4 February 2020

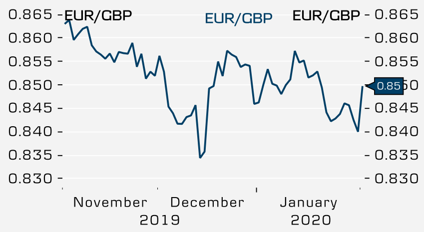
Brexit Monitor

Withdrawal done, now moving to the real Brexit talks

Key takeaways

- **UK formally left the EU on Friday, marking the beginning of the transition period running until 31 December 2020.**
- **Both the UK and the EU have published their trade agreement objectives. The most important red lines for the UK are to end regulatory alignment and the jurisdiction of the EU court. For the EU, it is to protect the integrity of the single market and the customs union, securing rights to fish in British waters and ensure the UK does not undercut EU standards (i.e. level playing field conditions).**
- **These are initial positions and eventually both sides are likely to compromise. However, this is unlikely to happen until we are much closer to the deadline on 31 December 2020, as PM Boris Johnson has ruled out an extension.**
- **We think more GBP weakness is in the cards this year, as we expect investors will become increasingly impatient with the lack of progress. We also expect a 25bp cut by the Bank of England in May, as elevated Brexit uncertainty continues to weigh on business investments (see page 2).**

We expect EUR/GBP to move higher in coming months



Note: Past performance is not a reliable indicator of current or future results

Source: Bloomberg, Macrobond Financial

Complicated trade negotiations ahead

On Friday, the UK formally left the EU and started the transition period running until 31 December. Both the *UK government* and *the EU* have now outlined their objectives for the forthcoming trade negotiations, which can start as soon as the EU leaders accept the objectives, set for a ministerial meeting on 25 February. Both parties have stated that the ambition is to strike a comprehensive free trade deal but it is also clear that the two parties have different priorities. For a comparison, please see the table on page 3.

As Prime Minister Boris Johnson has refused to extend the transition period, there is less than 11 months to finalise the negotiations. This is a very short time frame and the EU has already hinted it cannot be done and that the UK and the EU must prioritise the most urgent issues (see *Reuters*). For the EU, that means fishery and level playing field conditions (i.e. that the UK does not give British companies an unfair advantage by significantly cutting taxes, give state aid to them or slash environmental standards or workers' rights).

PM Boris Johnson has stated that he would rather walk away from the negotiations and trade on WTO terms from 1 January 2021 than sign a deal where the UK becomes a rule-taker and falls under the jurisdiction of the EU Court, see *The Guardian*.

We note that EU officials have stated very clearly that the deadline of 1 July for extending the transition is an inflexible one, i.e. the EU leaders cannot easily extend the current transitory arrangements after 1 July. However, we believe that a de facto/artificial extension could be achieved by agreeing that the divergence would happen slowly over time, as part of a more comprehensive deal.

For an overview of the time frame, see the timeline on page 4.

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Another matter to resolve is whether the final UK-EU agreement should be ratified by only the EU institutions or the member states as well. If the deal must be ratified by all member states it complicates things, as evidenced by the experience with the EU-Canada trade agreement (for some time, a regional parliament in Belgium blocked the ratification process due to domestic political discussions). For example, an association agreement would likely be considered a so-called mixed agreement, which would have to be ratified by both the EU system and member states. An anonymous EU senior official hinted yesterday that the EU is confident the agreement will fall under EU competence, i.e. EU approval only, see *The Independent*.

According to the Withdrawal Agreement, the parties must agree on three things before 1 July: 1) Extension, or not, of the transition period, 2) fishery conditions and 3) financial services terms. The final deal would have to be concluded probably no later than early October in order to give enough time for ratification both within the EU and the UK. On page 4 we provide an overview of the timeline for 2020.

Our base case remains that the two parties will agree on a simple free trade agreement this year, perhaps including some elements of a de facto transition in some areas due to the short time frame. That said, the risk of a no deal Brexit from an economic perspective (i.e. trading on WTO terms) is not negligible if the two parties cannot agree on a permanent trade agreement and the transition period is not extended before 1 July. We estimate the risk at around 20%. There is also a higher risk of a no deal Brexit happening by accident, in particular if the agreement must be ratified by all member states and not just by the EU. We would not be surprised if the upcoming negotiations follow the same pattern as the withdrawal negotiations, where a compromise is not reached until we are much closer to the deadline. This is quite normal in political negotiations.

FX: More GBP is in the cards

Yesterday, EUR/GBP rose around one figure to above 0.85, from 0.84 early morning, that we think was probably driven by the initial negotiating positions outlined by the UK government and the EU. Investors appear to have become slightly more concerned about the prospects of a deal, as the initial positions seem to contradict each other.

We see two reasons for a weaker GBP. Firstly, at some point, we expect investors will become impatient about the lack of progress in the negotiations, leading to higher no deal Brexit fears. Secondly, the continued elevated Brexit uncertainty means we are unlikely to see any investment boom yet, as companies are likely to wait for the outcome of the negotiations before taking projects out of the drawer again. Weak growth would force the Bank of England to cut at the May meeting, which is not fully priced yet (60%).

We target 0.87 in 3M and 0.89 in 6M-9M, when we think the Brexit uncertainties will peak.

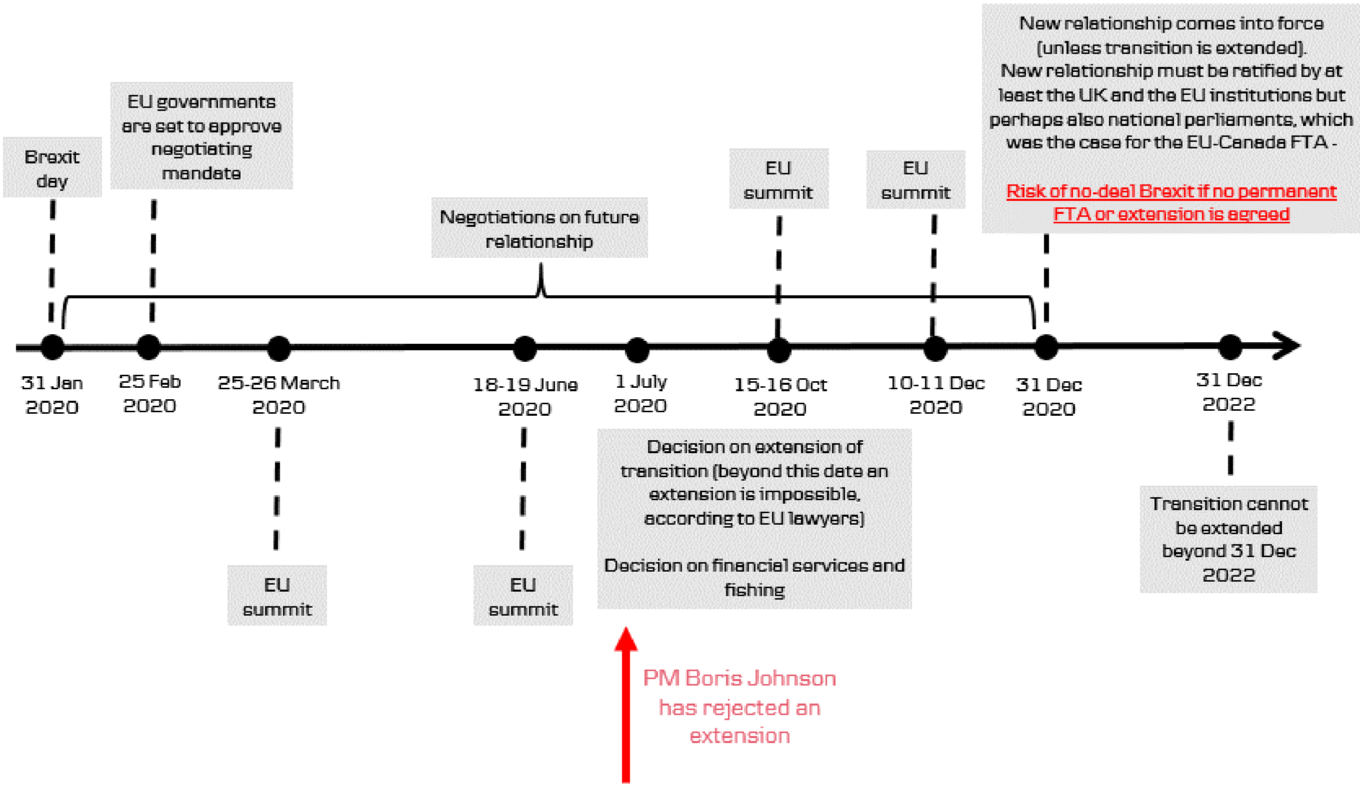
As our base case is for the two parties to agree on a permanent deal, we think the GBP will rally as soon as such a deal is in sight. We target 0.84 in 12M.

Summary of negotiation objectives

	UK position	EU position
Deal	- Possibly more inclined to make several smaller agreements from area to area - Aims at EU-Canada type of deal but can live with EU-Australia (i.e. WTO terms)	- One single overall governance framework
Extension	- No extension of the transition period	- Thinks an extension is a good idea as time is short
Trade in goods	- FTA should reflect existing international best practices in FTAs already agreed by the EU (i.e. EU-Canada). - Zero tariffs, zero quotas - No regulatory alignment - Independent policies in areas such as competition, subsidies, environment and social policy.	- Respect integrity of EU's single market and customs union - Level playing field conditions (no state aid, no big corporate tax cuts, environmental standards, workers' rights) - Says UK must implement EU state aid rules
Fisheries	- Annual negotiations with the EU on access to waters like Norway, Iceland and the Faroe Islands - British waters are first and foremost for British fishermen	- Continued reciprocal access - Stable quota shares, which can only be adjusted with the consent of both parties
Trade in services	- Agreement should minimise barries to the cross-border supply of services. Scope for go further on professional and business services	- Go beyond WTO commitments
Financial services	- Enhanced provision for regulatory and supervisory cooperation with the EU	- Close cooperation on regulatory and supervisory matters. - Financial services equivalence decisions will be unilateral.
EU court	- End of EU court's jurisdiction	- EU Court to rule only in cases that concern and refer to EU law
Gibraltar	- Agreement should cover the whole of the UK, including Gibraltar	- Agreement should not cover Gibraltar
Movement of people	- End free movement of people, new point-based immigration system	- No discrimination between EU citizens from different countries - No single market access without free movement of people
Dispute resolution mechanism	- EU Court has no jurisdiction in the UK - All agreements should have government and dispute settlement arrangements appropriate to a relationship of sovereign equals	- Independent arbitration panel to solve disputes where a mutually satisfactory resolution cannot be found. - EU Court to rule only in cases that concern and refer to EU law

Source: EU, UK Government, Danske Bank

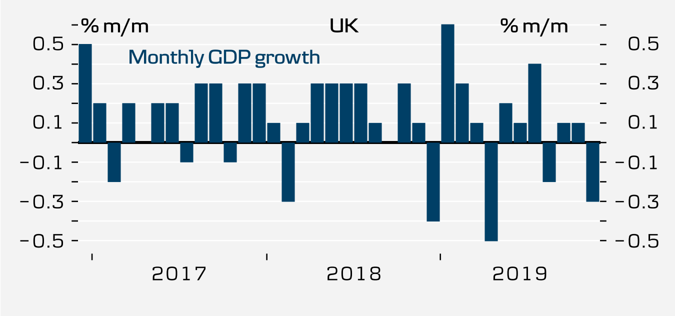
Trade negotiation – timeline and important deadlines



Source: EU-UK Withdrawal Agreement, EU, UK Government, Danske Bank

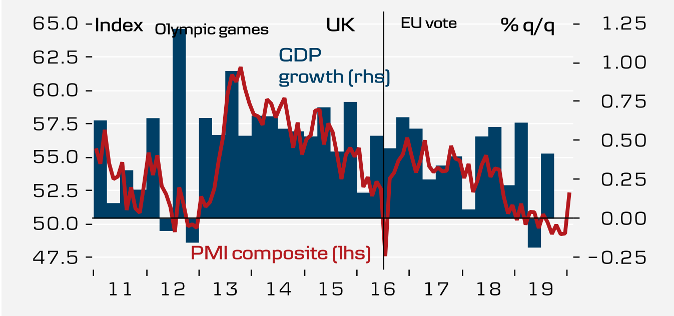
Macro charts

Weak GDP growth in H2 19 according to monthly GDP estimates



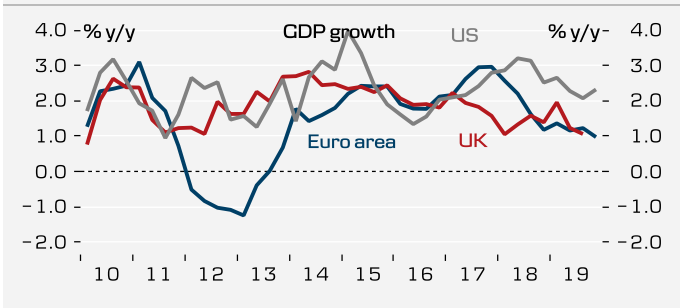
Source: ONS, Macrobond Financial

PMI composite has rebounded since Johnson's landslide election victory



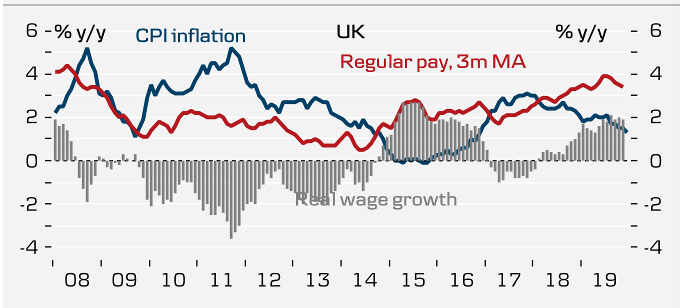
Source: ONS, Markit Economics, Macrobond Financial

GDP growth has weakened



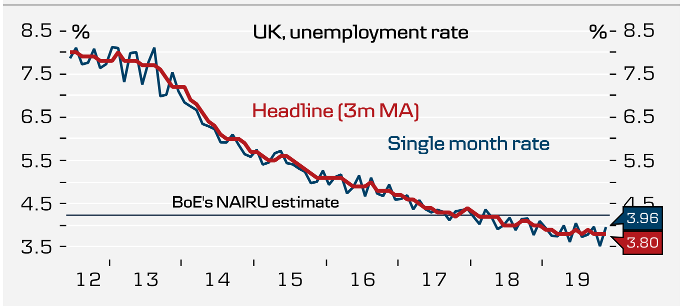
Source: ONS, Eurostat, BEA, Macrobond Financial, Danske Bank calculations

Real wage growth is solid



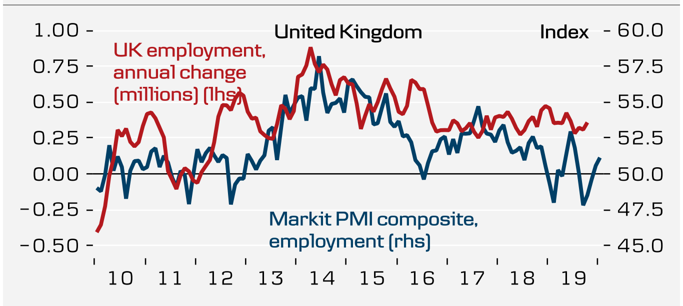
Source: ONS, Macrobond Financial, Danske Bank

Unemployment rate stopped moving lower in 2019



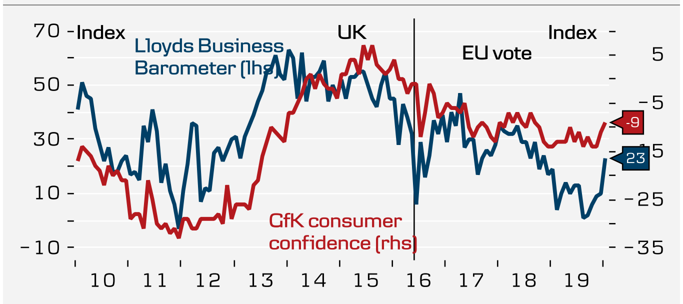
Source: ONS, Bank of England, Macrobond Financial

PMI employment index suggests weaker employment growth



Source: ONS, Macrobond Financial

Slight rebound in confidence indicators after Johnson's election victory



Source: Lloyd, GfK, Macrobond Financial

Companies have reduced their inventories again

Source: IHS Markit, Macrobond Financial

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This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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