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Hermes Investment Office

Ahead of the curve

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Brexit - has the fog lifted?...

- **Explanation of the Brexit process & The Supreme Court ruling have made the UK's departure date & destination clearer. But, the largest uncertainty now is probably the length of the journey ahead.**
- **Our negotiations could stretch well beyond the two years assumed by Article 50. Maintaining access to, rather than full membership of, the customs union looks nearest to Canada's model. But, this took seven years, & ours may have to be even more ambitious.**
- **As we open the exit 'trapdoor' in a highly-charged political year, EU law will forbid our committing trade-deal 'bigamy', in terms of enacting quick agreements elsewhere, such as with the US.**
- **Which leaves the BoE watchful of the pound. Our simulations show further pound weakness &/or oil strength would lift CPI inflation to 3%yoy. But, we'd still expect the Bank to 'turn a blind eye'.**
- **Politically, we could be choosing one of the worst times to negotiate an exit, & may have to compromise if we want to keep tariff-free trade. So, any tie-ups in future - with Europe or elsewhere - will probably come 'with strings'. A bit like EU membership then!...**

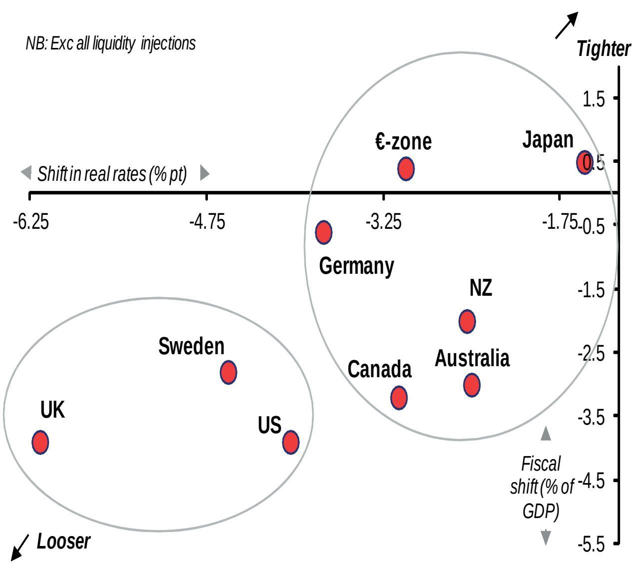
Buckling up for a long journey...

"It is not partial membership of the EU, associate membership or anything that leaves us half in, half out". "We do not seek to hold on to bits of membership as we leave". (PM Theresa May, 17 January 2017). There are *"limits to the extent to which above-target inflation can be tolerated" (BoE governor Carney, 16 January).*

Theresa May's explanation of the Brexit process and The Supreme Court ruling lift much - but not all - of the uncertainty facing investors. They confirm that after nine months in the 'departure lounge', Article 50 should be triggered in late March to start negotiating the exit she craves. Prior approval by Westminster and fall-out from N. Ireland's election risk delay. But, the destination is clearer, with her broadly looking to give up Single Market *membership* and European Court of Justice adherence as *quid pro quos* for regaining immigration control.

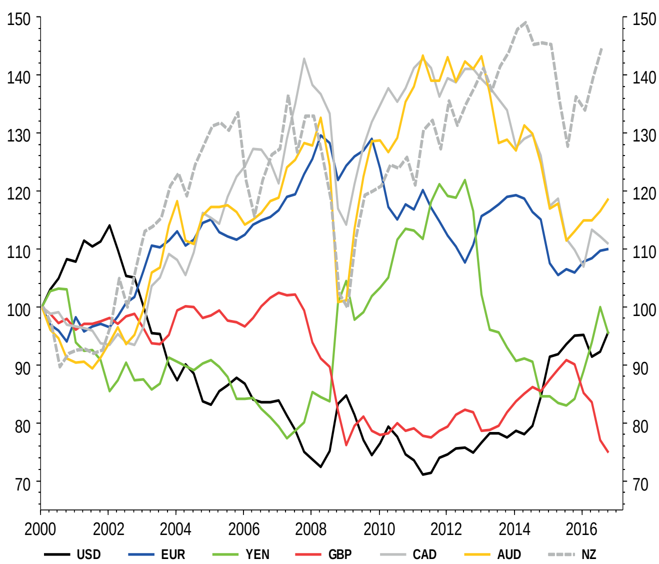
Officially, no other countries' *membership* models will be sought, which seems to rule out Norway and Switzerland's associate memberships. **Yet, her desire to maintain without penalty a *"positive and constructive partnership"* and *"pursue a bold and ambitious***

Chart 1. No major economy has loosened policy more than the UK...
Shifts since 2000 in real rates (using CPI, 3m Libor), & cyc adj budget balances



Source: Hermes Investment Mgmt, based on OECD projections, IMF, & Bloomberg

Chart 2. ...Which helps explain the pound's relative weakness
Trade-weighted exchange rates, re-based to Q1 2000 (= 100). Quarterly data



Source: Thomson Reuters Datastream

***free trade agreement"* with an EU that needs *"overwhelmingly"* to succeed, suggests she will negotiate to maintain access to - but no longer full membership of - the tariff-free customs union.** With the former no longer requiring EU membership, this may prove a helpful compromise for Westminster to endorse triggering Article 50.

Securing access could be the 'best of both worlds'. Turkey and Canada have similarly enjoyed customs-union access with the EU without membership. Turkey's in 1995 was aimed at aligning it to EU law, already adhered to of course by the UK. But, Canada's in 2016 came after seven years of negotiation. And, needing sign-off by all EU states, it was stalled by Wallonia! Chancellor Hammond's threat that without access, much lower UK corporate tax rates will be needed to maintain FDI and competitiveness (which risks a European 'chase to the bottom') looks an early stick to achieving similar privileges.

Maintaining access to the customs union could be achieving the best of both worlds

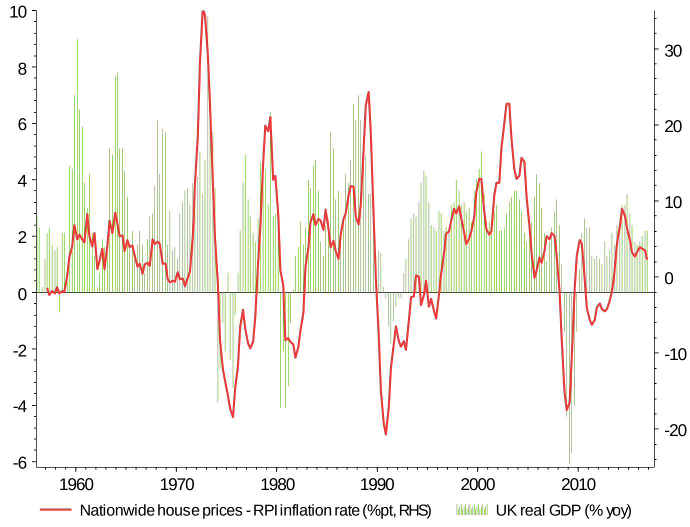
Even this will need time, given Angela Merkel's early shot that Britain should not be allowed *"cherry picking"*. **So, while our departure date and destination may now be clearer, the largest remaining uncertainty is probably the length of the journey ahead.** During this time, the pound will remain the 'barometer of progress' - vulnerable to outcomes deemed outside the UK's interests, and perceptions we're having to pull up the drawbridge on our main trading partner.

The negotiations could stretch well beyond the two years assumed by Article 50. First, the deal when struck will need Parliamentary approval, after input from devolved governments in N. Ireland, Scotland, and Wales. It will then be subject to a 'phasing in' period (Mr Hammond has suggested two years) to allow firms, consumers and officials to adjust to the new arrangements. This later involvement of the devolved governments may have appeased the Supreme Court, whose ruling precludes the need for them to vote to trigger Article 50.

But, a second independence referendum in pro-EU Scotland, though not precluding Brexit, could provide an extra hurdle to completing it before the General Election scheduled for May 2020.

Chart 4: UK GDP growth & real house-price shifts

Real GDP growth, & nominal house-price growth deflated by RPI inflation. Both % yoy



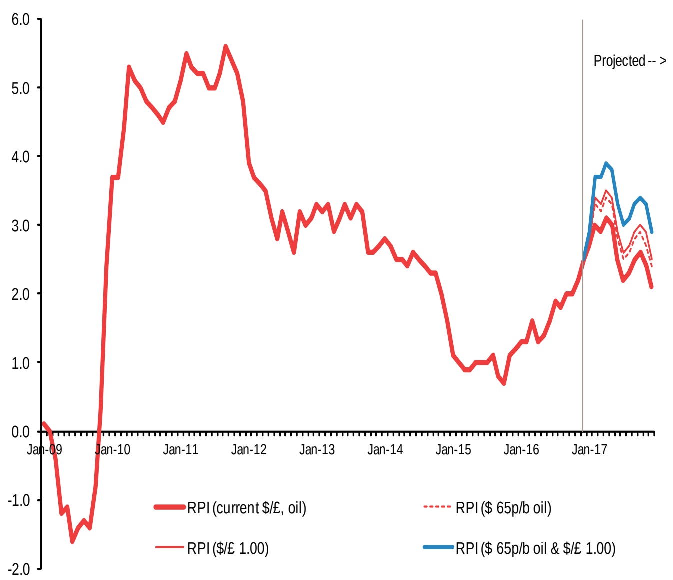
Source: Hermes Investment Management, based on ONS, & Nationwide data

Second, the UK is relying on a cooperative sign-off by its 27 EU peers. The only real precedent we have is Greenland's exit' in 1985. This was a 'soft' exit, but it took three years with negotiation centred on just one main issue: fishing rights. We, larger and 44 years entwined in the EU, will need longer. Unless, of course, EU leaders perceive the potential spillover to be so strong that it brings forward an early 'suits-everyone, no strings' compromise deal. **The risk to this 'grown up' approach, though, is having delivered exit-risk onto the doorsteps of other EU governments, themselves vulnerable to rising anti-establishment feeling, the UK receives little sympathy from them.**

We're opening the 'trapdoor' in a highly-charged political year ***(chart 7)***. Voters facing 2017 national elections in Germany, France, The

Chart 3. Possible RPI-impact if Brexit further weakens the pound

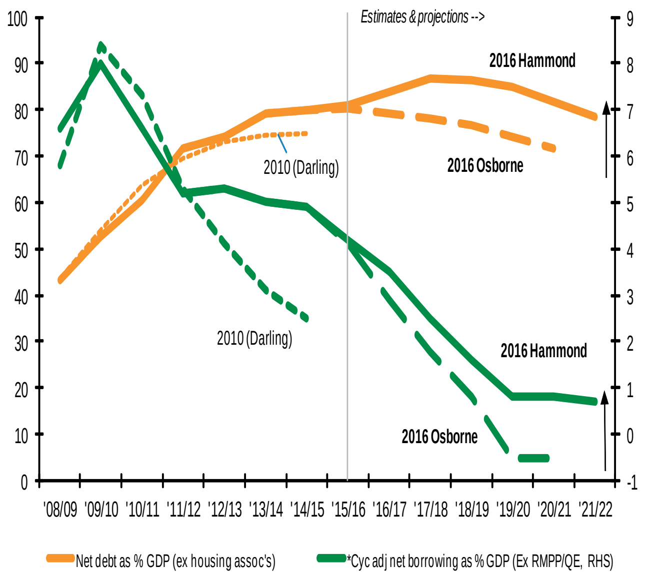
Simulations based on possible $/£ & oil scenarios. Assumes no further rate changes



Source: Hermes Investment Management simulations, based on ONS data

Chart 5: Fiscal slippage will not be halted by Brexit savings

Compares Chancellors' planned fiscal paths *adjusting for special factors. Fiscal years



Source: OBR Mar 2016 Budget & Nov 2016 Autumn Statement, 2010 Budget, & *Hermes

Netherlands and probably Italy may want to approach it as a protest to elevated unemployment, and six years of euro-zone austerity. And in the 'peripheral' economies, reform fatigue and populist parties are building. Incumbents may be thus be reluctant to condone an easy UK exit that puts its economy ahead of their own. **And with large members like Germany and France far down the EU 'path', the threat of exit probably applies more to the newer entrants, like Croatia and central/eastern Europe whose EU pedigree is less engrained.** Hopefully, Russia's shadow will help hold their EU 'glue' together.

Governor Carney's 'blind eye' would be akin to King's when the CPI breached 5%

Third, EU law forbids trade-deal 'bigamy', in terms of enacting agreements elsewhere while still an EU member. This prevents quick compensating tie-ups with say the US and The Commonwealth. **So, a challenge is to remain close to the European negotiating table to maintain the best trade and regulatory deals for services.** This makes it more ambitious than a Canada-style deal. Services represent 80% of the UK's gross value added, compared with 50-60% in Germany and France, and have been the heartbeat of the recovery. Only a minority of EU trade deals explicitly apply to services, but those that do require shared regulations and labour movement.

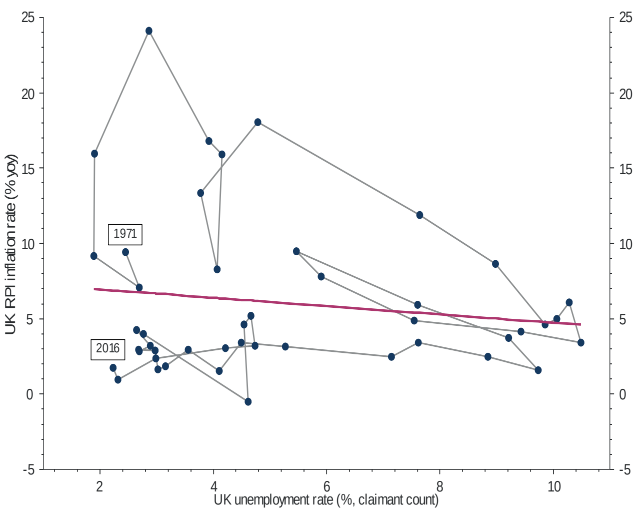
Which leaves the BoE watchful that a weaker pound doesn't pump inflation, especially with the main activity data having held up since June's referendum. But UK growth could still almost halve in 2017 toward 1%yoy as uncertainty on capex plans builds, real wage growth stutters as inflation pushes up, and global markets start to smell beggar-thy-neighbour policies emerging in the US and Europe.

Should protectionist forces build, which seems likely, inflation will reappear. But, it will be the 'wrong sort' – cost-push, led by tariffs, goods and labour shortages, rather than 'feel-good' demand-pull. Central banks will thus 'turn a blind' eye as economies stagflate. **This portends more to the inflation rises of the early 1980s and 1990s UK recessions, than the overheating of the late 1980s and 2007. In which case, the inflationary flame may snuff itself out without BoE action.**

Our simulations in ***chart 3*** show at current USD/GBP and oil prices RPI inflation this April lifting to +3%yoy, from January's +2½%yoy. But,

Chart 6: The UK's Phillips Curve has been relatively flat

Shows the long-run trade-off between UK unemployment & RPI inflation shifts



Source: Thomson Reuters Datastream, based on ONS data

Chart 7. The EU's highly-charged political year

Key scheduled & expected political events in 2017

22 Jan '17	France - 1st round of Socialist primaries - Hamon/Valls win
29 Jan	France - 2nd round of Socialist primaries - Hamon wins
12 Feb	Germany - Presidential election
2 Mar	N. Ireland - Snap General election
15 Mar	**Netherlands - General election**
25 Mar	**60th Anniversary of Treaty of Rome**
26 Mar	Germany - regional election in Saarland
Mar/Apr	**UK triggers Article 50**
Apr/May	UK council elections
Apr	Hungary - Parliamentary elections
23 Apr	**France - 1st round of Presidential election**
7 May	**France - 2nd round of Presidential election**
7 May	Germany - regional election in Schleswig-Holstein
14 May	Germany - state election in North-Rhine Westphalia
June	France - Election of Lower House **Italy - likely General election**
Sept/Oct	**Germany - Federal election**
Oct	Czech Republic - Legislative/general election Luxembourg - Legislative/general election

Source: Hermes Investment Management

combinations of a weaker pound and/or higher oil could feasibly take the RPI to +4%yoy. This would be a five-and-a-half year high. **In each case, the CPI (not shown) breaches its +2%yoy target in April. Further GBP weakness and/or oil strength would push it up to +3%yoy. But, should that occur, we still doubt the MPC would react to it, given the feared hit to growth and the housing market *(chart 4)*.**

Governor Carney's worry seems to be the *"extent to which"* it breaches target, rather than the breaching itself. This would be akin to the 'blind eye' governor King turned in 2011 when the CPI climbed to +5.2%yoy as the pound weakened and energy/food prices rose. The likelihood now that real wage growth slows amid still rising labour participation rates should keep the Phillips Curve relatively flat ***(chart 6)***.

Helpfully for growth, though, the Treasury no longer aims to return the public finances from 'red to black' by 2019/20. An underlying balance is targeted now for 2022/23. And, with lower-than-planned tax revenue since the 2016 Budget and softer GDP assumptions, Brexit savings (£8-10bn *p.a.*) are not enough to counter the £122bn extra borrowing over five years. This amounts to about 5% of GDP. **And, adjusting for special factors such as QE proceeds and the transfer of RMPP, Mr Hammond's plans look far looser than his predecessors' *(chart 5)*.**

This has further implications for the pound. *Chart 1* suggests that no major economy has in the longer-term net loosened its overall (monetary and fiscal) stance more than the UK. **And, given the subsequent inflation premium, there's little coincidence that those running the more expansionary policies like the US/UK have generally sustained the weaker currencies *(chart 2)*.** The prospect now for UK policy to stay loose, Brexit negotiations stretching beyond the two years hoped for, and USD strength as the Fed raises rates and protectionism/repatriation beckons, should leave the pound vulnerable. And, especially if the BoE injects more QE to support gilts.

So, we could be choosing one of the worst times to negotiate an exit - given the anti-establishment feeling in the US and Europe's election calendar. And, we'll now have to compromise if we want tariff-free trade - after all, this is our second European 'divorce', after the ERM in 1992. So, any tie-ups in the future - with Europe or elsewhere - will probably come 'with strings'. A bit like EU membership then!

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