Confidence must be earned

Amundi ASSET MANAGEMENT

12 March 2019

Brexit: an agreement is now more likely, but be aware of a no deal risk, not priced in

INVESTMENT TALKS

Didier BOROWSKI
Head of Macroeconomic Research

Laurent CROSNIER
Head of Global Fixed Income

Matteo GERMANO
Head of Multi-Asset

Tristan PERRIER
Senior Economist

Developments and scenarios ahead: This is probably the most decisive week for Brexit and the situation is still rapidly evolving. Last night, Mrs. May and Mr. Juncker announced an agreement on the most controversial part of the Brexit deal: the Irish border backstop. This agreement is aimed at getting the U.K. Parliament to accept the Brexit deal previously rejected in January. May described what was achieved yesterday as "legally binding changes" to the deal, Juncker instead spoke of assurances and guarantees. Theresa May has failed to get what Parliament had asked her; however, she has obtained some assurances (a "legally binding" agreement") that could clearly lead a very significant number of MPs to change their minds and accept the proposed deal. The most controversial part of the witdrawal agreement (the fact that the Irish backstop was permanent) has been revised to give the UK the technical opportunity to backtrack later.

What is important now is to see how the hard Brexiteers and the DUP (Northern Ireland Unionists) will react today ("we will be taking appropriate advice, scrutinising the text line by line and forming our own judgement," a DUP spokesman said). Even if May convinces the Brexiteers in her own Party and in the DUP, she still needs to convince the moderates and Remainer. That's why, she is also promising to end austerity on the fiscal side if MPs back her deal. One of the key point mentioned yesterday by Juncker is that if **the UK has not left the EU by 23-26 May** (the European elections date), it will be legally required to hold these elections, which is a red line for many MPs (and will thus be perceived as a game changer). Thus a short-lived extension cannot go beyond this date. **By opening the door to a long period of uncertainty with a possible UK participation in the May European elections, the EU has given the British prime minister an additional advantage to get her deal passed by 29 March**. Indeed, **should the deal be rejected tonight, the agreement reached yesterday would increase the likelihood of new general elections and/or another referendum, which de facto increases the likelihood of a deal by March 29**. The concession made yesterday night is the last concession that the EU will make.

At the time of writing, it is likely that the Parliament will likely vote today for a deal presented by May. If that deal were to be rejected there could be another vote on a no deal. And should the no deal also be rejected, there will likely be a vote on an extension of the Brexit deadline, which would leave the country with high uncertainty on the next extended deadline.

We still see three scenarios: a deal ratified by March 29 has now become more likely (50%), followed by "prolonged uncertainty" scenario (30%), with a Brexit deadline extension, and a no deal scenario (20%).

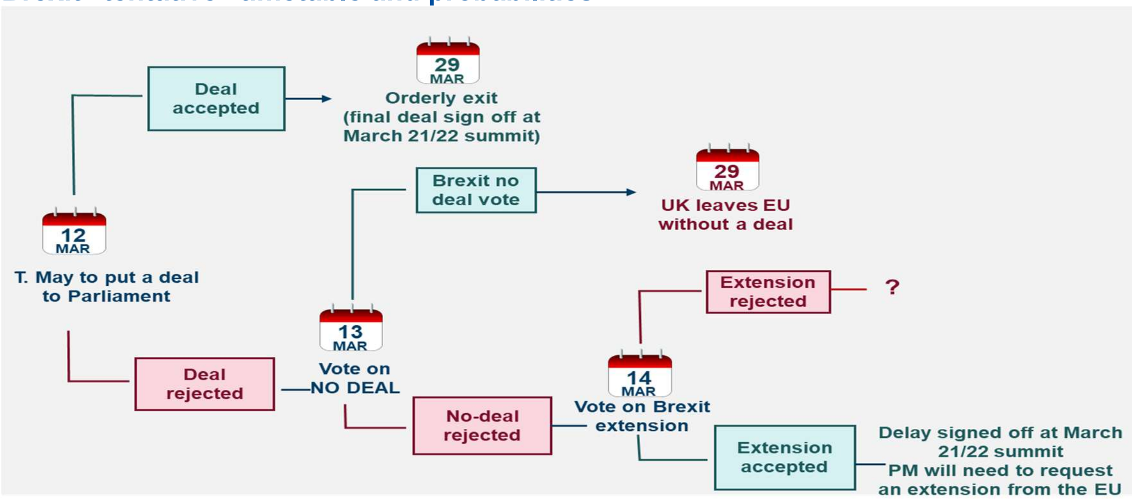
Investment views: we believe that a deal reached today, will bring relief to financial markets, taking away a source of significant uncertainty. Also a short extension, could bring some relief, but uncertainty would be back once the new deadline approaches. On the contrary, a no deal is not priced in by the markets and would put pressure on risky assets, European equities and UK equities, in particular. From a **multi asset perspective**, we have become more cautious on risky assets, equities in particular: the year to date rebound for equities has been too fast, in an enviroment of weak economic data, with earnings being revised down and higher geopolitical risks (i.e trade) still on the table.

From a **fixed income perspective**, we have a neutral view on duration, and we see only a moderate rise in Gilt yields from current levels. The economic slowdown, a benign inflation outlook and accommodative central banks (at global and domestic levels) exert downward pressure on bond yields. However, we expect new yield lows (below 1%) only in the case of a no deal. The GBP is not pricing in a no deal, which would be very negative for the GBP (with potential loss of a further 10% from current levels). As we are closer to a binary outlook, we believe investors should remain neutral/slighly positive on Sterling, avoiding taking a strong directional risk, as the tail risk of a no deal is not priced in at all.

Brexit: where do we stand?

We have entered a decisive week. At the time of writing, we know that the Parliament will vote for a deal presented by Theresa May (likely on March 12) and, if that deal were to be rejected, for a no deal later on. If the no deal were also to be rejected, there would be a vote on an extension of a Brexit deadline, which would leave the country with high uncertanty for the next extended deadline. Compared to the last vote, we would expect more votes in favor of a deal today, as some Members of Parliament (MPs) have begun to fear a long-lasting extension with a possible new referendum or new elections. There is even the possibility that a deal is reached as some MPs may want to secure a deal, after the agreement reached last night between May and Junker.

Brexit "tentative" timetable and probabilities



Source: BBC, Bloomberg, Amundi. Data as at 12 March 2019.

What are the Brexit possible scenarios and market reactions?

"The agreement reached yesterday has increased the probability of new elections/ referendum if the deal is rejected today: this has also increased the probability of a deal by 29 March".

Ratified deal by 29 March

- UK leaves the EU and enters a transition period, retaining its access to the European Single Market at least until end 2020
- Hard Brexiteers have had few incentives to soften their positions. The agreement reached by May and Juncker could be a game changer in this respect
- Yet, Hard Brexiteers may prefer to approve the deal if the alternative is a prolonged extension
- The UK would probably need a technical extension. In that case, the EU parliament would still need to ratify the withdrawal agreement, and the British Parliament will need to adopt the implementing legislation afterwards. We see 30% probability that the agreement is reached on March 12.

50%

Market relief

Prolonged uncertainty

- **Art 50 is extended until EU election (50% probability) or more than this period (50% probability)**
- This would put more pressure on the hard Brexiteers
- A long extension could re-open the door to a new referendum or new elections
- With an extension beyond EU election date, the UK would participate in the EU elections in May (very tricky situation from a legal standpoint that both sides want to avoid, hence the lower probability for a long-lasting extension
- In the case of a long-lasting extension: uncertainty about the future of the European model (long term), but more clarity over the short term.

30%

Partial market relief, but still uncertainty, approaching the new deadline

No deal

- The UK exits the EU without (or with only a very limited) transition regime
- Sub scenarios: an outright "default" to a WTO regime is a risk, but mitigation measures ("managed no-deal", "deals under no-deal") may be agreed.
- Negative impact on EU GDP growth with differences across countries (Ireland would be the worst hit, followed by countries well integrated in international supply chains)
- Extreme uncertainty concerning the Irish border issue.

20%

Not priced in by the market, negative for EU equities and GBP

Source: Amundi. Data as at 12 March 2019.

"On balance we expect only a moderate raise of gilts rates from current levels, while a fall below 1% could be seen in case of a no deal".

How would you expect UK rates to react to Brexit possible outcomes?

Bond yields are sensitive to Brexit news, but also to the weak economic data at the global and domestic level.

With risk of a no deal Brexit abated at the end of February, the bond market started to react positively to a more constructive view, with 10 year yields increasing slightly, from the minimum of the year at 1.15%. However, this has been short lived: the market has been driven by weak global macro data and more accommodative Central Banks.

The next Bank of England meeting is scheduled for March 21, and we don't expect any interest rate hikes: there is no upward rise in inflation and employment data were better than expected, there's no hurry to raise interest rates. The stance will likely remain neutral (wait-and-see approach).

The scenario of weak growth and dovish central banks is likely to continue for the coming weeks and we believe that investors should not fight the bulls and favor long dated maturities which should benefit from the growth slowdown and reduced inflation fears. We have a neutral view on duration, and we believe investors should favour curve flattening positions. On balance, we expect only a moderate rise in Gilt yields, from current levels, with an extension deal reached this week.

In our view, new Gilt yield lows, below 1%, could be reached only in the worst-case scenario,: in the case of a collapse in Brexit talks (no-deal Brexit), we expect a further fall in GDP growth and inflation surprising on the downside. May's resignation (that is possible in summer) would not make any difference at that point.

At the moment, we are quite cautious on inflation linkers, mainly for two reasons. The first is that UK inflation is expected to go down. The second lies in the uncertainty brought by the suggestion made by the Lords' Economic Affairs Committee to switch to the CPI-based measure from the currently used Retail Price Index (RPI). Investors who bought linkers made their decisions based on RPI, so a potential change could have a negative impact on UK inflation-linked bonds. If nothing changes, we look favourably at ultra-long UK linkers.

"A no deal is not price in for GBP, we believe that it's appropriate to avoid to take too much currency risk".

What is the GBP pricing in? What could be the reaction with the various outcomes?

The market until yesterday expected Members of Parliament to reject the current Brexit deal (they will very likely vote it down), turning in favour of a Brexit delay. In that case, we may expect Sterling's reaction to be slightly negative, but not too much as it is mostly priced-in. The real catalyst would be what happens next. It would be a debacle if the UK leaves the EU without a deal as the market is no longer expecting this. A no deal is not priced in and we may see a further 10% depreciation in Sterling if this extreme event were to happen. If they vote for excluding a no deal Brexit, it will be positive for the GBP, because no deal chaos would be almost eliminated. If they vote not to exclude a no deal, it could be negative for sterling but still not the end of the game.

A 2-3 month extension would be more acceptable for the market, it would mean just reconciling and re-adjusting. An extension beyond three months would prolong uncertainty weighing on Sterling and the UK economy overall.

Investors are positioned long Sterling, trying to catch some speculative opportunities, but for the real part of the economy (such as industry, property, long-term investors) UK assets are still underweight. On balance, we have a neutral/slightly positive view on GBP, but as the outcomes are becoming more binary and the worst case outcome is still priced as a very low probability event, we believe that it's appropriate to avoid taking too much risk.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at **www.amundi.com**

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of March 12, 2019.

Diversification does not guarantee a profit or protect against a loss.
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).

The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management, and are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, as securities recommendations, or as an indication of trading on behalf of any Amundi Asset Management product. There is no guarantee that market forecasts discussed will be realised or that these trends will continue. These views are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. Investments involve certain risks, including political and currency risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested.
This material does not constitute an offer to buy or a solicitation to sell any units of any investment fund or any services.

Date of First Use: 12 March 2019.

Chief Editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Office

Amundi
ASSET MANAGEMENT