renewed downward pressure on sterling next year if the negotiations between the UK and EU start to prove fraught, with clear difficulties emerging on the terms of the UK's exit, over which it has no veto. In this scenario, **EUR/GBP could well move up towards the 90p level, with sterling falling towards $1.20 versus the dollar.**

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