MARKET INSIGHTS

Market Bulletin

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Brexit: Ready for the main event

What's happened?

Following the Brexit vote on 23 June 2016, there were always two negotiations to follow. The first was a negotiation within the UK to reconcile the desires of the 48% of the population who didn't want to leave the European Union (EU) with the 52% who did. The second was a negotiation with the EU itself.

The divide within the UK population was just as evident within the UK Conservative Party. On Friday, the Prime Minister Theresa May convened a meeting with her cabinet to try to hammer out a common ambition to allow her to begin formal negotiations with the EU on a future partnership.

Essentially, what the government had to decide on Friday was whether to prioritise an ongoing close relationship with the EU, or whether to aim for increased trade with other nations to compensate for a lack of access to the EU's market. UK trade is overwhelmingly skewed towards the EU and the supply chains are highly integrated. While other trading partnerships could be established, it is unclear how quickly such agreements could be achieved, or how fruitful they may be.

Agreeing to prioritise trade in goods with the EU by establishing a customs partnership overcomes the issue of a potential border between Northern Ireland and the Republic of Ireland. But to maintain access to the single market for goods, the UK government has acknowledged that it will have to respect the regulatory framework imposed and overseen by the European Commission and European Court of Justice. While this may look like a concession on the UK's ambition to restore sovereignty, it is worth remembering that regulatory agreement is an important bedrock for trade. Without common standards, one country could have the ability to obtain market share by using practices which do not fit with the values of another (child labour as one extreme example, or chlorinated chicken as a less extreme example).

David Davis—former Secretary of State for Exiting the EU—decided on Sunday night he was unable to support the government's position and has stepped down. He has been replaced by Dominic Raab, the former housing minister. The market will remain nervous that David Davis is the first Brexiteer domino to fall but our core assumption is that for the sake of the future of the Conservative Party, the Prime Minister's plan will get the majority backing.

What's next?

This is a considerable step forward, which will allow the UK government to begin negotiations with the EU. There are still challenges ahead. It is not clear whether the EU will find all elements of the government's ambition palatable (we will most likely start to hear more from Brussels when the government's White Paper is released next week). The government maintains that there is a technological solution that will allow the UK to act as an EU customs border while also establishing trade deals with other countries. But the EU may not be willing to engage in such a deal until the solution is clearly workable.

And the government remains firm that it must regain control of migration. This could compromise the UK's ability to reach a broad agreement on free trade in services. But our core assumption is that there will ultimately also be a deal on services. The fragmentation of financial services that would be caused if no deal is reached would raise the cost of capital for European businesses and could disrupt the much needed recovery in the eurozone. We expect agreement to be reached on a joint oversight framework between the two regulators—the Bank of England and the European Central Bank—which will pave the way to a deal in services.

Sterling is up marginally on the day although Mr Davis's resignation has most likely tempered excitement. We remain the view that, by year-end, the UK will have negotiated a relatively soft Brexit. We would expect a broad-based rise in sterling, which will lower UK inflation at a time when wage growth is picking up. This would promote an upgrade to the economic outlook heading into 2019 and most likely a faster pace of rate increases from the Bank of England.

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