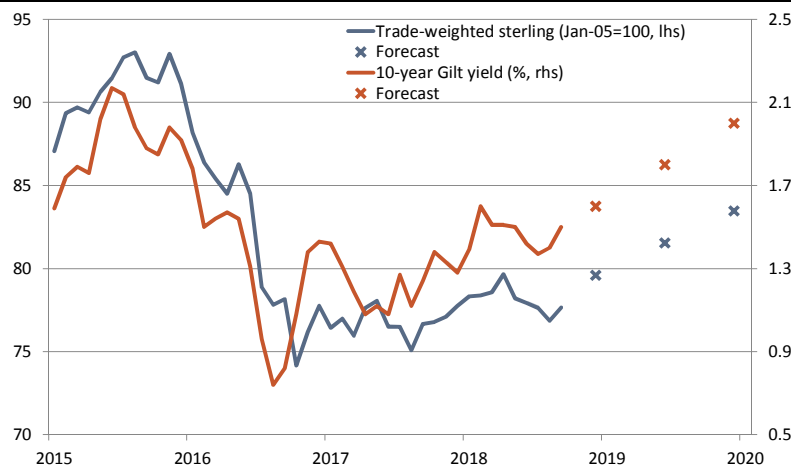


12 October 2018

Brexit: breakthrough ahead?

Brexit: sterling and gilts still price in more downside than upside risk



Monthly data. Source: Bank of England, Berenberg forecasts.

- Close to a Brexit deal:** Ahead of the EU summit on 17-18 October, the *FT* reports that UK Prime Minister Theresa May is ready to soften the UK position to such an extent that a Brexit deal could be struck with the EU27 shortly. To make sure that the Irish border will remain open under all circumstances, May is reportedly ready to accept two key EU demands: first, the entire UK would remain in the EU customs union indefinitely if no other solution could be agreed before the end of the transition period in December 2020; second, Northern Ireland will de facto remain part of the EU single market for goods by staying in “regulatory alignment” with the EU, implying a need for some border controls for goods moving between Northern Ireland and the UK mainland.
- Serious political trouble ahead:** Both aspects of such a “backstop” guarantee to maintain an open border in Ireland under all circumstances are highly controversial in the UK. The Northern Irish DUP (Democratic Unionist Party), whom May’s Conservatives need for a working majority in parliament, threatens to bring down the government if May accepts a deal that would involve a border down the Irish Sea if the backstop is ever activated. In addition, at least another 20 hardline Brexiters among the Conservatives in parliament look likely to vote against any deal that could potentially keep the UK in a customs union with the EU indefinitely. If May indeed strikes such a deal with the EU27, she would thus need support from moderates in opposition parties to get it ratified in parliament.
- Towards a semi-soft Brexit:** We have long seen a 60% probability that May will sign a semi-soft Brexit deal with the EU27 and that the UK parliament will ratify it. Assuming the reports are accurate, the chance of a deal to minimise frictions in the flow of goods between the UK and the EU27 may now be rising beyond 60%.
- Walking a tightrope:** May’s problems would not end if she gets a Brexit deal through parliament with some help from the opposition. Factions of her government, the Conservative Brexiters and/or the DUP, may not back her and her government on other issues afterwards, if she overrules them on Brexit.
- The likely timeline:** With luck, the UK and the EU27 may settle the key controversial issues ahead of the 17 October EU summit. But if the UK needs more time for its internal debate – or if some details still need to be hammered out – the envisaged special EU Brexit summit on 17-18 November would still be the most likely date to formally conclude the deal. If May thinks she has enough support, she could try to push the agreement through parliament fast. If she succeeds, we should be able to scrap our longstanding call of a 20% risk of a no-deal hard Brexit by late November if the UK passes the deal; however, a risk remains that this could slip to December or even early January.
- Economic and market impact of a deal:** In our view, gilts, sterling and domestic-oriented UK stocks are pricing in more downside than upside risk. If the UK avoids a hard Brexit, markets will price out this tail risk. On this basis, we expect real GDP growth to accelerate from around 1.3% in 2018 to 1.7% in 2019 and 2020 and the BoE to step up the pace of rate hikes to two per year (versus one per year in 2017 and 2018). If and when the UK and EU strike a deal and the UK parliament then approves it, expect benchmark UK assets to gradually realign with economic fundamentals over the course of 2019. We look for gilt yields to edge up towards 2.0%, along with a rise of 5-10% for trade-weighted sterling – reversing part of the drop following the Brexit vote in June 2016.

Disclaimer

This document was compiled by the above mentioned authors of the economics department of Joh. Berenberg, Gossler & Co. KG (hereinafter referred to as “the Bank”). The Bank has made any effort to carefully research and process all information. The information has been obtained from sources which we believe to be reliable such as, for example, Thomson Reuters, Bloomberg and the relevant specialised press. However, we do not assume liability for the correctness and completeness of all information given. The provided information has not been checked by a third party, especially an independent auditing firm. We explicitly point to the stated date of preparation. The information given can become incorrect due to passage of time and/or as a result of legal, political, economic or other changes. We do not assume responsibility to indicate such changes and/or to publish an updated document. The forecasts contained in this document or other statements on rates of return, capital gains or other accession are the personal opinion of the author and we do not assume liability for the realisation of these.

This document is only for information purposes. It does not constitute investment advice or recommendation to buy financial instruments. It does not replace consulting regarding legal, tax or financial matters.

Remarks regarding foreign investors

The preparation of this document is subject to regulation by German law. The distribution of this document in other jurisdictions may be restricted by law, and persons, into whose possession this document comes, should inform themselves about, and observe, any such restrictions.

United Kingdom

This document is meant exclusively for institutional investors and market professionals, but not for private customers. It is not for distribution to or the use of private investors or private customers.

United States of America

This document has been prepared exclusively by Joh. Berenberg, Gossler & Co. KG. Although Berenberg Capital Markets LLC, an affiliate of the Bank and registered US broker-dealer, distributes this document to certain customers, Berenberg Capital Markets LLC does not provide input into its contents, nor does this document constitute research of Berenberg Capital Markets LLC. In addition, this document is meant exclusively for institutional investors and market professionals, but not for private customers. It is not for distribution to or the use of private investors or private customers.

This document is classified as objective for the purposes of FINRA rules. Please contact Berenberg Capital Markets LLC (+1 646 949 9000), if you require additional information.

Copyright

The Bank reserves all the rights in this document. No part of the document or its content may be rewritten, copied, photocopied or duplicated in any form by any means or redistributed without the Bank’s prior written consent.

© 2018 Joh. Berenberg, Gossler & Co. KG



BERENBERG CAPITAL MARKETS LLC

Member FINRA & SIPC

Internet www.berenberg-us.com

E-mail: firstname.lastname@berenberg-us.com

EQUITY RESEARCH

GENERAL MID CAP - US
Samuel England +1 646 949 9035

HEALTHCARE

MED. TECH/SERVICES
Ravi Misra +1 646 949 9028

SPECIALTY PHARMACEUTICALS
Patrick R. Trucchio +1 646 949 9027

CAPITAL GOODS

Andrew Buscaglia +1 646 949 9040

LEISURE

Brennan Matthews +1 646 949 9024

INDUSTRIAL MATERIALS

Paretoosh Misra +1 646 949 9031

REAL ESTATE

Nate Crossett +1 646 949 9030

SHIPPING & TRANSPORTATION

Donald McLee +1 646 949 9026

SOFTWARE & IT SERVICES

Alexander Frankiewicz +1 646 949 9029
Gal Munda +1 646 949 9021

EQUITY SALES

SALES
Albert Aguiar +1 646 949 9218
Enrico DeMatt +1 646 949 9230
Nate Emerton +1 617 292 82 11
Kelleigh Faldi +1 617 292 8288
Ted Franchetti +1 646 949 9231
Shawna Giust +1 646 949 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 949 9202
Michael Kaye +1 646 949 9216
Jessica London +1 646 949 9203
Anthony Masucci +1 646 949 9217
Ryan McDonnell +1 646 949 9214
Emily Mouret +1 415 802 2525
Peter Nichols +1 646 949 9201
Kieran O'Sullivan +1 617 292 8292
Rodrigo Ortigao +1 646 949 9205

CORPORATE ACCESS

Adriane Klein +1 617 292 8202
Olivia Lee +1 646 949 9207
Robert Meyers +1 646 949 9215
Panthea O'Connell +1 646 949 9208

CRM

LaJada Gonzales +1 646 949 9213
Monika Kwok +1 646 949 9212
Stephanie Rieben +1 646 949 9240

EVENTS

Laura Hawes +1 646 949 9209

ECONOMICS

Mickey Levy +1 646 949 9099
Roiana Reid +1 646 949 9098

SALES TRADING

Ronald Cestra +1 646 949 9104
Mark Corcoran +1 646 949 9105
Michael Haughey +1 646 949 9106
Christopher Kanian +1 646 949 9103
Lars Schwartz +1 646 949 9101
Bob Spillane +1 646 949 9102