

UK: Snap Election to “Speed up” Brexit

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Key Insights

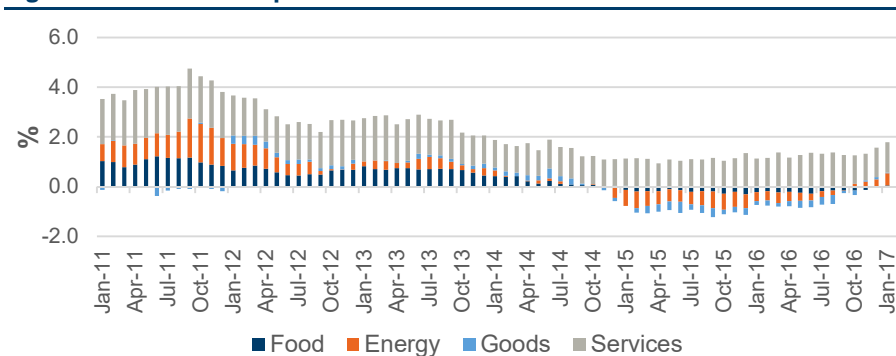
- After few months of strong growth, in the aftermath of Brexit, economic momentum is now waning, suggesting that the predicted slowdown may start to come through. With inflation rising, consumer spending could diminish its contribution to GDP growth, but sterling weakness should support the external sector.
- The political outcome of June’s snap election will be crucial to frame the attitude of both the UK and the EU during negotiations and a strengthening of the anti-Euro movement in mainland Europe may lead to a tougher stance by EU negotiators. It is our view that a good outcome is in the best interests of both parties.
- The banking and financial services sector is one of the most pressing risks for the UK, with many banks poised to move a share of their business and employees outside of the UK in anticipation of a potential loss of passporting rights.

The UK economy is relatively resilient, but uncertainty about future arrangements with the EU is negatively influencing business investments.

What is the Situation of the UK Economy?

The UK economy has shown unexpected resilience since the Brexit vote and the main driver of this robust growth - one of the highest among European countries - has been private consumption, which has been supported by the Bank of England’s easing monetary policy and by high levels of consumer confidence. At the same time, uncertainty about future arrangements with the EU has negatively influenced business investments, with new projects placed “on pause” after the June referendum, especially in export-oriented sectors. The UK economy has been starting to show signs of a slowdown in recent months: the strong depreciation of sterling and the jump in oil prices, compared to last year, have significantly contributed to a rise in headline and core inflation. The UK services sector remains the major driver of stronger price growth, but for the first time in 3 years rising food prices have also positively contributed to increased inflation. In addition, the latest data shows that industrial and manufacturing output, despite maintaining a good pace of growth in YoY terms, slowed quite significantly in February and the trade balance of goods also worsened.

Figure 1: UK Inflation Composition



Source: Pioneer Investments, Thomson Reuters. Data as of April 18, 2017.

With wages growing at a slower pace than consumer prices, private income is shrinking in real terms, so that key driver of UK economic growth appears to be stuck in a rut. While uncertainty is still too high for the business sector to help, via investments, exports started to pick up a bit in Q4 2016 thanks to the competitive gains linked to the depreciating currency. Overall, GDP grew on average 1.8% in 2016 and CPI inflation by 0.8% (but at a pace of 1.6% YoY in December).

What will the post-Brexit world look like?

On 29th March, Prime Minister Theresa May signed the letter to trigger Article 50 of the Lisbon Treaty, initiating the two-year process that will drive the UK out of the EU. From a formal point of view, the current President of the European Council, Donald Tusk, has proposed draft guidelines for the EU’s Brexit negotiations, which will be led by Michel Barnier. The following principles have been declared:

- 1) to protect the rights of all EU nationals already living, working and studying in the UK;
- 2) to prevent a legal vacuum for EU companies that operate in the UK;
- 3) to ensure that the UK honours all financial commitments and liabilities it has already taken as a Member State;
- 4) to seek flexible and creative solutions aiming at avoiding a hard border between Ireland and Northern Ireland, as support of the peace process is considered of maximum importance.

The British Parliament, meanwhile, will start discussions of the so-called ‘Great Repeal Bill’ - a proposed law aiming to end the European Union’s legal supremacy over UK laws. Moreover, the announcement of a snap election in the UK on 8th June has added, if possible, more complexity to the picture. At the moment, polls suggest that the Conservative party of PM May has a sizable advantage over the Labour party and the Liberal Democrats, but the short election period and wide array of strategies that could be adopted by the main parties make the future development of the electoral campaign unpredictable. The most immediate consequence of this decision is that some of the precious time for Brexit negotiations will be lost.

The negotiation process will largely depend on the political situation in Europe too. The stronger the anti-EU political movement on the continent becomes, the tougher the attitude of the EU towards British representatives will likely be: if European unity is perceived to be at risk, EU institutions will want to clearly show that leaving the EU is not without negative consequences.

Political uncertainty may be further exacerbated by UK internal problems, such as the call for a vote on Irish unification or renewed claims for Scottish independence. Therefore, a “smooth” agreement process seems unlikely and largely conditional on the outcome of June’s elections, as the starting positions of both parties are far apart and current attitudes do not appear strongly collaborative. One of the initial matters the UK and EU must agree on is whether negotiations over issues – such as trade and citizens’ rights – will be carried out sequentially or concurrently. Eventually, we hope both sides will come closer together or reach a reasonable compromise: such an outcome is in the overwhelming economic interest of both parties.

The call for a snap election on 8th June has added, if possible, even more complexity to the Brexit picture.

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The structural worsening of the trade balance could cause further movement in sterling, with risks being strongly skewed towards depreciation.

What is the Immediate Impact on the UK Economy?

In the short term, we expect British rates of growth to slowdown from current levels, but not dramatically. According to our 2017 forecasts, UK GDP will grow by 1.8%, on average, and CPI by 2.8%, while GDP is projected to grow by 1.5% and CPI by 2.5% in 2018. The consumer spending trend will continue to shrink, as the growth of consumer prices continues to outperform the rise in wage growth. Investment should mildly recover in the second half of 2017, while exports are expected to be the real driver, with an average growth of 4.7% in 2017 and 2.5% in 2018.

In the medium-term, some preliminary structural changes related to Brexit may start to appear. Among the most evident and immediate effects is the almost certain loss of passporting rights for financial services towards the EU, which could trigger a movement of jobs from London to Ireland and continental Europe, the partial withdraw of foreign investments into the British financial industry and a worsening of the UK’s trade balance as a consequence of lower exports in financial services to the EU. The structural worsening of the trade balance could cause further movement for sterling, with risks being strongly skewed towards depreciation.

Figure 2: UK GDP Growth and CPI Inflation Forecasts



Source: Pioneer Investments, Thomson Reuters. Data as of April 18, 2017. 20th and 80th represent confidence range of model forecasts.

In the medium term, the UK will have to change its growth model. It will also no longer benefit from the inflow of skilled foreign labour, which suggests that the potential growth rate of the UK economy will slightly diminish.

What will the Long-Term Consequences of Brexit be?

It is difficult to foresee too far into the future, but it is almost certain there will be significant changes in the economic and legal structure of the UK. As a consequence of Brexit the UK will have to change its growth model, which was designed to benefit from being inside the EU as the UK’s high-quality institutional setting made it the ideal point of entry to the single market, especially for the provision of sophisticated financial services to continental European countries. The loss of this “beneficial” status implies, among other things, that a key challenge will be to revise the balance between business stemming from this competitive advantage and other type of activities. It is also clear that the UK will no longer benefit from the inflow of skilled foreign labour, which might suggest that the potential growth rate of the UK economy will also slightly diminish.

The BoE has a soft tightening bias at the moment and a rate hike is unlikely for the time being, unless inflation spikes.

Will the BOE Have to Act Again?

The Bank of England (BoE) lowered short-term interest rates from 0.50% to 0.25% in August 2016 to soften the impact of Brexit on the UK economy and financial markets. It has held rates unchanged since then (the vote was 8-1 in favor of holding rates in March), as British economic growth has been balanced so far, but growth expectations have weakened. The spike in inflation, due to in part to the increase in commodity prices and the strong currency depreciation, may prompt monetary tightening. As indicated in the minutes of the March meeting, there have been signs that some BoE members are moving towards a tightening bias, asking for a 25bps rate hike. However, the BoE has a soft tightening bias at the moment and a rate hike is unlikely for the time being unless a wage-price spiral takes hold of the UK economy and takes YoY inflation above the upper limit of tolerance of the 1-3% range around the 2% target. This cannot be entirely ruled out but, is unlikely to manifest itself before the latter part of 2017 in any case.

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