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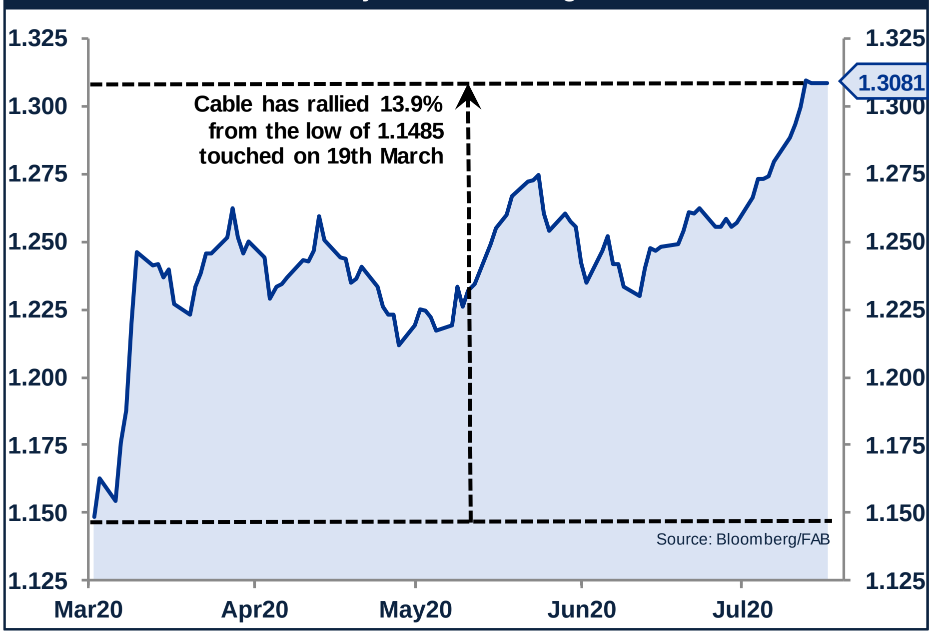
FAB Macro Strategy: Brexit revisited; countdown to 'no deal'

- **Covid-19 has taken the spotlight away from Brexit, at exactly the wrong time**
- **Lack of progress on a trade deal suggest 'no deal Brexit' now the default outcome**
- **U.K. trade on WTO terms could be a triple-whammy negative**

In the immortal words of Clint Eastwood's Dirty Harry character in the 1971 movie of the same name, "Did he fire six shots or only five? Well, to tell you the truth, in all this excitement, I've kinda lost track myself… (so) you've got to ask yourself one question: 'Do I feel lucky?". The same could almost be asked today of the latest situation in the Brexit saga in the U.K.

Amid all the Covid-19 gunfire this year we seem to have lost track of the evolving and, we would suggest, increasingly precipitous situation concerning the U.K's departure from the EU. There has apparently been little or no progress made toward agreeing a trade deal between the U.K. and the EU thus far during this transition period. As a result, the U.K. is now facing an increasingly likely 'no deal' Brexit scenario on December 31.

Unjustifiable strength



Source: Bloomberg/FAB

Given the socio-political mess, uncertainty and, in a worst case scenario, the near-paralysis of trade to/from the U.K. that this could create in the opening months of next year, we find if incomprehensible that sterling has rallied over 13% from this year's March low, with cable currently sitting back above $1.3000. It remains our belief therefore that the underlying Brexit risk, coupled with the ongoing macroeconomic pressures from still elevated coronavirus infection numbers, is certainly not priced in at current levels.

Indeed, while the distraction of coronavirus may have taken the focus away from U.K./EU trade deal negotiations, or lack thereof, the recent price performance of sterling certainly suggests that the market is feeling lucky. Given the balance of risks though, we believe that such optimism is misplaced and that sterling and UK risk assets could be set for a meaningful correction before year-end when markets come to the realisation that the Brexit issue hasn't gone away and the harsh reality of a no-deal Brexit sets in.

There is little evidence that Westminster is now any closer to agreeing a post-Brexit trade deal with the EU than it has been at any stage since the original Brexit plebiscite back in 2016, even as the pressure mounts with the December 31 end of the transition period now looming. In fact with the latest (July) negotiations having come to an end without yielding anything, we would conjecture that we may have gone past the point of no return. Effectively, it may now be too late get any deal agreed and ratified by the December deadline.

Michel Barnier, the EU's chief Brexit negotiator has suggested that the U.K. and the EU are 'unlikely' to agree a free-trade accord in time, unless the U.K. softens it's demands – something that we see absolutely no incentive for the Brexiteer BoJo government to do. Boris Johnson was returned to 10 Downing Street last December with an 80-seat majority, all on the back of his 'get Brexit done' manifesto. Why would he go soft now? Indeed, a recent Bloomberg Intelligence article suggested a 70% probability of a no-deal scenario prevailing at year-end. We would put the figure even higher at around 85%.

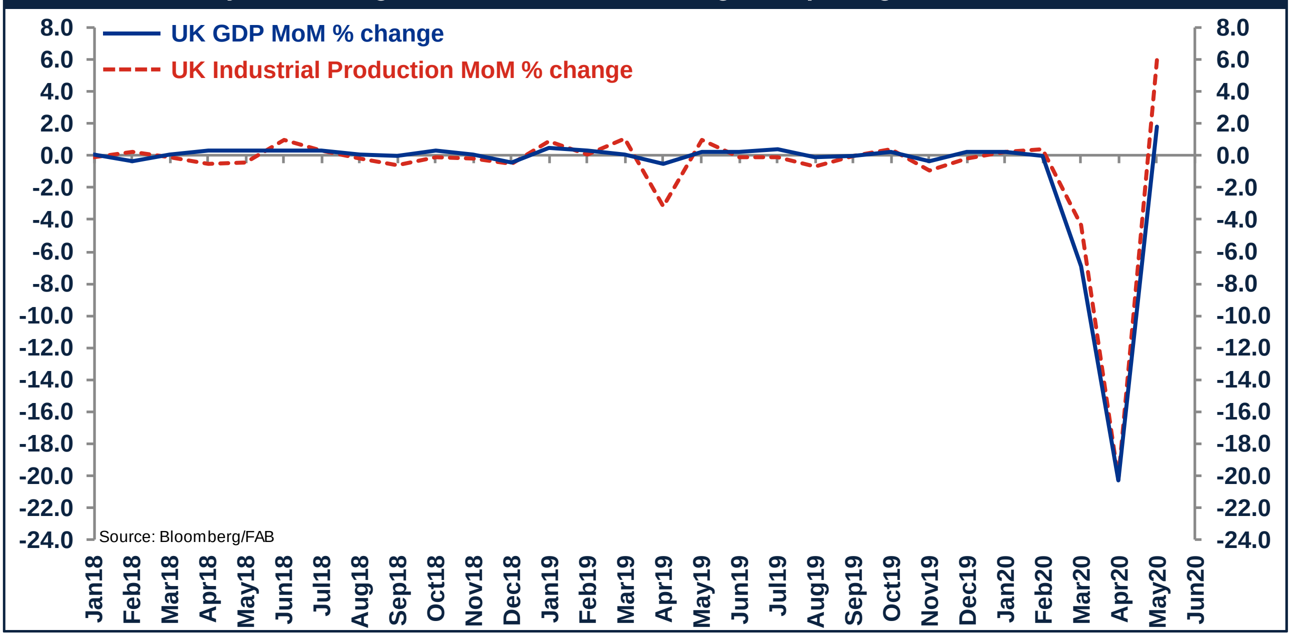
Without an agreement on their future trading relations – particularly some kind of free trade agreement – trade between the UK and the EU will be based purely on WTO terms. And yet sterling is trading as if Dirty Harry has run out of ammunition, with cable having rallied over 12% from its March 2020 low to now be flirting with the pre-pandemic $1.30 level.

What are the (basic) implications of being 'under WTO terms'?

The latest reports that we have read from experts in the field of WTO trading, confirm that the U.K. leaving the EU with no trade deal in place, will result in import duties and various controls being imposed on trade between the two regions. Within this, the greatest impact will fall on agricultural and industrial goods, those that tend to make numerous crossings between the UK and the rest of the EU during the production process, such as auto sector components or food processing ingredients.

Furthermore, once no longer an EU member and therefore following individual WTO terms, the U.K. will cease to be included in (need to renegotiate) any beneficial free trade agreements currently in place between the EU and third party countries, such as Canada and South Korea. Consequently, British imports and exports to and from these third countries will potentially be subject to tariffs.

Certainly not trading on macroeconomic strength, or pricing in 2nd lockdown risk



Source: Bloomberg/FAB

Of course, for many Brexiteers, the main allure of the U.K. leaving the EU is the possibility of then being able to agree a free trade deal with the U.S. (among others). But given that the EU has been trying, unsuccessfully, for years to reach a trade deal with the U.S., but has consistently failed to do any better than smaller bilateral agreements, one has to ask what chances there are of the U.K. having more luck on its own. Very little, some would argue, but time will tell. At the very least the smaller agreements will also need renegotiating; progress beyond these seems unlikely to be straightforward.

Bottom line: Buckle up

So it seems likely that the U.K. is now walking blindly toward a 'no deal' scenario in December, at which point the EU and U.K. will end up trading under World Trade Organisation (WTO) terms. Given the harsher trading environment that will surely follow, with tariffs imposed on both agricultural and non-agricultural goods, a 'no deal' Brexit scenario and consequent falling back onto WTO terms could prove to be a three-way suboptimal outcome - political, economic and social.

The combined impact of a no deal split between Britain and the EU together with the (far from over) ongoing pain from the coronavirus socio-economic restrictions on economic activity suggests to us that the path of least resistance for sterling should only be lower over the next 6 months. Cable hit our $1.15 target in March and has subsequently rallied as Brexit optimism (or denial?) has been priced in together with dollar weakness itself as a result of the Fed and U.S. government Covid-19 rescue programs, but the lows could easily be revisited, if not surpassed, when 'no deal Brexit' reality sets in later in the year.

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