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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Brexit: extension of the deadline is likely, but the final outcome remains uncertain

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- ***Recent developments and next steps:*** *Early this month, the UK Parliament passed a motion instructing the Prime Minister (PM) Boris Johnson to request an extension of the Brexit deadline by 19 October, and rejected the PM's request for elections before 31 October (the current Brexit deadline). This week, the UK Supreme Court judged "unlawful" the advice to susped the legislature given by Boris Johnson to the Queen. These events strengthen our view that another extension of the Brexit deadline is the most likely scenario. In this case, we would also expect a snap election to be called. Current polls say that the Tories may secure an outright majority, meaning that the no-deal risk would remain significant after the extension (although our central scenario is that the extension is followed by a deal).*
- ***The EU position:*** *While the EU wants to avoid a disorderly exit and the related economic cost, it is first and foremost preoccupied by the integrity of the EU's single market, the risk of moral hazard if excessive concessions are made to a country leaving the block, and the need to stand by one of its members (Ireland). Even in case of an orderly Brexit, a major long-term risk for the EU is that Brexit encourages the "leaver" political offer in other EU countries, especially if the UK's economic performance, after the initial shock, is not that bad. On the positive side, the departure of the UK may facilitate future decision-taking, notably regarding new projects to deepen and strengthen the EU architecture.*
- ***Possible scenarios after 31 October and investment implications:*** *The uncertainty about the Brexit end-game will be very high moving into 2020, with different implications for investment and asset classes.*
- ***GBP****: The most sensitive asset to Brexit newsflow is the GBP. In case of a deal, a recovery towards 1.35/1.40 vs the USD is possible, while a no-deal Brexit would likely push the GBP vs the dollar to 1.10-1.20.*
- ***Fixed income market****: Gilts are moving on par with the other DM government bonds. In the case of the UK, the likelihood of higher public spending (all parties have abandoned the austere policy stance) is certainly a threat to the current low level of 10-year yields. All in, playing the yield curve steepening theme and being agile in currency exposure (cautious on GBP, but quick to adapt to the political situation) are the main levers for fixed income investors to play the Brexit theme.*
- ***Equities:*** *We are currently cautious on the UK, as we see better opportunities elsewhere in Europe at the bottom-up level and the market has been heavily affected by the uncertainty related to the Brexit outcome. However, a lot is already priced into the equity market: the downside in case of no deal could be short-lived and limited. Given that only about a quarter of FTSE 100 companies' revenue is domestic, the drop in the currency would therefore be positive on average for FTSE 100 companies. Therefore, in an overall cautious stance, we have recently become more constructive on the market as selective opportunities in the domestic sector are very attractive from a risk-reward perspective.*

"After the Supreme Court's decision, PM Johnson is weaker".

Brexit: what are the recent updates and the next steps?

Early this month, the UK Parliament passed a motion instructing the PM to request an extension of the Brexit deadline by 19 October. Johnson lost his majority in Parliament in the process, after a number of moderate Tories abandoned him. Parliament also refused Johnson's request to call a snap election before 31 October (currently the official Brexit deadline). However, Johnson continued to state that: 1) he would not request an extension, despite Parliament's instruction, and that he would take the UK out of the EU by 31 October whatever happens, including without a deal if necessary; and 2) that he had made major progress in his discussions with the EU in order to secure a deal. However, the EU has not confirmed that a deal was near. Moreover, on Tuesday, 24 Sptember, the UK Supreme Court judged "unlawful" the advice to

suspend the legislature given by Boris Johnson to the Queen. The position of the PM is now weaker, as is his authority to negotiate with the EU.

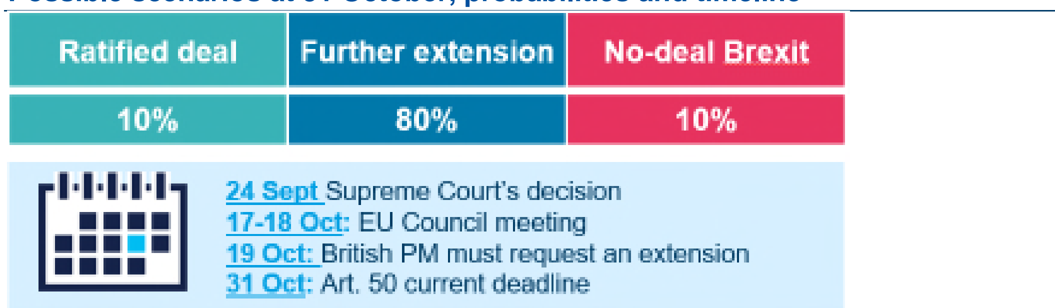
What are the possible Brexit scenarios ahead?

Regarding what happens on 31 October (currently the official Brexit deadline):

- **The most likely scenario (probability of 80%) is that the Brexit deadline will be extended**, presumably into Q1 2020, following Parliament's instruction. A snap election would probably follow (although this is not fully certain), as Johnson's government currently does not have a Parliamentary majority and the sharp political tensions over Brexit calls for a government with a clear people's mandate. This implies that Johnson finally accepts that he has to request an extension, or that he resigns or is removed (removal or resignation have become more probable following the Supreme Court's recent ruling).
- **A no-deal outcome by 31 October is, in our view, very unlikely (probability of 10%).** It would require Johnson to find a constitutional backdoor to avoid obeying Parliament (which can anyway remove him through a no-confidence vote) until the no-deal Brexit happens as it is the default legal outcome. In theory, the EU could also refuse an extension (remember, there is a unanimity rule), but we believe that such a refusal is very unlikely as long as the UK's request for extension is justified by the need to organise new elections (or a referendum).
- **A deal outcome by 31 October is also very unlikely (probability of 10%).** The EU will be preoccupied with the issue of moral hazard (ie, granting more concessions to Johnson after the EU said that the deal concluded with previous PM, Theresa May, was not open to renegotiation, all the more so as Johnson is viewed as a populist leader). Moreover, Johnson has no majority to pass a potential deal. **Note, however, that things could change very quickly** if, against all odds, Johnson accepts the lifting of some of the previous UK "red lines" (for instance, accepting that Northern Ireland could have a different regime than that of the rest of UK in terms of tariffs and/or product and services regulation if no other solution is found to avoid a "hard" border across Ireland). Things could also change if Johnson resigns or is removed, but even then the probability of ratifying a deal before 31 October appears low.

"The most likely scenario is that the current Brexit deadline (31 October) will be extended".

Possible scenarios at 31 October, probabilities and timeline



Source: Amundi. Data as of 25 September 2019.

What is your view regarding what happens after the probable extension?

"In case of extension of the deadline, a snap election looks very likely…"

In case of an extension of the Brexit deadline, **there would very probably be a snap election** (there is a possibility of a new referendum without a snap election, but this is less likely). The election result is very difficult to predict, due to: 1) the UK's first-past-the-post electoral system; and 2) the rapidly changing political dynamics. Current polls say that the Tories might secure an outright majority. However, they could be weakened by the departure of moderates, all the more so if there is any attempt at alliances with the Brexit Party (considered far-right). The opposition, on the other hand, will have a hard time campaigning on any common platform but a second referendum, and even that is disliked by many pro-Brexit Labour voters. Moreover, due to his hard-left views, Labour leader Jeremy Corbyn is a very difficult figure to rally to for other opposition parties.

- **All in, a no-deal Brexit by Q1 2020 is possible (probability 35% after the deadline extension).** This would probably require: 1) a Tory victory in the snap election; and 2) the refusal of both the new Tory government and the EU to make significant concessions.
- **A deal remains the most likely option (probability 55%).** This could happen in case of an opposition electoral victory (the withdrawal agreement could then be similar to the one proposed by previous PM May, but with the intention of negotiating a closer relationship during the transition period, or there could be a full reset of negotiations towards a "softer" deal). A deal is also likely if the Tories win elections, provided the newly elected UK government and the EU give mutual concessions to each other.
- **There remains a residual possibility that the UK could remain in the EU (probability 10%).** This would probably require a referendum (much more likely in case of opposition victory in a snap election) and that the UK voters choose the "Remain" option (cannot be taken for granted).

"…with a highly uncertain final outcome for Brexit".

Based on different scenarios, what are the main macroeconomic implications?

"In case of a no deal, GDP shock would be at least 1% for UK and 0.2% for the EU. Monetary and fiscal policies would need to be enacted to mitigate the effects".

Our current macroeconomic forecasts (UK real GDP growth of 1.2% in 2019 and 1.1% in 2020) are based on an **extension-followed-by-deal assumption.** However, note that a victory of Corbyn's Labour Party in a snap election while reducing the probability of no-deal Brexit could be damaging to UK economic growth if Corbyn's "hard-left" agenda is effectively implemented (although it is unlikely that Labour party could win an outright majority).

A no-deal Brexit (be it on 31 October or later) would lead us to very significantly cut our 2020 forecast for the UK, and significantly downgrade our expectation for the Euro area. The magnitude of the shock would, however, depend on whether mitigation measures could be put in place rapidly. In any case, our estimate, at this stage, is that the **GDP shock would be at least 1pp for the UK and at least 0.2pp for the EU**. These represent minimums and we note, for instance, that the OECD recently forecast a larger shock in case of no deal. Fiscal stimulus would need to be put in place to mitigate the pain in the UK, and fiscal measures could be decided in the Euro area as well. Note that it is unclear what will happen regarding the Irish border and a resolution could potentially be very challenging for the EU. Regarding the UK, we cannot fully rule out that Brexit could have extremely far-reaching political consequences (notably, new attempts by Scotland to secure independence). However, there is little visibility at this stage to qualify these risks.

Conversely, **an "upside surprise**" (such as a deal by 31 October or a choice by the UK to remain in the EU) **would lead us to increase our GDP forecasts, at least marginally**.

What will be the lingering effects of Brexit on the European Union?

"The EU wants to avoid other countries being tempted by an exit, but, ultimately, an orderly Brexit may facilitate some steps towards a stronger EU architecture".

Looking beyond the short-term economic pain, slightly reduced potential growth (due to a contraction in trade with the major partner that is the UK), and the need to make up for the UK's former contribution to the EU budget, the main risk to the EU is probably that **Brexit encourages the "leaver" political offer in other EU countries, especially if the UK's economic performance, after the initial shock, is not that bad.** While there seems to be a lower appetite today (than a few years ago) in other member countries for leaving the EU, the situation could change in case of an economic or political crisis. This could happen in southern EU member states, but potentially also in northern countries where "leaver" political parties could try to sell the idea of a closer relationship with the UK. Note that a UK economic outperformance vs the Euro area is not our central scenario (**we believe that Brexit will have very detrimental economic consequences for the UK, and for a long time**), but this, obviously, also depends on the future economic policy decisions in both the UK and EU.

In any case, Brexit creates a precedent which, by itself, means the trust in the permanent nature of the EU architecture will be eroded. In terms of economic policies, it could be that the departure of the UK weakens the camp that advocates freer competition regarding goods and services markets, and more labour market flexibility. **On the positive side**, the departure of the UK may facilitate future decision-taking, notably regarding new projects to deepen and strengthen the EU architecture. Note that this may even be the case for projects at the scale of the Euro area only (and not only at the wider scale of the EU) as British resistance had sometimes been felt even in such instances.

INVESTMENT IMPLICATIONS

As we discussed in the previous sections, an extension of the Brexit deadline (31 October) is the most likely scenario. The uncertainty about the Brexit end-game will be in any case very high moving into 2020, with different implications for investments and asset classes.

Beyond 31 October deadline, Brexit scenarios and investment implications

Scenario	Brexit with a deal	UK remains in the EU	Brexit without a deal
Probability	55%	10%	35%
GBP/USD (range)	1.35 – 1.40	1.28 – 1.33	1.10 – 1.20
Stocks	Up – outperform, cyclical and domestic names would outperform	Up – outperform	Overall, negative market reaction. FTSE100 could be helped somewhat by a weaker currency. Defensives / exporters will likely outperform cyclicals / domestic stocks
10Yr Gilts	BOE keeps rates on hold, yields little changed, following global trends	BoE could hike rates, leading to a possible rebound in bond yields	BOE would need to cut rates but a weak currency would not allow BoE to cut rates; rise in bond yields and possible downgrade

Source: Amundi. Data as of 25 September 2019.

FIXED INCOME AND FX

What is the fixed income market pricing in at the moment for UK rates? What could be the reaction regarding rates in the different Brexit outcomes?

"BOE's action will be highly dependent on Brexit scenarios".

Bond markets have recently started to price in the possibility of rate cuts from the Bank of England (BoE). There is about a 50% chance of a 25bps cut by mid-2020. In truth, market rate expectations are a blend of several possible outcomes: **a Brexit with a deal**, and thus a transition period, likely leading to rates on hold; **a no-deal Brexit,** leading to immediate World Trade Organization terms and considerable disruption, likely requiring rate cuts to cushion the impact on growth; and the smaller chance of the **UK staying in the EU**, which would then open the door to rate hikes. A key consideration will be whether the BoE can 'look through' the impact of sterling depreciation pushing inflation still higher in one of the downside scenarios. There is also the possibility that **sudden supply constraints might squeeze prices higher, complicating the BoE's decisions**. Bear in mind that Mark Carney's term as Governor comes to an end in January 2020. Along the curve, **Gilts are pricing in a very modest growth and inflation outlook,** with the benchmark 10-year Gilt yielding just about 50bps.

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The GBP has been highly sensitive to Brexit newsflow. What is the GBP pricing in and what are the expectations regarding possible outcomes?

Movement in the GBP is being driven by headlines. Ones that suggest a crash-out Brexit on 31 October or soon thereafter push sterling lower vs the US dollar and lower but less so against the euro. Headlines that suggest a compromise may be reached or, even, that Brexit might be avoided, lead to a rapid appreciation of sterling.

With a GBP/USD rate at around 1.25, the markets seem to signal some hopes that the worst outcomes can be avoided. This reflects the recent passage of a Bill through Parliament that will require the government to request an Article 50 extension if, by 19 October, a withdrawal agreement has not been passed through the UK Parliament. Recent Scottish court decisions and discussion of a 'Northern Ireland only' backstop have also led some to hope that disaster can be averted. However, PM Johnson has continued with his strident rhetoric on exiting on 31 October, come what may. Currency volatility will likely remain very high and will depend on news flow.

In terms of investment conviction, how do you believe investors should play the Brexit theme in a fixed income portfolio?

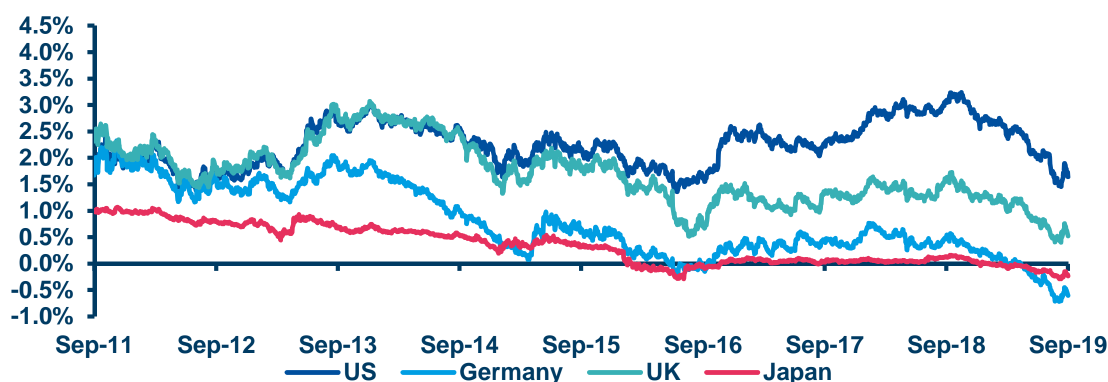
"Playing the yield curve steepening and being agile in currency exposure (cautious on GBP, but quick to adapt to the political situation) are the main levers for fixed income investors to play Brexit theme".

One thing is clear: uncertainty is likely to continue, and this has already negatively affected growth in the UK. Even a Brexit with a deal will simply open a new chapter in the negotiations with the EU. And a no-deal Brexit would likely be followed swiftly by a number of sectoral mini-deals and pragmatic workarounds, as has already happened with the financial sector. For as long as **uncertainty continues, foreign direct investment and business investment, more generally, are likely to be weak.** As a result, productivity, which has already been subdued since the crisis, is likely to continue to weaken, hurting trend growth.

Even though Gilts are now handsomely priced, following the rally in all G7 fixed income markets in recent months, it seems logical to hold them as part of a fixed income portfolio.

The curve has flattened considerably, and we expect some normalization. To play this, it would be appropriate to be long the two-year part of the curve and short the 10-year (building therefore a 2-10Y steepening position) to benefit from a normalization of the curve. What could prompt that normalization? **The likelihood of higher public spending, and thus of higher Gilt issuance, is certainly a threat to the current low level of 10-year yields**. All political parties appear to have abandoned the austerity goals of the Theresa May administration. Fear of a Jeremy Corbyn-led radical left administration could also lead to a sell-off in Gilts. More broadly, a rise in yields globally could lift Gilt yields higher if, for example, the developed market data continue to improve into year-end, and the US and China edge towards a trade deal of some sort. At the long end of the curve, the 10-30Y spread has dropped significantly over recent months as yield curves globally have flattened. However, it may yet flatten further. **Some exposure to the 30-year Gilt is therefore attractive, in our view.**

UK 10-year government bond yield compared with the global trend on yields



Source: Amundi. Data as of 24 September 2019.

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“We are cautious on sterling at present. It is necessary to be very nimble in adjusting position as political winds change”.

Inflation-indexed Gilts are harder to call. Already demand from UK pension funds has kept them well bid. There has also been the question of reform of the Retail Prices Index to which they are linked. That reform appears to have been put on the back burner again for now, but it perennially returns because the current system is both illogical and costly for the government. Shorter-dated Gilt linkers are also likely to be affected by movements in the exchange rate as hopes of a deal ebb and flow. Inflation is high already and weak sterling, BoE rate cuts and fiscal stimulus are likely to push it higher. But, passage of a withdrawal agreement and a sterling rally, with BoE cuts priced out, would put downward pressure on inflation.
On currency, **although we are cautious on sterling at present, it is necessary to be very nimble in adjusting positions as political winds change.** It is also worth remembering that in a portfolio, a short sterling position and a long Gilts position (especially if it is in inflation-indexed bonds) is highly correlated. To improve diversification, as said, focusing on a 2-10Y steepening of the curve can be beneficial, as this position is negatively correlated to these other two positions (short sterling and long Gilts).

EQUITY

This year, the UK equity markets have underperformed the broad European market. Do you expect this trend to continue and under what circumstances?

“A lot of bad news is already priced in, but the UK equity market still appears cheap in both absolute and relative terms”.

The UK equity market appears cheap, and it is on multi-year lows compared with both its own history and relative to international equity markets. This is largely due to the Brexit uncertainty, where we are now three years post the 2016 referendum and still have all options on the table and therefore a high level of uncertainty. **A lot is priced in, to be fair**, but whether the market continues to underperform depends on the development of Brexit. The UK market (especially the FTSE100) has traditionally been defensive, and given recent underperformance, **there is valuation support** (dividend yield stands at 5% for the FTSE100, which is high).

What are your main convictions for UK companies?

“In order to build a resilient equity allocation to different Brexit outcomes, it is important to test each investment case for a range of possible outcomes”.

UK companies face huge uncertainty which leaves them with very low forward visibility. This has already impacted demand and caused delays to investment and other important corporate decisions. We cannot view the market as a whole, as individual circumstances are very unique depending on each company and sector. From a bottom-up perspective, we think it is key not to attempt to forecast Brexit and therefore take a view on a certain outcome; instead, **we prefer to test all investment cases for a range of Brexit outcomes** (as well as other external variables). This helps to ensure a more resilient European equity allocation. We are currently cautious on the UK, as we see better opportunities elsewhere in Europe bottom-up. However, in an overall cautious stance, we have recently become more constructive on the market, as selective opportunities in the domestic sector are very attractive from a risk-reward perspective. An example of a compelling investment idea is a UK house builder which specialises in building affordable houses outside of London. This is a company with a strong balance sheet and a solid business model. We are also looking at stocks in the leisure sector, where we think risk-reward is looking increasingly attractive.

For the UK market, what could be the stocks/sectors most affected by a no-deal Brexit, and on the contrary, the one that might shine in case of a more favourable outcome (delay or deal)?

In the case of a no-deal Brexit, we expect to see multiple impacts:

- **Impact 1:** Our expectation is that **a no-deal Brexit** would **weaken sterling**, which has already depreciated. This would make imports expensive and exports cheaper. Given that only about a quarter of FTSE100 companies’ revenue is domestic, the drop in the currency **would therefore be positive on average for FTSE100 companies, after an initial negative market reaction**.
- **Impact 2:** We would expect **consumer and business confidence to drop** significantly given the lack of visibility in a no-deal Brexit scenario. This could **harm economic growth significantly in the near term.**

"A no-deal Brexit scenario would, in our view, weaken sterling, benefitting the highly export-driven equity market. But, this would also result in a negative impact, due to lower consumer and business confidence".

So in a **no-deal Brexit** situation, we would expect domestically focussed stocks (especially cyclicals) to be most negatively impacted while exporters and defensive stocks would benefit in relative terms. On the contrary, **if there is a deal,** we expect the certainty of an outcome to cause a reversal where **cyclical and domestic stocks outperform defensives**.

At the European level, which might be the stocks/sectors more affected by a no-deal Brexit?

Initially, we expect a **no-deal Brexit to trigger a broad market selloff,** as significant new uncertainty would be introduced in terms of what a no-deal Brexit would mean for businesses and consumers. In such an event, **we expect the classical "defensive" sectors, such as consumer staples, telco, pharma and utilities, to do relatively better while the more "cyclical" sectors, such as banks, consumer discretionary and industrials, would underperform.** As the dust settles, there is likely to be a more fundamental reaction where companies that are exposed to UK end-markets would underperform those with no or little exposure. Clearly, the size of the UK economy would mean that any negative impact on growth would also impact the European economy, but we do expect the UK economy to be the hardest hit.

Euroland equity will not be immune to a no-deal Brexit, but we would expect Euroland to outperform in such a case. On the contrary, Euroland is also likely to underperform in a case where a deal is agreed. Any real fundamental impact longer term would obviously depend on what solution/deal is eventually negotiated vs the state of play in a no-deal Brexit situation.

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Definitions

- **Correlation**: The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **First-past-the-post**: An electoral system in which voters indicate on a ballot the candidate of their choice, and the candidate who receives the most votes wins.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Yield curve bull steepening**: A bull steepening is a yield/rate environment in which short-term rates are falling faster than long-term rates. This causes the yield curve to steepen.
- **Yield curve flattening:** An environment in which the difference (spreads) between yields/rates of short-term and long-term bonds of the same credit quality reduces.
- **Yield curve normalization:** An environment in which yields on short-term debt instruments are lower than yields on long-term debt instruments of the same credit quality.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

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