

A thin and last-minute Brexit deal should give temporary relief to UK assets



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- **The deal:** the core of the deal is a zero-tariff/zero-quota free trade agreement for goods, but trade will be affected by new non-tariff barriers such as customs checks and compliance procedures. The deal is lighter concerning trade in services, and in most services sectors providers will need to seek approval on a case-by-case basis with national authorities.
- **Political implications:** the British Prime Minister has fulfilled his promise of getting Brexit done, but the Covid-19 emergency is limiting his opportunities to reshape the British economy, notably by hindering any major investment plans. When it comes to the EU, the essential goals of the Brexit negotiation were met. EU countries showed that they were capable of maintaining a united front and any breaches in the integrity of the EU single market were avoided. With the Brexit 'no-deal' risk now out of the way, the EU will be able to focus on new projects in 2021.
- **UK economic outlook:** Brexit will add to the weakness caused by tighter Covid-19-related restrictions, but we still expect a technical recovery if and when progress in the vaccination campaign allows for restrictions to be eased.
- **Investment implications:** as we believed that it was in the interests of both parties to find an agreement – even if at the very last minute – we became positive on UK equities in early December and we retain this positive stance as we believe that UK equities remain undervalued compared with the rest of Europe. We have a neutral view on UK fixed income markets and GBP. In our view, the best opportunities are in UK domestic stocks, with a focus on reflation exposure stocks such as banks, house-builders, leisure/domestic consumption stocks and selected non-disrupted retailers such as discount retailers. EU equities also appear attractive, but their appeal is more driven by the economic recovery, while the Brexit outcome was already priced in and does not provide any additional support.



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“This new trade regime eliminates the risk of a major trade shock at the beginning of 2021, but is nonetheless underwhelming when considering in mid-2019 there was still some hope of retaining a much closer relationship.”

What are the key features of this very last-minute Brexit deal?

As widely expected, the core of the deal is a zero-tariff/zero-quota free trade agreement for goods. This means that EU-UK trade will be much less affected than if the UK had 'crashed out' without a deal, to be governed solely by the WTO regime. However, trade will not be as fluid as it was before: new non-tariff barriers have appeared in the form of customs checks and compliance procedures as the United Kingdom has left the EU customs union and single market. Some of these new procedures will be phased in gradually. Another important aspect of the deal is that each side will have the chance to protect its market if it finds itself undercut by looser regulation on the other side (this was a difficult part of the 'level-playing field' issue, which was only resolved at the very end of the negotiations). Regarding the Irish border, the United Kingdom has confirmed that it will implement the 2019 agreement whereby customs checks will be across the Irish Sea. However, the deal is much lighter when it comes to trade in services, even though there is room for amendments at a later date. Airlines and hauliers will continue to operate across the Channel but, in most services sectors, providers will need to seek approval on a case-by-case basis with national authorities. Importantly for financial services – which have been negotiated separately from the main trade deal – UK providers have lost their passporting rights in the EU. The EU has granted temporary 'equivalence' only for a very limited number of financial activities (for example, for derivatives clearing houses for 18 months). However, negotiations in this field will continue. All in all, **this new trade regime eliminates the risk of a major trade shock at the beginning of 2021, but is nonetheless underwhelming when considering in mid-2019 there was still some hope of retaining a much closer relationship, for instance, with the United Kingdom retaining its access to the EU single market and/or remaining in the EU customs union.**

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What are the political implications of this outcome, both at the UK and European level?

Leaders from both sides can claim the deal as a success. There is a lot of relief in the United Kingdom, where there was much ‘Brexit fatigue’ and where Brexit has been a bigger theme than in the EU. The British Prime Minister has fulfilled his promise of getting Brexit done. However, to what extent he can use the rest of his mandate to reshape the British economy – notably through major investment plans – will hinge on the speed at which the Covid-19 emergency dissipates. Moreover, the implementation of the Brexit deal – some details of which may leave room for interpretation – may generate new disputes with the EU. The United Kingdom will also have major work to do to build new links with third countries, replacing those that it had as an EU member. Finally, there is the possibility – although not the certainty – that Brexit will increase the Scottish pro-independence sentiment and thus threaten the integrity of the United Kingdom. In this respect, the May 2021 Scottish parliament election will need to be watched closely. When it comes to the EU, the essential goals of the Brexit negotiations were met. EU countries showed that they were capable of maintaining a united front, something that could not be taken for granted initially. In addition, key aspects of the deal – notably, the ‘level-playing field’ provisions, as well as the Irish border arrangement – have avoided breaches in the integrity of the EU single market. Just as importantly, the EU has escaped the ‘moral hazard’ situation where the United Kingdom would appear to obtain better conditions outside than inside, which could have encouraged would-be exiters in other countries. With the Brexit ‘no-deal’ risk now out of the way, the EU will be able to focus on new projects in 2021, notably the Recovery Fund and new plans for the Banking Union and Capital Market Union, among others. Brexit reduces the overall weight of non-euro EU members that have lost their main representative, as well as reducing the weight of the ‘pro free-market’ camp. This may have implications on the appetite for and direction of future EU integration projects and regulatory developments.

This outcome comes at a time when the United Kingdom is facing the challenge of the new virus variant, which has put England into emergency lockdown. How is this affecting the outlook for the UK economy?

According to a BoE estimate, new trade frictions despite the deal could cost the UK economy 1% of GDP in Q1. Such a drag would be visible under normal circumstances, yet probably not so much against the current backdrop, where the Covid-19 situation is generating enormous GDP volatility. Thus, as Brexit only adds to the weakness caused by tighter Covid-19-related restrictions at the beginning of this year, it should not prevent a technical recovery, at least, if and when progress in the vaccination campaign allows for restrictions to be eased. Longer term, the looser trade relationship with the EU – with frictions for trade in goods and the lack of access for many services – should, all else being equal, come at a significant cost to the UK’s potential growth. Much will also depend on other UK policy choices, notably on how the country wants to reshape its economy after closing its EU chapter.

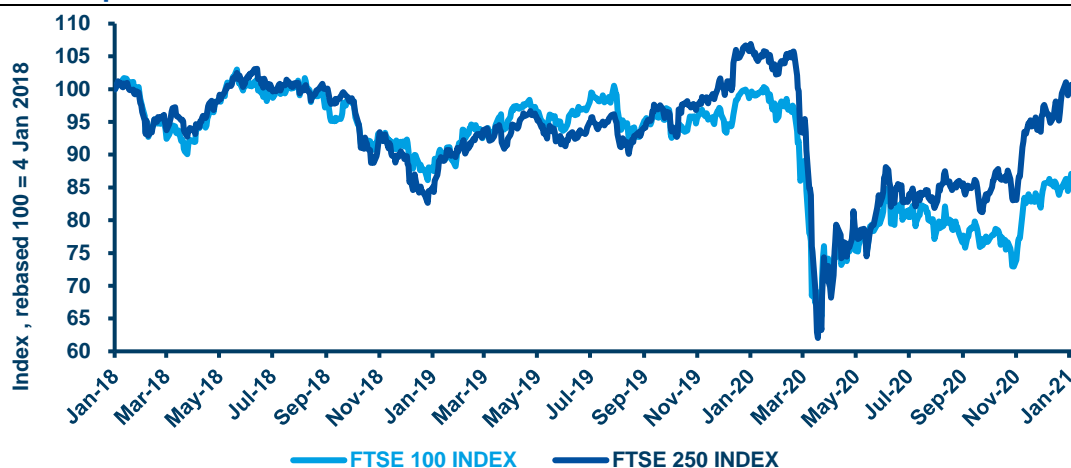
In 2020, the UK equity market has underperformed other European equity markets. What is your view for 2021? Where do you see opportunities in this market?

Brexit has been a significant ‘binary overhang’ for equity investors looking at UK equities since the 2016 vote. In our view, it is not wise to position only for one outcome and investors should test their investment cases on a range of outcomes. What has happened now is that the ‘tail risk’ of a no-deal hard Brexit has gone, which is very positive even if it was the most expected outcome. However, we still have Brexit uncertainties, for example, in relation to services, although the terms of trade on goods are clearer. In any case, we at least have a clear framework now. Therefore the agreement is positive overall as it gives certainty and removes the tail risk. But investors should be mindful that the UK economy will still take a hit from this. UK equities look undervalued and undervalued. Getting Brexit done also means a stronger GBP, which is bad for large-cap UK stocks that have a majority of sales overseas. While we like a few of the large-cap UK names in healthcare and consumer stocks (for other reasons), the real opportunity lies in UK domestic stocks. **They have been rallying for some time now, but we**

“The agreement is positive overall as it gives certainty and removes the tail risk. In UK equities our preference remains for domestic stocks.”

continue to like them, albeit we take a strongly selective approach. We see opportunities within reflation exposure stocks such as banks, house-builders, leisure/domestic consumption stocks and one or two selected non-disrupted retailers such as discount retailers. EU equities also look attractive, but these are more driven by the economic recovery in Europe, which is being accelerated by stimulus and vaccine hopes. Brexit being over does not materially change our view on European equities, as it had already been largely discounted.

The outperformance of ‘domestic’ stocks could continue in 2021



Source: Amundi, Bloomberg. Data as of 4 January 2021. The FTSE 100 Index is a capitalisation-weighted index of the 100 most highly capitalised companies traded on the London Stock Exchange. The FTSE 250 is a capitalisation-weighted index of the 250 most highly capitalised companies, outside of the FTSE 100, traded on the London Stock Exchange.

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From a multi-asset perspective, how does the Brexit outcome and the UK economic outlook affect the view on UK asset classes and the GBP?

From a multi-asset perspective, we became positive on UK equities in early December to benefit from and capture the ‘Brexit’ discount that was embedded in the UK market. Our decision was based on the view that it was in the interests of both sides to agree a deal, but that political posturing meant that there was a strong incentive for both sides not to yield (or be seen to be conceding) until the very last moment. We expected a ‘skinny’ or limited deal and that was what was delivered. Over the past few months, UK equities have decoupled from macro fundamentals because of Brexit concerns, leaving the UK market undervalued compared with the Europe ex-UK index. Earnings revisions relative to global markets are incrementally improving, but the performance of the UK equity market has not yet reflected this. On the FX side, we are neutral on GBP and note that the positive Brexit news could spur some short-term GBP strength. Likewise on GBP fixed income, we have no strong view and are maintaining a neutral approach.

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Definitions

- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **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.

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Date of First Use: **5 January 2021**.

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