



بنك الإمارات دبي الوطني
Emirates NBD

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Brexit: It's not over

- Negotiations over a trade deal between the UK and the EU went down to the wire, with the agreement inked at almost the last moment possible before the end of the Brexit transition period.
- Failure to clinch a deal would have seen the trading relationship between the two revert to WTO rules. Give the importance of this trade to both economies, and especially the UK, the new deal removes a significant threat to growth in 2021.
- While the prospect of a deal was broadly priced in, there has been some bullish momentum in British asset classes, with sterling and the FTSE 100 both ticking upwards.
- There remain significant questions regarding the future relationship between the UK and the EU, not least in terms of services. The agreement largely covers trade in goods, while that for services is to be settled over the coming months. Given their importance to the UK economy this leaves major uncertainties ahead, not least for the economically important financial services sector which employs over a million people and accounts for some 7% of national output.
- The impact of the departure from the EU will be hard to quantify given the economic disruption caused by the pandemic crisis, with which the UK is struggling currently. Nevertheless, it seems self-apparent that even if the disruption is not to the same magnitude as would have resulted from a no-deal crash out, it will still weigh on growth over the coming years, especially if the outlook for services exports does not become clearer soon.
- Aside from finalising the relationship with the EU, the UK government will look to sign new trade deals around the world. The US under President Elect Joe Biden will be less enthusiastic however, and a new UK-US deal feasibly might not materialise until after 2021.
- Given these Brexit-related factors, and the renewed lockdowns related to the Covid-19 pandemic, we are under consensus on UK GDP growth at 4.5%. The Bank Rate will likely remain at 0.1%, with the argument for negative rates now weaker with the signing of the deal, however flawed. We see modest further upside for sterling, but believe most of the gains have already been realised.

GBPUSD at multi-year highs



Source: Bloomberg, Emirates NBD Research

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Last minute deal means no tariffs or quotas on goods trade...

Over four years and three prime ministers since the 2016 Brexit referendum which saw the UK vote to leave the EU, the two sides finally implemented a trade deal at the last possible moment. The UK had already left the political bloc in early 2020, but the so-called transition period, which maintained economic relations on their previous footing, was due to come to an end with the close of the year. With little will on either side to extend this, failure to ratify an agreement by the stroke of midnight on New Year's Eve would have seen the relationship revert to WTO trading rules. As it was, the deal agreed by both sides just days before the deadline sailed through the Westminster parliament with the opposition Labour Party's support, and was given the royal assent in the early hours of January 31. It will not be ratified by the EU until later this month, but this is just a remaining formality as the treaty has received written approval from the ambassadors of the 27.

Following years of tortuous negotiations and brinksmanship – especially elevated over the past several months – the signing of the deal removes some of the largest questions regarding the UK's future trading relationship with the EU. While UK politicians were keen to talk up the supposed benefits of a no-deal break, there is little doubt that at the very least there would have been a significant short-term economic hit given the frictions to trade that would result from newly imposed tariffs and quotas. Even with the deal the new relationship will not be all plain sailing, given new regulatory checks which will add red tape to highly integrated just-in-time supply chains. And while the outlook for trade in goods is on a somewhat surer footing, that for services – which accounts for around 80% of the UK economy and 50% of exports – remains uncertain.

...but access to EU markets for services remains unresolved

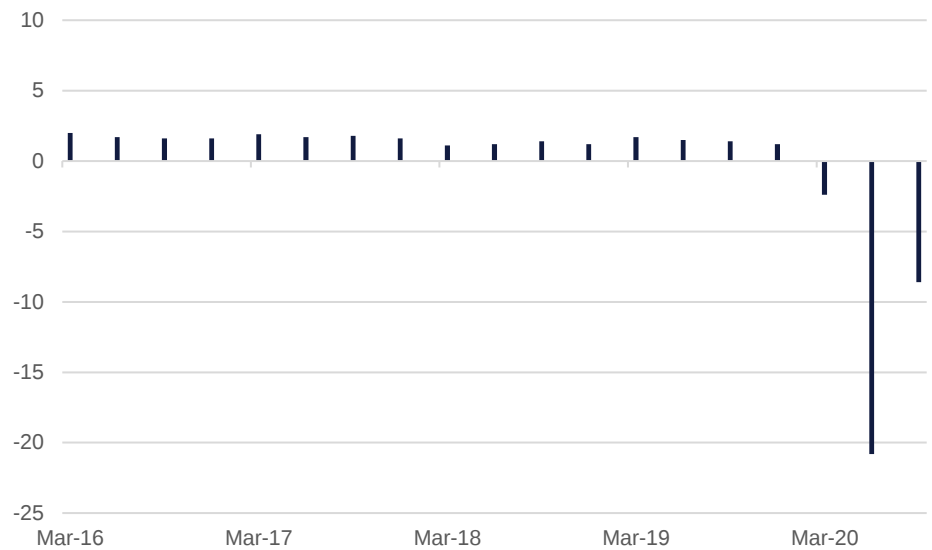
The Brexit project has always been as much about politics as economics, and this has been starkly illustrated by the importance that the fishing sector, a fraction of the UK economy, took on in negotiations over the past several months. The issue over quotas for EU fishermen in UK waters nearly derailed the talks, and was one of the final sticking points in discussions along with the issue over the future 'level playing field', on the face of it a far more economically meaningful aspect. In the deal itself, 'fishing' is mentioned 87 times, while 'financial services', which employs over a million people and accounted for 6.9% of national output in 2018, garnered 90 mentions, just three more than fishing.

Even ebullient Prime Minister Boris Johnson has conceded that the deal 'perhaps does not go as far as we would like' on financial services, and major banks listed in London saw their shares drop following the publication of the text of the deal. The failure so far to agree a financial services deal with the EU as a whole will necessitate negotiating a patchwork of member state regulations until a deal can be struck. The Brexit trade deal provisions for a three-month negotiation with the hope for obtaining regulatory equivalence within that time, but banks have already implemented plans to relocate parts of their business in the expectation that this will be drawn out. It is hard to ascertain exactly what the government wants for the financial services industry, and just how many EU rules it is prepared to accept in order to retain its access, but the long-term prosperity of one of the UK's most important industries hangs in the balance.

Growth will be weaker

Leaving political considerations and desires for greater autonomy aside, it is hard to build the case that the deal is an economic improvement on membership of the EU, and even some of the staunchest supporters of Brexit have conceded that any economic benefits might not materialise for 50 years. However, much as the economic impact of the Great War is hard to disentangle from that of the Spanish Flu pandemic which took hold in the closing stages of that conflict, so the short-term impact of the new trading arrangement will be somewhat lost amongst the Covid-19 fallout.

Real GDP growth (% y/y) will take time to recover



Source: Bloomberg, Emirates NBD Research

The UK has already suffered its biggest economic contraction in hundreds of years in 2020, and with restrictions on movement and activity ramped up once more from the start of 2021, the outlook for the first quarter at least remains especially weak. The consensus projection for real GDP growth of 5.4% next year following an estimated -11.3% contraction in 2020 seems bullish to us in light of the latest lockdowns and rapid ramp-up in new cases, and we believe that growth of around 4.5% seems a more likely scenario, leaving the economy still considerably smaller than it was prior to the pandemic.

Hospitality venues across most of the UK are now closed once again in another blow for the services sector, and while the extension of the government's furlough scheme into 2021 will help prevent job losses, household spending will nevertheless remain severely curtailed. The elevated saving rate that has come as a result of the lockdowns provides scope for a solid bounce back once the virus is contained, but even as vaccines start to be administered this remains some months away.

Google mobility data shows retail and recreation footfall down



Source: Google

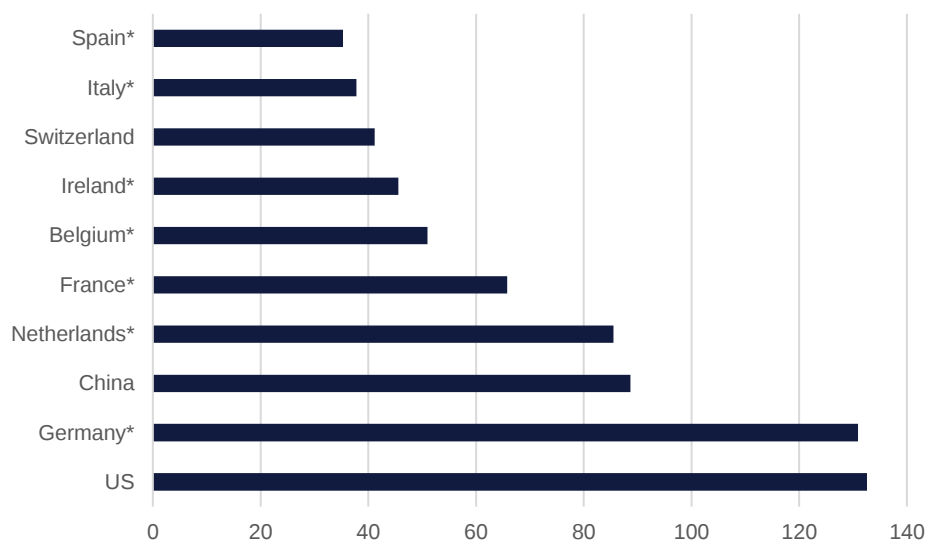
Meanwhile, in a foretaste of what the new trading regulations with the EU could mean, the new strain of the virus which seemed to originate in the UK has already complicated relationships with other states as transport links were closed in the run-up to Christmas, leaving hauliers stranded by the side of the road for several days. Trade will also likely slow over the start of 2021 given the level of stockpiling firms engaged in in the run-up to the transition period's end. Eager to build up inventories prior to the New Year uncertainty, stockpiling by UK firms drove the manufacturing PMI to a three-year high of 55.6 in November. This will likely have remained high in December, but will slow markedly once again from January on.

The UK won some concessions on the 'level playing field' allowing it greater flexibility to change its subsidy regime as well as tweak other regulations. However, the UK cannot stray too much from 'shared principles' on subsidies agreed with the EU, nor from the minimum standards on environmental, social and labour regulations. Either side can initiate a review of what has been agreed, if they feel trade is being distorted by subsidies or regulatory changes. This will limit what the UK can do in these policy areas to attract investment or boost growth.

New trade deals

Now that the transition period is over and the future relationship with the EU broadly settled, the UK can forge ahead with brokering new trade deals with other nations around the world. Turkey was the first such deal agreed in the wake of the agreement with the EU, signed on December 29, and this followed previous significant agreements with Switzerland (eighth largest trade partner), Norway (11th) Canada (12th), Japan (14th) and some 60 other states around the world.

UK trade, USDbn, 2019



Source: Bloomberg, Emirates NBD Research. * = EU member state

Aside from defining the final points of agreement with the EU, the focus for the British government will now likely turn towards securing a free trade deal with the US, the UK's largest individual nation trade partner (Germany comes a close second, while the EU as a whole accounts for around half of the UK's trade). However, the prospect of the 'mini deal' that was being touted by present US trade representative Robert Lightizer in mid-December has seemingly not advanced, and the likelihood is that the incoming Democratic Joe Biden administration will see a trade deal with the UK as far down the pecking order in terms of its priorities. With pressing demands on the home front, a greater level of support for the European project than his predecessor, and emotional and ancestral ties to Ireland which have to now informed his views on Brexit, President elect Biden will be in no rush to clinch a deal with the UK, and this could feasibly not materialise until past 2021.

GBP has only modest further upside

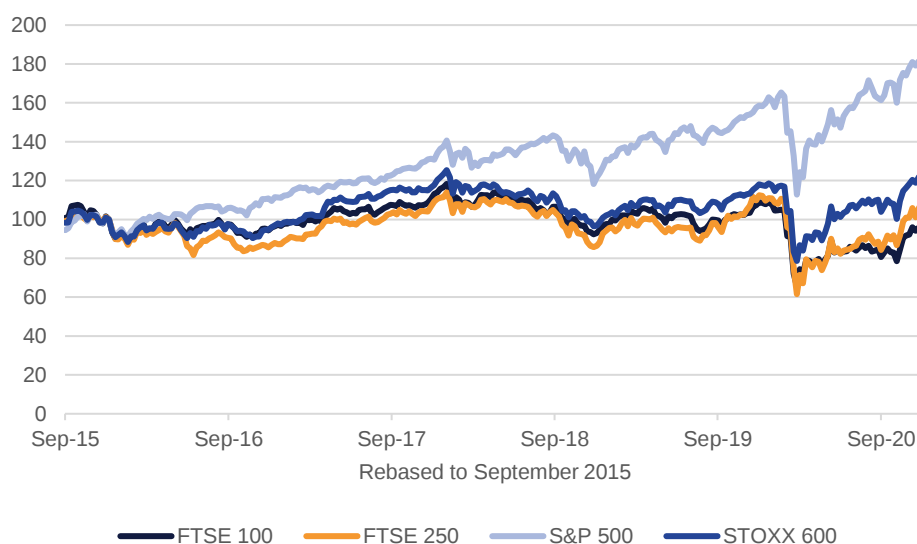
The prospect of a deal being agreed had seemingly already been baked into sterling, but the currency has nevertheless strengthened since it was finally struck, hitting levels not seen since February 2018. It is currently trading at 1.3672, and with a general trend of dollar weakness expected to persist through the year, and the threat of a no-deal Brexit now removed, the likelihood is that it will appreciate further still against the greenback. However, the gains from here will be more muted as while the most immediate threat to UK growth has been largely neutered the country continues to struggle with the pandemic, and the uncertainty over aspects of the services sector will further weigh on the outlook. We forecast a year-end level of 1.4000, implying only a fairly modest appreciation from hereon in, and softer than the more bullish projections of as much as 1.4500-1.5000 being seen. That being said, a rapid and comprehensive resolution of the trading relationship for services offers some upside risk to our outlook.

FTSE remains the global laggard

The FTSE 100 has been one of the major laggards amongst global equity indices since the Brexit referendum, and this has been exacerbated in 2020 as the heavy preponderance of defensive stocks and slim exposure to the tech stocks which have been the prime beneficiaries of lockdown life has slowed its recovery from the March sell-off. While the benchmark index will continue to be more heavily affected by the global recovery from the pandemic crisis given the large number of multinationals, energy and mining firms within it, the smaller cap, more UK-exposed FTSE 250 has recorded strong gains over the past two months as the risk of a no-deal Brexit dissipated.

Both indices remain off their start-2020 levels, and in dollar terms their performance over the past five years has been especially poor when compared to the US and pan-European benchmarks (see *chart*). While valuations remain cheap, investors may wait on the side-lines for now given ongoing uncertainty regarding the new relationship with the EU and the renewed pandemic lockdown.

UK equities the global laggards



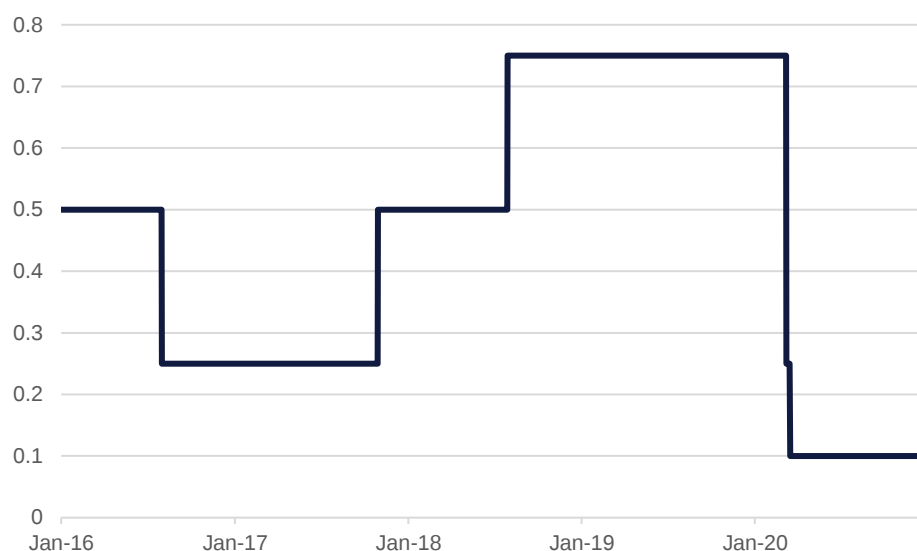
Source: Bloomberg, Emirates NBD Research

Interest rates

While the case for negative interest rates in the UK has gone back and forth in statements made by policymakers this year, the 11th hour deal with the EU makes them far less likely than they might have been otherwise, and we would now expect the Bank Rate to remain on hold at its present 0.1% through 2021. Bank of England Governor Andrew Bailey has been fairly resistant to the pro-negative rates argument, and with the big-impact threat of a no-deal Brexit removed we believe that arguments against by the banking sector will win the day. This is especially the case given the mixed successes in boosting growth and inflation recorded by the Japanese and European experiments into sub-zero territory.

With the new deal, the rollout of vaccines now started, and hopes for some return to normality by year-end at least, the case for further cuts has weakened and instead the bank will rely on continued quantitative easing as its primary policy tool over the course of 2021.

BoE Bank Rate, %



Source: Bloomberg, Emirates NBD Research

Key Economic Forecasts

UK	2016	2017	2018	2019	2020e	2021f	2022f
Real GDP %	1.7	1.8	1.2	1.5	-11.3	4.5	4.8
Current A/C% GDP	-5.4	-3.8	-3.7	-3.1	-2.6	-3.6	-3.3
Budget Balance % GDP	-3.2	-2.4	-2.1	-2.1	-16.7	-8.7	-6.3
CPI %	0.7	2.7	2.5	1.8	0.9	1.5	1.9
GBPUSD eop	1.23	1.35	1.28	1.33	1.37	1.40	1.45

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