THIS MONTH'S TOPIC

A Brexit deal: probably, but not just yet

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The essential

Risks of a no-deal Brexit have receded materially over the past few weeks, implying that the Bank of England is now more likely to keep its monetary policy on hold, in a wait-and-see mode over the next year. UK nominal yields have already removed most of the no-deal risk, having repriced up by almost 30bps from their October lows, and are seen moving more in line with the global trend in nominal rates going forward.

There were major developments in the Brexit saga in the last two weeks of October. The United Kingdom and the European Union reached a new Withdrawal Agreement on 17 October but while the UK parliament accepted the agreement in principle, it refused to ratify it under a fast-track procedure. This obliged the British prime minister to request, and obtain, a new extension of the Brexit deadline until 31 January 2020. The UK parliament thereafter gave the go-ahead for an early general election on 12 December, while the government announced there would be no new attempt to seek approval of the Withdrawal Agreement before then.

The main consequence of these events is that the risk of no-deal Brexit, which was still high a few weeks ago, has declined sharply. While the outcome of UK general elections is always difficult to predict due to the country's electoral system, most scenarios do not suggest the United Kingdom will crash out of the EU.

Victory for the Conservative Party (currently clearly ahead in opinion polls) would probably be followed by the ratification of the withdrawal agreement. This is a fundamental change, because before a Brexit agreement acceptable to both the EU and the pro-Brexit wing of the Conservative Party was reached, the scenario of a Conservative election victory was generally seen as increasing the risk of no-deal Brexit.

Conversely, if the opposition parties win, the United Kingdom could be heading for a second referendum. At present, the outcome of a new referendum remains extremely uncertain, all the more so because we do not know exactly what question would be asked (one of the choices would probably be to remain in the EU, but there are several possibilities regarding the other choice or choices). Nonetheless, a referendum would create a possible path to the UK remaining in the EU.

The few remaining paths leading to no-deal Brexit seem highly unlikely. It would require a combination of events such as, for example, an election that fails to produce a majority government, the rejection by voters of alternatives to a Hard Brexit in a referendum, or a toughening of the position of Conservatives seeking to renegotiate the Withdrawal Agreement, poisoning relations with the European Union. But even if these situations do arise, all possible alternatives would have to be ruled out before a Hard Brexit actually happens.

Having said that, the ratification of the Withdrawal Agreement, which now seems the most likely scenario, will be far from settling Brexit once and for all. Under the Agreement, as of the official departure date, the United Kingdom will enter a transition phase under which it will retain most of its access to the Single European Market (though without participating in decision-making bodies). The country will have to negotiate a lasting framework for its relations with the EU during this transition period (due to last until the end of 2020, with the possibility of an extension to the end of 2021 or 2022). This will not be an easy task given that free-trade agreement negotiations generally last several years.

Further surges in Brexit-related stress cannot therefore be ruled out even in the event of an orderly Brexit. For example, the hardest pro-Brexit conservatives could attempt to prevent an extension to the transition period so they can be free to sign trade agreements with third countries (in principle, the UK and the EU must agree on such an extension before 1 July 2020). Therefore, in theory the United Kingdom could lose its access to the Single Market at the end of 2020, without having had time to negotiate a free-trade agreement with the EU (note that in any case, the pro-Brexit Conservatives could try to use this threat to speed up negotiations with the EU). The fact that such a scenario seems fairly unlikely (Europe has shown many times that it can find solutions and extend deadlines when necessary), does not necessarily rule out that it could be temporarily perceived as a credible risk.

However, overall, we consider that Brexit should cause fewer tensions in 2020 than in 2019. This is a positive development, primarily for the UK economy, which we expect to grow by 1.1% in 2020, though we believe that if the country indeed opts in the end for a permanent trade regime that severes its access to the Single European Market, itspotential growth will be negatively affected. The decline in the no-deal ris is also positive – albeit to a lesser extent – for the euro zone economy, where the negative effects of Brexit on industrial confidence and foreign trade (in particular in Germany) have been visible in 2019.

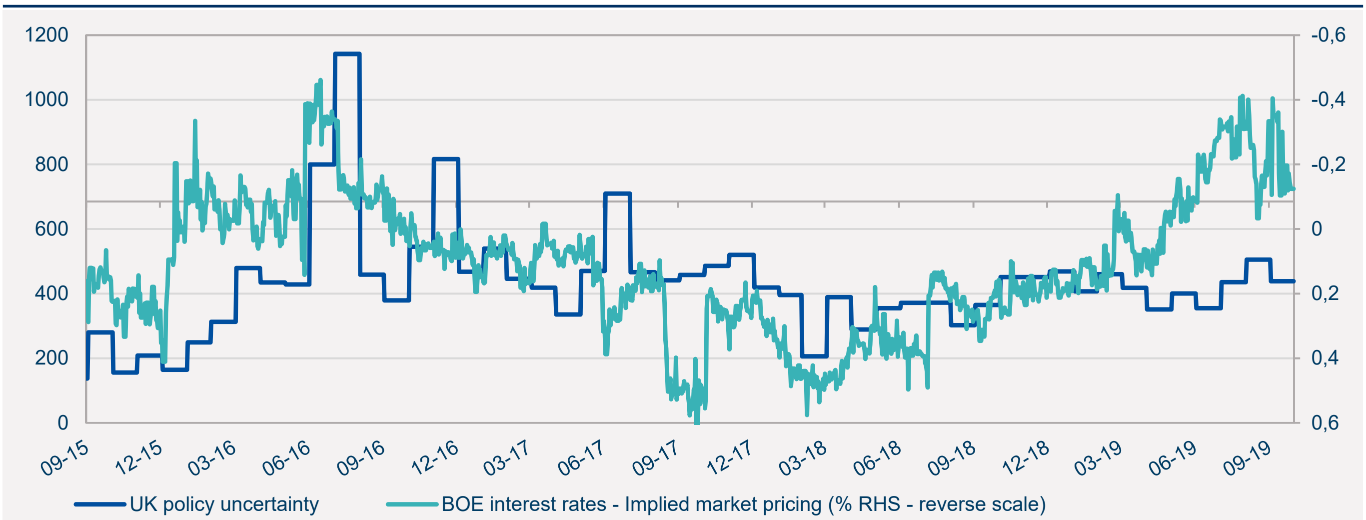
Perspective on the Bank of England

Since the Brexit referendum on 23 June 2016, the Bank of England (BoE) has travelled a difficult path. The central bank has been calibrating its monetary policy, while seeking to strike a balance between inflation's being pushed high by the prolonged depreciation of the pound, and the weakening in economic activity, resulting from the uncertainty due to the UK's negotiation with the EU on the features of the withdrawal agreement.

Monetary policy resulted in a 25bps cut to interest rates in the aftermath of the referendum (August 2016), in order to sustain the economy, given the expectation of a strong weakening path ahead, followed by two rate increases (of 25bps each) in November 2017 and August 2018. The two rate hikes were predicated upon inflation's being consistently above target and an economy that has proved more resilient than projected in the central bank's forecasts. Despite the constant and very elevated level of political noise, the BoE's forward guidance has always been centred around its willingness to tighten monetary policy to a limited and gradual extent in the event of a smooth Brexit. However, with the global slowdown started to unfold in the second half of 2018, becoming since then a serious market concern, major central banks have tilted their stance to more dovish, and the BoE has conditioned its forward guidance not only on an orderly exit from the EU but also to seeing some recovery in global growth.

Currently, amid yet some uncertainty, the probability of a hard Brexit has receded materially (from 40% at its peak, to currently around 5%, as priced by the bookmaker Betfair) since the UK and the EU produced a shared draft of the withdrawal agreement at the European Council meeting during the week of 17 October. A deal is now looking like the most probable outcome, given the clear willingness of the Conservative party to promote its approval by the UK Parliament.

1/ UK policy uncertainty and BOE implied interest rates change



Source: Bloomberg, Baker, Bloom and Davis, Amundi Research. Data as of 28/10/2019

In our view therefore, the three-month extension period to Article 50 will be conducive to a deal but will not offer the BoE significant space to normalize interest rates. The likeliest attitude, in our reading, would be for the central bank to keep rates on hold, unless the global picture deteriorates further, creating the conditions for a cut, rather than a hike. There are two major factors supporting an "on hold" stance. One is one more domestic, represented by the Brexit cliff uncertainty at the end of the transition period, as trade deals usually take years to be discussed and ratified. The other is more global and has to do with the profound changes that took place in monetary policies over the last quarters, now clearly tilted towards a synchronized easing stance.

Bank of England Chatterbox - Recent Policy Comments and Decisions

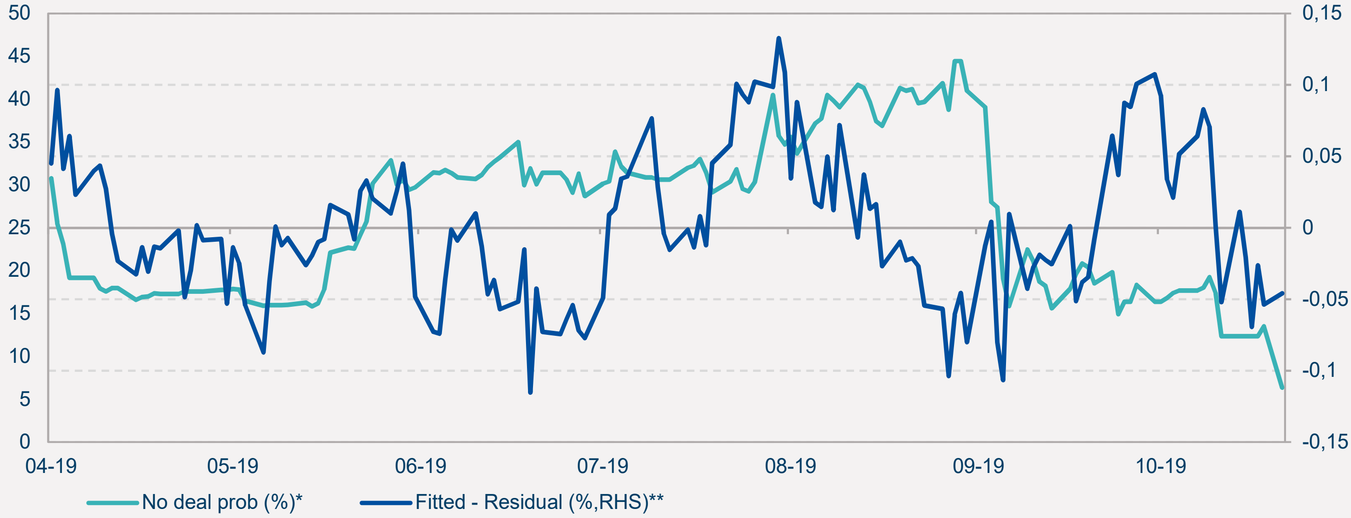
Date	Speaker	Key Quote(s)	Venue
18 October	**Mark Carney Governor**	"If this is adopted (i.e., Brexit deal) it would remove much of that uncertainty, we would expect a rebound in some of that investment."	Interview with Bloomberg TV
16 October	**Mark Carney Governor**	"We don't see negative interest rates as being part of the toolkit at the Bank of England."	Speech at Harvard
15 October	**Gertjan Vlieghe, MPC member**	"A near-term Brexit deal that reduces uncertainty and gives businesses adequate time to prepare for any future changes in the UK-EU trading relationship might yet stimulate investment sufficiently to prevent the need for easier monetary policy, and put gradual and limited rate hikes back on the agenda, eventually. A scenario of entrenched Brexit uncertainty is likely to keep economic growth below potential, and require some monetary stimulus. Finally, a "no deal" Brexit is more likely to require monetary stimulus than tightening, but given that supply, demand and the exchange rate are likely to experience significant declines, the direction for interest rates is not automatic."	Speech in London
14 October	**Jon Cunliffe, Deputy Governor**	"Low for long makes demand management of the economy more difficult in downturns, reducing the space for monetary policy easing with conventional tools."	Speech in London
13 October	**David Ramsden, Deputy Governor**	"I see less of a case for a more accommodative monetary position."	Interview with the *Daily Telegraph*
27 September	**Michael Saunders, MPC member**	"If the U.K. avoids a no-deal Brexit, monetary policy also could go either way and I think it is quite plausible that the next move in bank rate would be down rather than up."	Speech in Barnsley

UK rates

On the back of the recent encouraging developments in Brexit negotiations, and to some extent also driven by a broader global trend in bond markets, UK nominal rates moved rapidly higher over the second and third week of October. Relative to early October lows, 10-yr paper moved higher, going from the 40bps area to the 65/75 bps range at the time of writing. No doubt, the fall of the no-deal Brexit scenario to very low or even marginal levels of probability played quite a role in this move. The markets' implied probabilities of an easier stance by BoE rapidly changed as well, as they moved closer to a more neutral attitude, while more than one 25bp cut was discounted at the peak of uncertainty in the aftermath of the latest developments.

In light of global monetary policy prospects and because of political uncertainties persisting in the short-term, we expect the UK 10Y yield to have limited space to move further up. According to the result of regressions run on Gilts using US Treasuries, markets' expectations on BoE monetary policy and the probability of "no deal", the UK 10Y looks fairly priced. Space for some overshooting to the upside is there, mainly on the back of technical factors, in case of a deal sooner than expected but this move may prove to be temporary in our view. In a nutshell, we tend to assess current market yield levels as already discounting most of the recent evolution in Brexit scenarios and forecast therefore: UK 2Y @ 0.30/0.50 and UK 10Y @ 0.60/0.80 in 12 months.

2/ UK 10Y fitted vs No deal probability



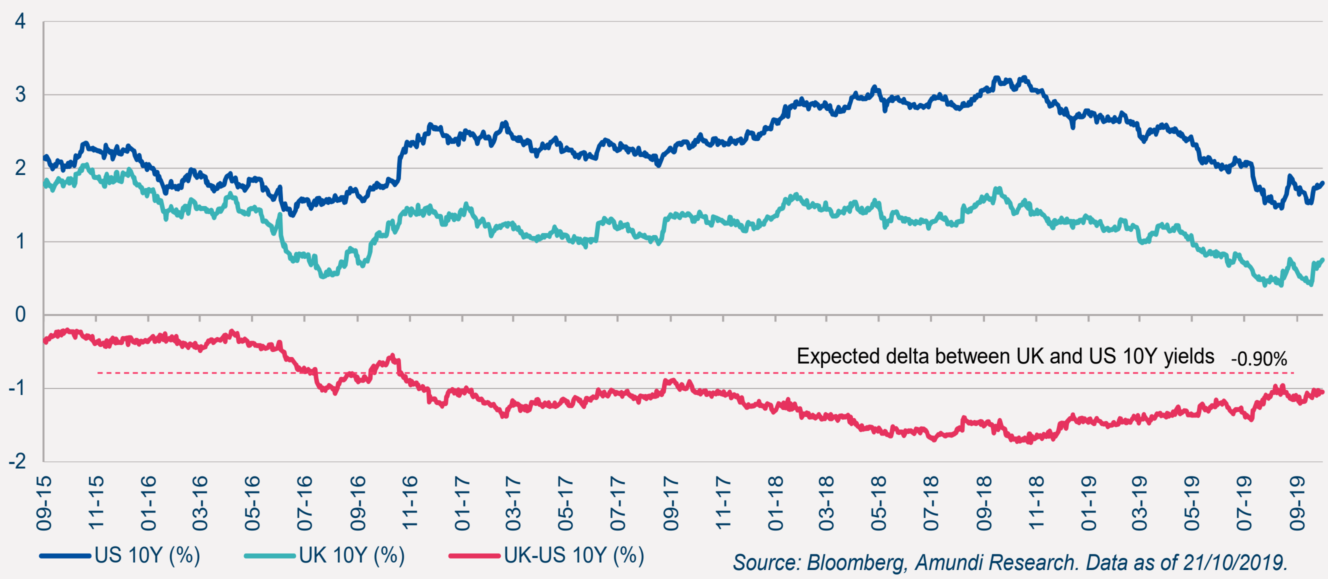
* According to Betfair

Source: Bloomberg, Amundi Research - Data as of 21/10/2019

** UK 10Y function of US 10Y, BOE 1Y implied interest rate, Probability of no deal Brexit by 31st of October 2019

In the current state of the art, the probability of a no-deal Brexit is very low but cannot be ruled out completely. Were this tail event to materialize, we would see the BoE embarking on rate cuts, which could ultimately bring interest rates down to 0% (from the current 0.75%). Nominal rates would rally, as a result of investors' seeking safe haven assets, although the extent of the fall in the UK 10Y yield would be conditional to the size of the fiscal package, delivery of which could be expected in order to limit the damage to the economy. In a no-deal scenario, we would forecast: UK 2Y @ 0/0.20 and UK 10Y @ 0.10/0.30 in 12 months.

3/ UK vs US 10Y



Source: Bloomberg, Amundi Research. Data as of 21/10/2019.

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