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Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | Jeffrey.ian.sacks@citi.com
Shan Gnanendran, CFA – Vice President, EMEA Investment Strategy | +44 207 508 0458 | shan.gnanendran@citi.com

Brexit tensions resurface

Having left the European Union on 31st January 2020, the UK is next due to leave its one-year transition period on 31st December 2020. During the transition, the UK's trading relationship, financial contributions, and legal obligations are the same as they were during its formal membership. With just over six months to go – and with the attention of both sides having focused on the COVID-19 pandemic over recent months – there is a rising risk that the UK will finish the transition without achieving the period's principal objective of striking an EU trade deal. Brexit is thus likely to be back in the spotlight in the coming weeks.

Four rounds of recent trade discussions have not gone well. The current impasse can only be resolved if both sides relax their "red lines." UK Prime Minister Johnson must decide by the end of this month whether to ask the EU for an extension of the transition period. While the EU has indicated its preference for an extension, our base case is that Johnson will not ask for one. Instead, we believe he will push for a deal to be struck by October, the latest time by which an agreement can be reached and then ratified by both sides before the end of this year. While both sides would prefer even a limited trade agreement, both sides are also preparing for "no deal." In this report, we analyse both sides' trade priorities and concerns, and the economic and market implications of a limited deal versus "no deal."

These are the main points of contention, with no signs of agreement on any of them yet:

1. **Sovereignty.** The UK's negotiating stance on this is that the UK is a sovereign country and is thus entitled to the same type of EU agreement as other sovereign countries like Canada.

2. **EU market access.** The EU wants a "level playing field" on labour, environment, state aid, and competition rules, in exchange for UK market access to the single market.

3. **Governance.** The EU would like a single agreement covering everything, overseen by the European Court of Justice (ECJ) which can also impose sanctions if necessary. The UK says that this would bind it to the EU's legal order and thereby violate UK sovereignty. The UK seeks a comprehensive free trade agreement, plus separate individual agreements covering such areas as aviation, energy, social security, nuclear cooperation, law enforcement, fishing rights, and asylum seekers.

4. **Irish border.** The Northern Ireland protocol was agreed alongside the exit deal signed last year. It stipulates that Northern Ireland remains part of the UK customs territory. As such, it can participate in any trade deals that the UK strikes with other countries. Simultaneously, however, Northern Ireland is covered by the EU customs code, thus ensuring no hard border with the Republic of Ireland. The EU is insisting on customs checks on goods entering Northern Ireland from the British mainland, to ensure that the correct tariffs are paid before the goods are moved into the single market via the Republic of Ireland. The detailed logistical arrangements of these customs checks are not yet agreed.

5. **Fishing rights.** The issue is what rights EU fisherman will have to the UK's Exclusive Economic Zone after Brexit, which could stretch as far as 200 nautical miles from the UK coastline. There are around 75 species of fish in the zone, including staples of the European diet like sole, mackerel, and herring. The UK is also incentivised to reach a fishing rights agreement, as it runs a trade surplus with the EU in fish. The UK also depends on the European

single market for sales of some of its most lucrative species like scallops and langoustines. The EU would like to "uphold" its existing fishing rights on a perpetual basis, while the UK wants to break free from the EU's Common Fisheries Policy and instead establish quotas based on "zonal attachment" (where the fish are) with an annual review. The political declaration agreed last year alongside the exit agreement specified that fishing rights would be agreed by the end of June 2020. Any fishing agreement would also need to address the issue of fish sustainability.

6. **UK financial services.** The sector contributes 12% of UK output and generates more tax revenue than any other sector. The UK accepts that "passporting" – full access for its financial services firms to all European single market nations – is unlikely. However, the UK is aiming instead for "mutual recognition" of closely aligned regulatory standards. But "mutual recognition" is more than the EU offers any other third country. So, the EU is instead seeking "equivalence". This is where the two sides would each set their own standards and regulations, while recognising each other's regulations as effectively the same. The major drawback of "equivalence" from the UK standpoint is that it could be withdrawn by Brussels at very short notice.

The pressure on both sides to compromise and to show flexibility is greater than it was during the three-year exit negotiations, for several reasons.

Firstly, COVID-19 has had a substantial negative economic impact on both the EU and the UK. Brexit was already going to pose economic challenges to both sides, arguably greater for the UK. The European single market makes up around 44% of UK's exports, while the UK represents only around 7% of EU exports. The pandemic-weakened EU economic environment also increases the importance of the EU's €94 billion trade surplus that it currently runs with the UK.

Secondly, the UK economic downturn is particularly severe. Even before the EU exit, the UK is already in a deep COVID-induced recession **– figure 1.** The local economy is dominated by 70% services, which have been particularly hard hit by COVID-19. The nation's pandemic response has been heavily criticised and there are fears that public nervousness could prolong the downturn.

Finally, the EU faces two further new pressures: First, the German Constitutional Court has recently challenged the principle of ECJ supremacy. Secondly, EU-27 member states are asking for flexibility and special allowances on issues like state aid.

Should no extension be agreed this month, two outcomes remain:

1. **No deal:** In this scenario, the UK would leave the transition period and trade with the EU on World Trade Organisation (WTO) terms. Preparation time for this scenario would be very limited, resulting in significant administrative challenges. After the transition period, the EU will classify the UK as a "third country", meaning that it is no longer an EU member and no longer benefits from its current trade access to EU countries and the outside world. The current average WTO tariff is 4.8%. However, the UK government has previously stated that it would introduce temporary measures to remove tariffs on 60% of goods so as to reduce the business disruption due to Brexit. Nonetheless, given that WTO members are required to treat countries with which they do not have a trade deal with in the same way, any UK tariff reductions or eliminations for a particular country would require it to grant the same to all other WTO member states.

2. **Basic trade agreement:** A basic deal could be largely WTO-based, with basic implementation provisions to smooth the transition towards any specified new deal. A basic deal would potentially see certain points agreed, with more contentious points delayed for further negotiations. The practical economic difference between a minimal, zero-tariff, zero-quota trade agreement and a no deal Brexit would not be that significant. The key benefit of a basic trade deal would be political, in that it would maintain a strong relationship and dialogue for a future broader agreement.

In recent discussions, UK negotiators have said that they would accept some tariffs in return for the EU dropping its demands for "level playing field" guarantees. The EU's chief negotiator Michel Barnier has recently suggested that talks could possibly extend until the end of October. There is now a crucial meeting next week between Johnson and the European Commission President Ursula von der Leyen, which could conceivably break the impasse and add some positive momentum to the discussions.

Market impact

Sterling – short-term caution as Brexit negotiations reach critical stage

Sterling's recent strength versus the US dollar has largely been driven by the US dollar weakness. In the weeks ahead, we expect that Sterling will start to move according to the progress of its EU negotiations. A rising likelihood of a hard "no

deal" outcome would result in Sterling consolidation. Longer-term Sterling direction is very dependent on the post-Brexit roadmap for the UK, which has yet to be elaborated on in detail by the government. We believe Sterling is attractive in valuation terms - **figure 2.**

Gilt outlook – positive, supported by Bank of England buying

Gilts have benefited from the fall in global yields. In the last two months, gilt 10-year yields have fallen from 0.8% to 0.30%. While increased gilt issuance is necessary to fund rising fiscal expansion in the face of COVID-19's economic fallout, and with the early signs of a cyclical pickup, Bank of England (BoE) buying is going to be necessary to maintain the current low level of yields. We expect that the BoE will increase its asset purchase programme in the months ahead – **figure 3.**

UK corporate bond spreads continue to tighten. Following the sharp spike to over 260bps in UK Investment Grade spreads in March, spreads have come down to 157bps. High Yields have also narrowed, down from over 900bps in March to 580bps currently. Both issuance and investor demand are both set to stay elevated. Corporates are seeking cheap access to funding while they can, while investors remain keen to lock in yields as the Bank of England considers boosting its QE programme.

UK Equities: long-term positive

UK equities remain down 14% so far in 2020, underperforming broader Europe (down 10%) and the US. With close to 70% of overseas revenue exposure, UK equities have been hit hard by a combination of the global slowdown, as well as the delayed virus containment strategy. With earnings and dividend uncertainty, the FTSE 100 currently offers a dividend yield of 4.5% and trades on a high teens multiple of prospective earnings. There are selective opportunities in cyclical areas like energy and financials, as well as in mid-caps as the economy starts to rebound – **figure 4.**

Figure 1: Rebound in UK Purchasing Managers Indices

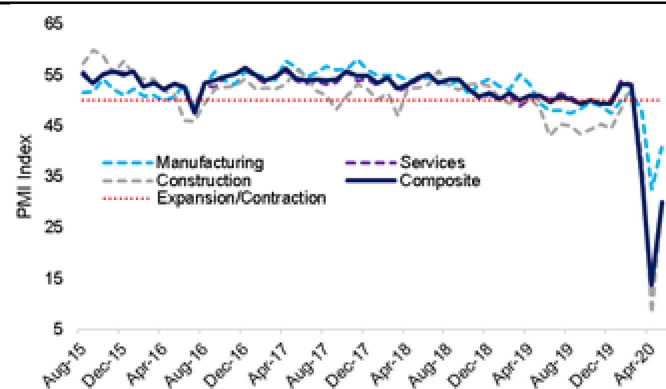
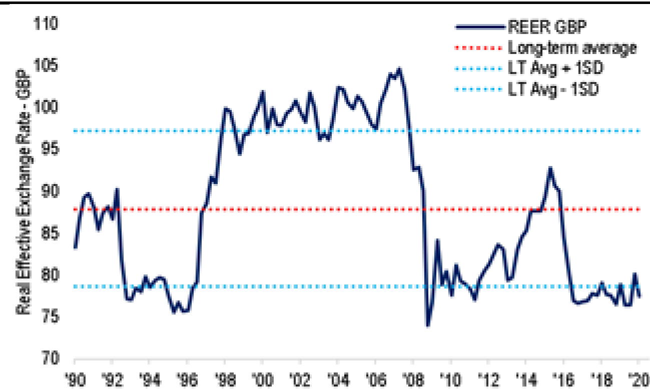


Figure 2: Long-term GBP valuation



Source: Bloomberg as of June 10th 2020. Past performance is no guarantee of future returns. Real results may vary. SD = Standard Deviation

Figure 3: UK 10-year Gilt Yields (%)

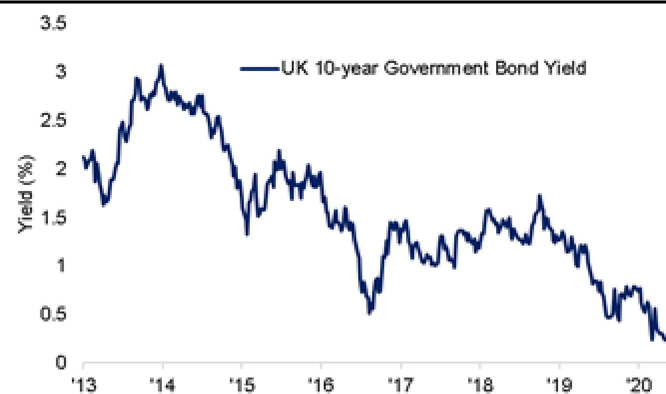
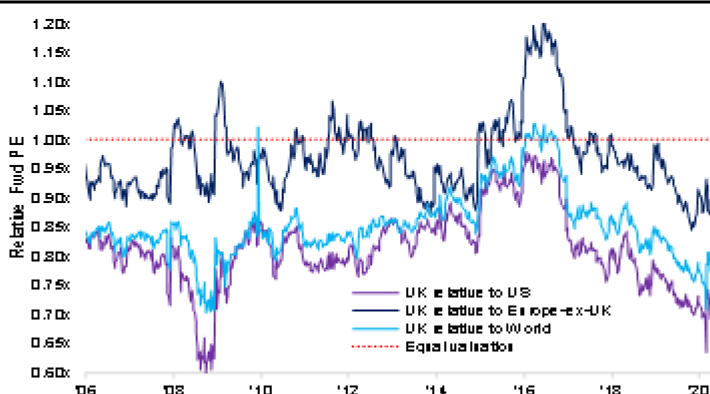


Figure 4: UK equities – relative valuations



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