Brexit – Half way there...

The outlook for the UK economy, negotiations and markets with one year to go
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The outlook for the UK economy, negotiations and markets with one year to go

With one year to go until the UK formally leaves the EU, talks are entering the most difficult phase yet.

Negotiators have as little as six months to agree on a high level framework for future trade, allowing time for ratification by EU members.

“Talks are entering the most difficult phase yet”

The UK has unveiled it’s preferred model for trade, although it has been met with a cold reception by EU officials. Negotiators are fiercely opposed to the UK ‘cherry-picking’ elements of the single market.

Finding a workable solution for the Irish border is also a key concern. Failure to resolve this issue remains a big – if not the biggest – risk to agreeing a deal. So compromise will be key over the next six months.

We could see the UK stepping back from key red lines – a tough ask for Prime Minister May given the divisions within her government. A looming customs union vote in Parliament could be the next big test for the UK leader.

Still, we believe both sides need a positive Brexit deal. For Britain, almost half of exports go to the EU. And with the UK set to be Europe’s youngest and most populous nation within 25 years, access for EU firms will become even more important than it is today.

“We could see the UK stepping back from key red lines”

For businesses, the agreement of a transition period after Brexit lifts one big layer of uncertainty. But there is still a question of whether 21 months will be long enough for companies to adjust. The possibility of a ‘cliff edge’ in 2020 remains a tail-risk for firms.

This uncertainty, alongside ongoing consumer caution, is a key reason why we expect growth to struggle again through 2018. In principle this takes some of the heat off the Bank of England. But with wage growth on the rise, as well as global economic prospects improving, policymakers look set to hike rates again in May.

This, alongside the recent agreement of a transition deal, should continue to give the pound a lift. We see GBP/USD at 1.53 at the end of 2018.
The economy
Light at the end of the tunnel?
Inflation spiked to 3% purely on the weaker pound, but now prices have more-or-less adjusted, we expect CPI to trend downwards. We think core inflation will dip back close to the 2% target by the end of the summer.
Our UK economic dashboard
How key variables have changed over the past year

Real wage growth (YoY% rhs)
Retail sales (ex. Auto fuel, YoY% lhs)

Real wage growth = Wage growth - inflation

The income squeeze has passed its worst. But we still expect disposable incomes to remain more-or-less flat and this prospect is continuing to dent confidence. Cautious consumers will keep a lid on overall growth, at least in the earlier stages of 2018.

Source: Macrobond, ING
Our UK economic dashboard
How key variables have changed over the past year

**Wage growth**
Firms appear under growing pressure to lift pay to retain/attract staff. It’s early days, but there are more and more signs that pay is rising faster.

**Hiring**
There are tentative signs that the dip in hiring at the end of 2017 was only temporary, but if we’re wrong, this could be a sizable economic risk in 2018.

**Investment**
Investment intentions have picked up off their lows, but with uncertainty over the final Brexit deal set to persist, we see few signs of an immediate pick-up.

**Trade/manufacturing**
Manufacturing has been a clear bright spot in the UK economy, with global growth and to some extent, the weaker pound, driving new orders.

**Building steam**

**Cautious**
How does UK growth compare globally?

Given all the warnings of recession around the Brexit vote, you might say growth of 1.6% in 2018 ‘could be worse’.

But with global growth set for its best year since the financial crisis, we think the UK economy should be growing almost twice as fast – or at a similar pace to the US.

Consumers in Europe and the US are the most optimistic they’ve been since the early-2000s, while confidence in the UK remains close to multi-year lows.

ING 2018 Growth Forecasts

1.6% 2.4% 3.0%
Carney’s clipboard: A May rate hike looks increasingly likely

With the economy still struggling to get up to speed, and core inflation set to return fairly rapidly to target over the next few months, on the face of it there’s less pressure on the Bank of England to tighten policy further.

But the Bank is increasingly focused on the better wage growth figures, as well as the latest Brexit progress.

**We expect a rate hike in May,** and markets are more-or-less on-board with this idea too.

But with Brexit talks set to reach a noisy conclusion later this year, a second 2018 rate hike may be a challenge.

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**May rate hike checklist**

- Faster wage growth
- Stronger global growth
- Brexit transition period
- Rebalance growth towards investment/exports

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Number of hikes priced over two years
(2-year OIS vs. current 0.5% rate)

<table>
<thead>
<tr>
<th>Nov 17</th>
<th>Dec 17</th>
<th>Jan 18</th>
<th>Feb 18</th>
<th>Mar 18</th>
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<td>3</td>
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Three hikes now priced in over two years

Source: Bloomberg
But Brexit could scupper a second rate hike later this year

**Bank of England hiking window**
Hikes after the summer could be tricky as Brexit talks reach noisy conclusion

- **Jan – March**
  Focus on agreeing transition period in-principle (not legally binding until ratification)

- **March – October**
  Trade talks begin, most likely agreeing a framework for a future relationship, leaving finer details until later

- **August – October**
  Lessons of 2017 suggest 3-4 months of noise/deadlock before deal struck

- **October – March 2019**
  Time needed for exit treaty to be ratified by individual EU parliaments, as well as UK parliament in ‘meaningful vote’

**22/23 March**
European Council summit: Agreement reached on transition period

**10 May**
Bank of England Inflation Report – most likely time for a hike

**18/19 October**
European Council summit: Unofficial deadline for withdrawal talks to conclude before ratification

**March 2019**
UK formally leaves EU
The Brexit deal
Now the real fun begins...
Progress check: Where the Brexit talks are up to...

Attention is turning to the vision for post-Brexit trade as well as a solution to the Irish border.

**Divorce costs**

Both sides reached an agreement on the UK’s post-Brexit financial liabilities in December 2017.

**Transition period**

A transition period will keep the UK in the single market until December 2020 under an agreement reached in March.

**Dispute resolution**

Both sides are still working on a plan for settling disputes during the transition, alongside the role of the European Courts of Justice after Brexit.

PM May’s recent speech hinted at accepting ECJ verdicts in certain areas, blurring an earlier red line.

**Brexit Deal**

The UK has outlined its vision for trade, but it has been met with a cold reception in Brussels where cherry picking is a big concern.

Talks will continue over coming months, most likely looking to form a free-trade agreement. Realistically, negotiations could extend well into the transition period (and maybe even beyond).

**Irish border**

Both sides have agreed the need for a ‘backstop’ option should the overall Brexit deal fail to avoid a hard border.

But negotiations are no closer to reaching an agreement on a more optimal solution.
The UK’s ability to win trade deals with other countries is being seen as one of the benefits of Brexit. Certainly, exports to the EU have grown less quickly than exports to non-EU countries over the past decade.

But the UK still exports a quarter of a trillion pounds worth of goods and services to the EU, on which millions of jobs are dependent.
High birth rates mean the UK’s population is growing quickly. The EU estimates the UK will be the most populous nation in Western Europe within 30 years. It will also be one of its “youngest”.

That means the UK will be less impacted by the cost of an ageing population (pensions & health) and taxes are likely to be structurally lower.

If productivity keeps pace with Europe, UK trend GDP growth should be well above average. This means the UK will be an increasingly attractive market to export to.

Source: Eurostat
“No deal” – is WTO really better than a bad deal?

What tariff applies to you?

Examples from the USA WTO tariff schedule

<table>
<thead>
<tr>
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Source: WTO

Navigating WTO tariffs is no easy task.
A download of the US “simple” spreadsheet, offering a fairly broad summary of tariffs, comes to 19,575 lines.

It also takes time
Dispute resolution takes time to resolve, complicating efforts of firms to get their goods to market.

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What is the UK asking for on Brexit?

**Managed Divergence:** How the “Three Baskets” approach would work

1. **Full alignment**
   In the first basket, effectively nothing changes: The UK abides by EU rules – but the UK would retain the “right to diverge” in these areas in future.
   
   Possible examples include aviation, manufacturing (to ensure frictionless supply chains) and medicine.

2. **Mutual recognition**
   Here, both sides would mutually recognize one another’s rulebooks, enforced by a dispute resolution mechanism to maintain a level playing field. This would allow UK regulation to differ to the EU’s, whilst achieving the same goals.
   
   Possible examples include environmental standards and financial services.

3. **Divergence**
   The final basket would involve different regulations and different goals. This would be where the UK would go its own way completely in cases where it perceived EU rules to be burdensome.
   
   Possible examples could include certain services and some forms of manufacturing (e.g. Hoovers).
But the UK’s proposals have been met with a cold reception

**Key EU concerns**

**Cherry picking**
This is perhaps the biggest concern – EU officials are adamant that the single market is indivisible. Under the UK’s model, it would effectively remain in the single market in some sectors, and move out in others.

**More leavers**
The EU fears that a deal that sees the UK thrive could embolden EEA members to demand concessions, or encourage more Eurosceptic nations to consider leaving the union.

**Practical problems**
With 28 countries in the negotiations, each with different industry interests, agreeing what economic sectors fall into each basket could be a logistical nightmare.
Squaring the circle: Can a hard Irish border be avoided?

The EU is seeking greater clarity on how border checks can be avoided when the UK leaves the customs union.

The UK government has suggested two possible ways of avoiding a hard border with Ireland:

1) **Technology** (e.g. pre-customs notifications)

2) ‘**Customs partnership’** (when a good ultimately destined for the EU arrives in the UK, EU rules/tariffs are applied – avoiding the need for additional checks at the UK/EU border)

Neither has been deemed suitable by EU negotiators, and talks will focus on this issue intensively over the next couple of months.

**Could Blockchain be the answer?**

Distributed ledger technology allows real time tracking of a good through the supply chain, reducing the need for paper work. It helps cut fraud and reduce transit times.

This could help reduce the need for manual checks at the border, easing pressure on infrastructure and congestion – although of course, this approach is largely unprecedented.
## Brexit options: No choice ticks everyone’s boxes

<table>
<thead>
<tr>
<th>UK Red Lines/Priorities</th>
<th>EU Red Lines</th>
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<td>No “hard” Irish border</td>
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<tr>
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<td>No cherry-picking</td>
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<td>Access for services</td>
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<tr>
<td>No ECJ jurisdiction</td>
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### EEA (Norway option)
- No Free Movement: ✗
- Negotiate trade deals: ✗
- Access for services: ✔
- No ECJ jurisdiction: ✗
- No “hard” Irish border: ✔
- No cherry-picking: ✔

### Customs Union
- No Free Movement: ✔
- Negotiate trade deals: ✗
- Access for services: ✗
- No ECJ jurisdiction: ✔
- No “hard” Irish border: ✔
- No cherry-picking: ✔

### Managed Divergence/Three baskets
- No Free Movement: ✔
- Negotiate trade deals: ✔
- Access for services: ✔
- No ECJ jurisdiction: ?
- No “hard” Irish border: ✗
- No cherry-picking: ✗

### Canada-style FTA (No “plus”)
- No Free Movement: ✔
- Negotiate trade deals: ✔
- Access for services: ✗
- No ECJ jurisdiction: ✔
- No “hard” Irish border: ✗
- No cherry-picking: ✔
Prime Minister May’s big test
The House of Commons will vote on customs union membership in what will be a big test for the government

The UK government has been clear it wants to leave the customs union in order to pursue trade deals with non-EU countries.

But the opposition Labour Party has now made it official policy to remain in a customs union. There are reportedly a number of Conservative MPs who agree.

The issue will reach a tense conclusion when MPs vote on an amendment committing the UK to remain in a customs union. The vote has been pushed back by as much as two months, but when it happens, it could be very tight given the Conservative’s slim majority in parliament.

A defeat would be a major (and potentially fatal) blow to Theresa May’s leadership.

321 MPs **In favour** of keeping UK in customs union

307 Conservatives  10 DUP  4 Labour

321 MPs **Against** keeping UK in customs union

10 Cons.  258 Labour  35 SNP  12 Lib Dem  6 others

Sin Fein, the speaker and a vacancy means there are 8 non-votes

Source: Estimates by the FT as of 27 Feb 2018
Public unimpressed by government’s Brexit handling

Labour now lead in the polls, while only 25% of voters think the government is doing well at negotiating Britain’s exit.

Source: YouGov Voting Intentions Poll 5-6 March
Is a 21-month transition period long enough?

Lorry traffic at selected UK ports
Number of lorries, 2015

Supply chains need time to adjust
Complex modern supply chains mean goods often travel multiple times between the UK and EU before being sold in the single market (e.g. BMW Mini)

These processes will take time (and money) to re-orchestrate.

There are logistical considerations too...
At Dover, less than 1% of lorries arriving/departing currently require checks\(^1\).

An Imperial College study has found that adding even two minutes to the current customs process could generate queues of up to 29-mile queues on the M20 motorway.

Avoiding this will require new staff, but this too takes time. For instance, it takes 3 years to train a new customs official in Germany, and 2 years in France.

Source: Institute for Government, Department for Transport

\(^1\) Implementing Brexit: Customs (Institute for Government report)
Is a 21-month transition period long enough?

Both sides want to keep the transition time-limited...

- Brexiteers want it over by next election in 2022 - don't want the Brexit decision reversed by a troublesome electorate
- December 2020 coincides with end of current EU budget period – UK would likely have to pay to extend transition

... but businesses and the government will have their work cut out

- Customs staff need be to hired and trained – David Davis has said up to 5000 new staff may be needed. To put this into perspective, Northern Ireland currently only has 57 Border Force officers
- IT infrastructure to cope with customs pre-approval
- New customs infrastructure needed – inspection posts at air and ferry ports
- New road and parking for lorries at ports – space is very limited around Dover port.
The outlook for sterling
Livin’ on a prayer
We’re bullish on the pound across the medium-term
Brexit progress, higher confidence and higher interest rate expectations look set to drive the pound higher

Short-term bias Neutral
Medium-term bias Bullish

Key themes
• GBP trading with a short-term Brexit risk premium
• Bar to sell GBP on short-term political risks very high
• Long-run GBP outlook constructive on Brexit progress

ING forecasts

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Source: Bloomberg, ING
Four potential scenarios for GBP over coming months

**Market implied BoE policy rate (%)**

- **Scenario 3:** Prolonged Brexit uncertainty & BoE on hold
- **Scenario 2:** Brexit Transition Deal & cautious BoE rate hike
- **Scenario 1:** Brexit Transition Deal & UK economic recovery

GBP sensitive to moves in this area of the curve

- **Base case**
  - GBP/USD: 1.45
  - EUR/GBP: 0.86

- **Progress**
  - GBP/USD: 1.42
  - EUR/GBP: 0.88

- **Brexit No Deal**
  - GBP/USD: 1.35
  - EUR/GBP: 0.92

- **Brexit No Deal**
  - GBP/USD: 1.25
  - EUR/GBP: 0.98

Source: Bloomberg, ING
Our key UK economic forecasts

2.4%  1.6%  2.0%  1.7%
2018 Headline CPI  2018 Real GDP Growth  2019 Headline CPI  2019 Real GDP Growth

Consumer Price Index (YoY%)

Real GDP (YoY%)

Source: Macrobond, ING

ING
“USD: Making everyone (else) great again!”

“What we really think of the Bank of England’s rate decision”

“Normalisation will be a long, uncomfortable journey”

“G10 FX: Careless Central Bank Whispers”

“When caution’s not enough for the euro”

“Some Brexit clarity at last?”

“Riding the cryptocoaster”

“Trade war: What is it good for?”

“Trump: The next 100 days”

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