HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

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Hermes Investment Office

Ahead of the curve

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Brexit - speed bumps, slopes, & cake...

- **After 12 months in the departure lounge, our Brexit negotiations have started. Political fall-out has added an extra 'speed bump' on a journey likely to take way longer than the two years hoped for.**
- **Mr Hammond's more conciliatory tone is welcomed, but is inevitably clouded early on by 'cherry picking'. Our negotiations could take years to potentially end up back close to square one, in terms of striking the free trade agreement that most parties want.**
- **When the deal is struck it will need Parliamentary approval, & be subject to a 'phasing in' period. And this after sign-off by our 27 EU peers. Striking a US deal by the 2022 UK election needs talks to start now - well before Mr Trump's 2018 'Mid-Terms' campaign.**
- **Which leaves the BoE watchful that a weaker pound doesn't keep pumping inflation. The MPC could feasibly reverse its 25bp 'safety net' rate cut from last August. But, in the absence of a recovery in real wages, we doubt they would hike any more aggressively.**
- **Tapering their QE reinvestments would be the gentlest way to tighten. If it helps, Mr Carney may then be able to have his 'cake' (unhindered consumption) & 'eat it' (still low policy rates)...**

Softening the tone...

The UK has to leave the EU"*...via a slope, not a cliff-edge*". (Chancellor Hammond, Mansion House speech, 20 June 2017). *"Before long, we will all begin to find out the extent to which Brexit is a gentle stroll along a smooth path to a land of cake and consumption"*. (BoE Governor Carney, Mansion House speech, 20 June 2017)

After 12 months in the departure lounge, our Brexit negotiations started formally on 19 June. The Brexit process was always going to be complicated, but the hung parliament, the need to maintain an amorphous government with the DUP, and possibility of cross-party negotiations form an extra 'speed bump' on a journey that could take way longer than the two years hoped for by Article 50.

Theresa May's call to bring forward the election was not just a way of consolidating her own position, which has failed. It was also tacit recognition that forming and ratifying a Brexit deal would need much longer than first thought. The plan was to get the election out the way, instead of waiting until May 2020, to offer an *additional* two years to strike a suits-all deal before having to go to the nation again.

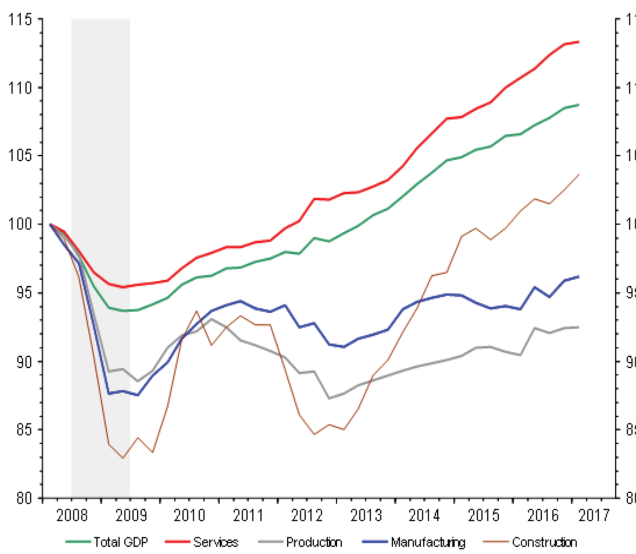
Chart 1. Possible alternatives to EU membership

Option	Access to EU market	Bound to transpose EU law	Free to regulate own financial sector	Influence EU law – voting rights	Contribute to EU budget
Existing EU membership	Yes	Yes	No	Yes	Yes
European Economic Area and European Free Trade Association (*e.g.* Norway)	Restricted	Yes	No	No	Yes
Bilateral agreements and European Free Trade Association (*e.g.* Switzerland)	Restricted	No	Yes	No	No
Customs union (*e.g.* Turkey)	Restricted	No	Yes	No	No
Free trade agreement	No	No	Yes	No	No
World Trade Organisation membership	No	No	Yes	No	No

Source: Hermes Investment Management, based on The City UK, CBI, Bloomberg

Chart 2. UK - services have driven the recovery

UK GDP by sector, re-based to Q1 2008 (=100). Grey is UK recession



Source: Thomson Reuters Datastream, based on ONS data

But, even this may not be enough, with the biggest question still about the length of the journey ahead. The Conservatives' preferred timetable - negotiations to November 2018, followed by six months' ratification in Brussels and Parliament, before a two-year settling-in period to soften the transition before the next scheduled election in 2022 - is optimistic. **An early UK concession on deferring the trade talks - core to a meaningful deal - till migration, the Irish border, and EU contributions are addressed - looks a sign of things to come.**

An early UK concession to defer the trade talks looks a sign of things to come…

Encouragingly, Mr Hammond's softer, more conciliatory tone after the election - espousing free trade and a promise that *"we are not about to turn inward"* - will be welcomed by business lobbies. As will his assurance that, rather than risking under Brexit the €48bn EIB funds earmarked for UK infrastructure projects, HM Treasury will act as the final guarantor via the British Business (development) Bank.

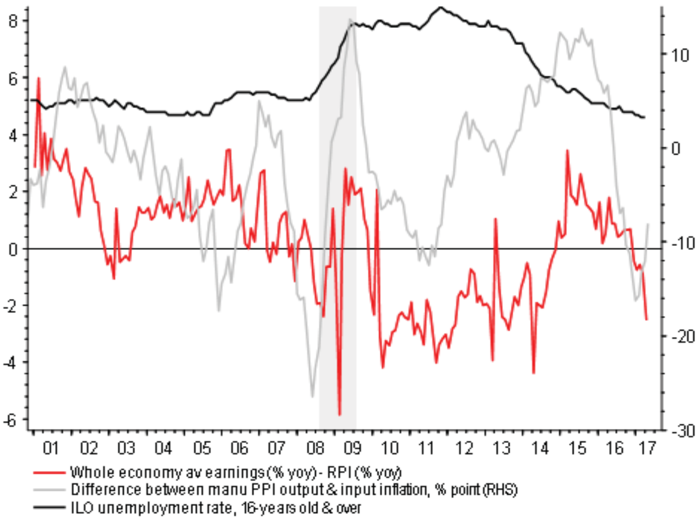
But, inevitably at the start of a negotiation process, even this is clouded by 'cherry picking'. This suggests at least initially that UK officials will chase their preferred free-trade goals (access to, though without full membership of, the Single Market and Customs Union), and try to shun elements (uncontrolled migration, heavy regulation) deemed undesirable. But, this too will have to rebalance, as the realities of the alternatives to EU membership set in ***(chart 1)***.

In practice, our negotiations could take years to potentially end up back close to square one, in terms of striking the free trade agreement that both the Conservatives and Mr Corbyn want. Pulling all sides together suggests they will negotiate to maintain access to, but no longer full membership of, a tariff-free system akin to Canada's deal, and/or a customs union similar to Turkey's.

Even this will need time. First, when the deal is struck it will need Parliamentary approval, and then probably still be subject to a 'phasing in' period to allow firms, consumers and officials to adjust to the new arrangements. If the parties cannot agree, the possibility of another, earlier election would be an unwelcome complication.

Chart 4: The UK's decade-long squeeze on real wages

UK unemployment rate (%), versus profit margins, & real average earnings growth



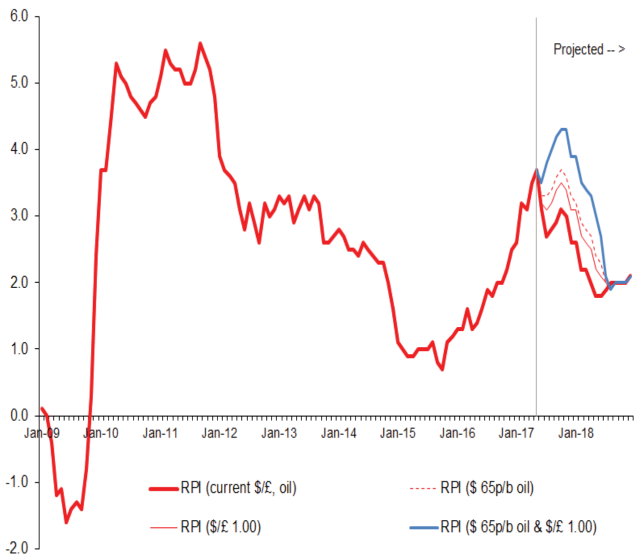
Source: Thomson Reuters Datastream, based on ONS data

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. The UK, being significantly larger and 44 years entwined in the EU, will surely need longer than this. And the obvious alternatives to this, such as a Norway-type European Economic Area (EEA) membership, do not look cost-free:

- even associate members still have to contribute to the EU Budget. Norway's *per capita* contribution is almost as high as the UK's;
- alternatively, securing WTO status, for example, would negate an annual EU contribution, but in turn deprives the UK from any input into, or preferential trade treatment from, the EU ***(chart 1)***; and so

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

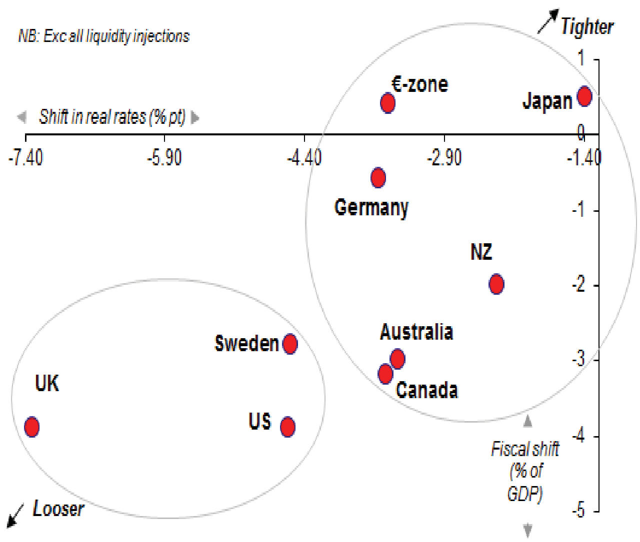
Based on possible $/£, & oil scenarios. Assumes no further rate changes



Source: Hermes Investment Management simulations, based on ONS data

Chart 5. No major economy has loosened policy more than the UK…

Shifts since 2000 in real rates (using CPI, 3m Libor) & cyc-adj budget balances (2016)



Source: Hermes, based on OECD projections, IMF, & Bloomberg data

- striking separate bilateral trade deals with the EU then needs time. Canada's elimination of selected duties with the EU took seven years. And, needing sign-off by all EU states, it was almost derailed at the end of 2016 by Wallonia. Only in 2020 will all their industrial goods be duty-free, and most agricultural quotas will still remain.

Whichever route is taken, the deployment of UK civil servants to unwind membership would push other priorities (*e.g.* environmental) down the line. And, even after a Brexit, any bilateral treaty to re-access the Single Market would probably necessitate freedom of labour movement. Switzerland, for example, accepted this condition, though after its own referendum in 2014, is now looking to re-negotiate this.

Mr Hammond's preferred slope could end up being a path back close to square one...

We're also opening the 'trapdoor' at a highly-charged political time. Some voters facing national elections in Germany and Italy may want to approach it as protest to seven years of euro-zone austerity. In the 'peripheral' economies, reform-fatigue and populist parties are building, while the US looks inward. Incumbents will be reluctant to condone an easy UK exit that puts its economy ahead of their own.

And, meantime, EU law forbids trade-deal 'bigamy' in terms of enacting agreements elsewhere while still an EU member. This precludes a quick compensating tie-up with the US, for example. There, new trade deals take an average four years to complete. **This suggests striking a US deal by the 2022 UK election needs talks to start now - well before Mr Trump's 2018 'Mid-Terms' campaign.**

And another big challenge for UK officials is to remain close enough to the European negotiating table to maintain the best trade and regulatory deals for services. These account for 80% of the our gross value added (compared with 50-60% in Germany, France), and are the driver of the recovery ***(chart 2)***. This makes it more ambitious than a Canada-style deal. **Financial services (at about 8% of UK gross value added) has been the heartbeat of this growth, providing disproportionate trade benefits, employment, and tax revenue.** It makes up the bulk of the UK's total services surplus, equivalent to about 1% of GDP, with 40% of our financial services exported to the EU.

Chart 6: ...Which helps explain the pound's longer-term weakness
Trade-weighted exchange rates, re-based to Q1 2000 (= 100). Quarterly data

Source: Thomson Reuters Datastream

Chart 7. In the long-run, the BoE can keep its peak rates down
Possible trade-offs between ultra-low peak rates & whittling down QE stocks (QT)

Market	Current policy rate (%)	Pref *long-term* peak rate?	Long-term average rate	Extra tightening required?	*Implication for *long-term* QT?
US	1.25% max	**3.0%** (e.g. Fed dot-plot)	circa 5.0%	+175bp	**$1,400bn** (= 31% of QE stock)
UK	0.25%	**2.25%** (e.g. Return to +ve real)	circa 5.0%	+200bp	**£267bn** (= 60% of QE stock)

*Derived from our Policy Looseness Analysis

Source: Hermes Investment Management, based on US Fed, & BoE staff simulations

If we lose our 'passporting' rights, extra costs will include setting up in other centres, maintaining capital there, and the compliance costs of seeking approval from multiple regulators. Also, 44 years of EU regulations have been fully/part implemented into UK law. Many of these apply directly to member states; they would ultimately fall away on a Brexit, and have to be passed as new UK law. **Even outside the EU, regulation would still be needed, and could not happen overnight.**

And, critically, the ECB is already threatening London's privileged clearing position, bestowed upon it by the ECJ. This ruled out the ECB's requirement that clearing houses of euro business between banks be based in the euro-zone, and regulated by the ECB.

All of which, on the macro side, leaves the BoE watchful that a weaker pound doesn't keep pumping inflation. Even if the worst of Brexit is priced in, the pound has limited upside. ***Chart 5*** suggests that no major economy has in the long-term net loosened its overall (monetary and fiscal) stance more than the UK. And, given the inflation premium, there's little coincidence those running more expansionary policies have generally sustained the weaker currencies ***(chart 6)***.

Yet, should the pound plummet and/or protectionist forces build, inflation will reappear. Our simulations show, at current USD/GBP and oil prices, RPI inflation peaking around this May's 3.7%yoy. But, combinations of a weaker pound and/or higher oil could take the RPI past +4%yoy ***(chart 3)***. This would be a five-and-a-half year high. In each case, the CPI stays easily above its +2%yoy target, with further GBP weakness/oil strength lifting it to +3.4%yoy.

But, it will be the 'wrong sort' – cost-push, rather than 'feel-good' demand-pull. This portends more to the inflation rises of the early 1980s and 1990s UK recessions, than the overheating of the late 1980s and mid-2000s. **In which case, the inflationary flame may snuff itself out. The MPC could feasibly reverse its 25bp 'safety net' Bank-rate cut from last August. But, in the absence of a recovery in real wages *(chart 4)*, we doubt they would hike more aggressively.**

Their hope is that productivity begins to lift from 2018, justifying higher wage claims. If it does, they could admittedly then get twitchy fingers. But, they do have another lever to pull to cap the rise in Bank rate, by beginning to wind down their £445bn balance sheet. As a guide, ***chart 7*** suggests the trade-off from peaking out at a historically low rate could over time be to wind down over half of their QE-bought bonds.

Selling the assets is one for later to avoid disruption during the Brexit talks. But, as a prelude, tapering their reinvestments would be the gentlest way of tightening. If it in any way helps facilitate *"the smooth Brexit"* Governor Carney craves, he may then be able to have his 'cake' (unhindered consumption) and 'eat it' (still low policy rates).

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