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INVESTMENT TALKS

Brexit still weighs on GBP, but the situation on rates and equity could normalise

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- ***Next steps and economic fallout****: Now that the United Kingdom is officially out of the EU, a new phase has opened up, during which UK officials will have to negotiate a trade deal with the EU to avoid a 'Brexit cliff edge' at the end of 2020. The available time span is short, but an agreement is possible on either a trade deal, another extension or some mixture of the two. The negotiations should be simplified now the UK is able to rely on a solid parliamentary majority, while on the EU side there can no longer be any hope that the UK will remain in the EU. Last year the possibility of keeping the UK in the EU could have acted as an incentive for Europeans not to offer an acceptable deal. In addition, despite his harsh tone, British PM Boris Johnson proved pragmatic in his negotiating strategy in 2019, and this pragmatism could again facilitate an agreement this year. However, there will be renewed moments of doubt related to that 'Brexit cliff edge' before a solution is found. Meanwhile, a US-UK trade deal is unlikely to be fully negotiated this year, while what happens next year will depend on the outcome of the US Presidential election. If Donald Trump gets re-elected a deal could be slightly more likely, while a Democratic President may feel less aligned with Johnson's views.* ***UK GDP growth*** *is expected at 1.1% this year and 1.4% in 2021, from an estimated 1.3% in 2019. This is a slightly better outlook than in the Eurozone as the UK benefits from the announced fiscal stimulus, which could be a game changer for the British economy. Longer term, we expect Brexit to slightly impair the British growth trend through less vigorous labour market and productivity dynamics. Nonetheless, Britain's potential growth will remain slightly stronger than that of the EU, due to demographic trends and also the fact that the UK remains an economy that is generally friendlier to competition and innovation.*
- ***Investment implications****: In* ***fixed income****, the 10-year Gilt is expensive, both in absolute terms and compared with other developed markets. We expect the UK yield curve to bear steepen as we foresee upside surprises from previously depressed survey data, low unemployment and the prospects for increased issuance due to higher fiscal spending. Playing curve movement could be a source of value to fixed income portfolio investors in a low-yield environment, particularly with many central banks now on hold. More generally, we expect some curve flattening in countries such as Japan, Europe and Australia, while we foresee curve steepening in markets such as Canada, where the central bank has not cut rates. On* ***FX****, the pound is likely to depreciate in 2020, hit by possible negative news flows on the ongoing negotiations and the dovish Bank of England (BoE) rhetoric. In* ***equities****, the UK market is cheap compared with its fundamentals and looks attractive in the long run. We see it as a buying opportunity, especially in relation to domestic-oriented stocks, for which the risk/return profile is most attractive.*

"A trade shock at the end of the year due to the lack of a trade agreement is a tail risk with limited probability, in our view."

What are the next steps in the Brexit process?

The United Kingdom officially exited the EU on 31 January 2020. The main topic regarding future UK-EU relations will now be the negotiation of a permanent trade deal – presumably a free-trade agreement (FTA) – to avoid a 'Brexit cliff edge' at the end of December. The UK government has legislated that it will not seek an extension of the transition period beyond 2020. During the transition period, the UK retains its access to the EU single market. In the absence of an extension or a trade deal, the UK will lose this access on 1 January 2021 and UK-EU trade would then be regulated only by the World Trade Organization regime. This would cause a significant trade shock, with tariffs and border checks for goods. However, such an outcome could be avoided for most sectors and an agreement is likely to be found, in our view.

What is your assessment of the upcoming UK-EU negotiations?

Many observers believe that the time available for negotiating a FTA before year-end is too short. Moreover, recent statements and documents – such as the EU's draft negotiating mandate – show the starting positions to be far apart. While the UK government is stressing that it wants regulatory autonomy, the EU insists that it wants a 'level playing field', which can be interpreted as at least some form of regulatory harmonisation.

"Pragmatism and the preservation of both sides' national interests could lead to an agreement."

The negotiation will be difficult and both sides will play hardball at the beginning. The EU will be adamant that the United Kingdom does not obtain better terms than what it had under the EU regime. However, **such negotiations appear simpler than the 2019 ones for at least two reasons**. First, on the UK side, there is now a parliamentary majority and it is therefore unlikely that we will again see the very confusing situation where the UK government agrees to something that is then rejected by the UK Parliament. Second, on the EU side, there can no longer be any hope that the UK will remain in the EU. This simplifies the negotiations compared with the situation last year, where the possibility of keeping the UK in the EU could have acted as an incentive for some continental European countries not to offer an acceptable deal. In addition, despite his harsh tone, British PM Boris Johnson proved pragmatic in the October 2019 negotiations by very much agreeing that there would be customs checks across the Irish sea, something that was a red line for his predecessor Theresa May. In the end, such pragmatism and the preservation of both sides' national interests should lead to an agreement on either another extension or a trade deal – or a mixture of the two – so that a trade shock can be avoided or at least largely mitigated. However, there will be further moments of doubt and stress related to that 'Brexit cliff edge' before a solution can be found.

What are the chances of a US-UK trade deal and what is the impact on the EU?

Despite some convergence of tone, style and views between US President Donald Trump and UK PM Johnson, we believe that the United States will be tough on the United Kingdom when it comes to negotiating a trade deal, with all US industrial lobbies at work. Unlike with the EU negotiation, the two sides do not start from a position of free trade and regulatory alignment. In addition, outside of the EU, the UK does not carry the same weight in negotiations with third parties, be it the United States or other countries. We could see a surprise to the upside, but in our view, **it is unlikely that a US-UK trade deal can be fully negotiated this year**.

What happens next year will depend on the outcome of the US Presidential election. If Trump gets re-elected a deal may be slightly more likely, while a Democratic President may feel less aligned with Johnson's economic and geopolitical views, so the negotiating phase could prove contentious. It remains unclear whether the UK could leverage its negotiations with the US to put pressure on the EU.

"Our UK GDP forecast has remained unchanged in recent months, at 1.1% for this year and 1.4% for 2021, only very slightly above our figures for the Eurozone."

How has your view on the UK economy changed recently and what are your expectations for 2020?

Our view on the UK economy has not changed much recently, as the orderly Brexit that just took place had been factored into our central scenario. UK growth will be influenced by a tug of war between the remaining Brexit uncertainty – weighing on investment, including real estate – and **the sizeable fiscal stimulus announced by the government, worth over 0.5% of GDP, to be confirmed in the March budget**. Labour market dynamics have remained strong throughout the entire Brexit process.

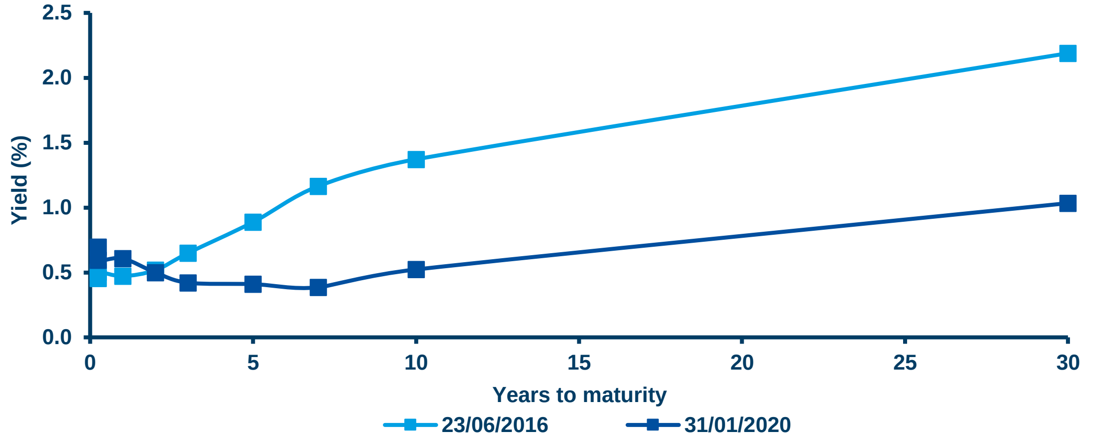
Overall, **our UK GDP forecast has remained unchanged in recent months, at 1.1% for this year and 1.4% for 2021, only very slightly above our figures for the Eurozone.** Longer term, we expect Brexit to slightly impair the British growth trend through less vigorous labour market and productivity dynamics. Nonetheless, Britain's potential growth will remain slightly stronger than that of the EU, due to demographics and the fact that the UK remains an economy that is generally friendlier to competition and innovation.

"We expect 10-year yields to rise relative to their two-year equivalents, with the UK yield curve to bear steepen."

FIXED INCOME AND FX VIEWS

Since the second quarter of 2019, 10-year Gilt yields have dropped from their post-referendum levels into a range of 0.4-0.8%. Valuations of this UK benchmark are expensive, both in absolute terms and compared with other developed markets. In this respect, we expect 10-year yields to rise relative to their two-year equivalents, with the UK yield curve expected to bear steepen. The spread between these two rates collapsed to almost zero on the back of the recent publication of the EU's draft negotiating mandate, together with PM Johnson's focus on the UK's regulatory autonomy. In addition, on 30 January, the BoE kept rates on hold despite two officials voting for a rate cut for the third consecutive meeting. However, recent comments from BoE officials have been dovish and the central bank stands ready to act quickly if the recent boost in sentiment fails to translate into higher spending. Over the next few months, **we expect Gilt yields to rise** as we foresee upside surprises from previously depressed survey data, unemployment remaining low and wage growth stabilising, as well as the prospect of increased issuance because of higher fiscal spending. We expect two-year and 10-year yields to be at 0.4-0.6% and 0.8-1.0%, respectively, in one year.

UK Gilt curve evolution between Brexit referendum day and the official UK exit



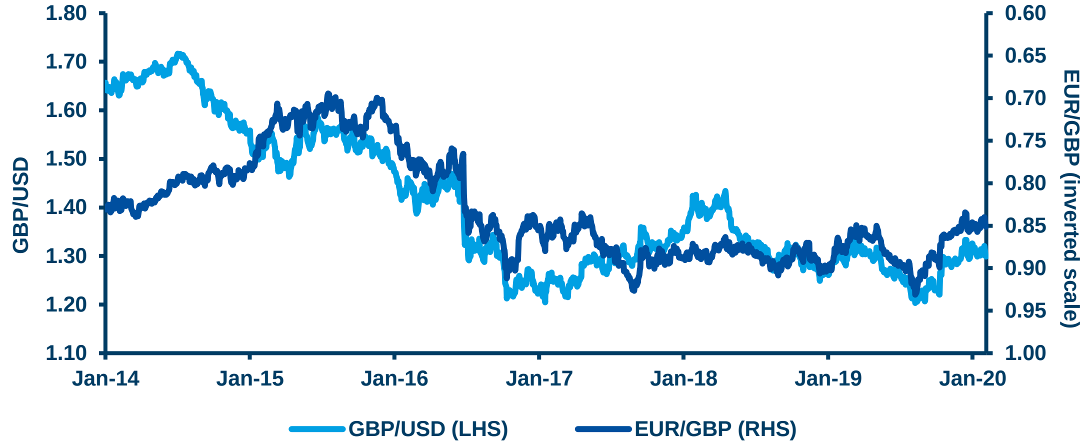
Source: Amundi, Bloomberg. Data as of 5 February 2020.

"In a low-yield environment and with many central banks on hold, country selection will prove increasingly relevant."

More broadly, on global bonds we have seen core government rates rallying in 2019 thanks to geopolitical and trade tensions, waning growth and the dovish rhetoric and action from G7 central banks. The New Year has opened with renewed fears of a global pandemic and this has weighed further on rates in the first few weeks of 2020. A slight duration underweight may be an option now. However, in such a low-yield environment and with many central banks now on hold, **country selection will prove increasingly relevant to generating value for global fixed income portfolios.** Global fixed income markets can be divided into two main categories. The first group has active central banks, low or negative yields but is upward-sloping, with countries including Japan, Europe and Australia. In these markets, there may be opportunities for some curve flattening, most notably in the German market. Further, the hunt for yield and the ECB's QE programme will support peripheral Eurozone bonds. The second group is made up of countries where either their central banks have not cut rates – at all or as aggressively – such as Canada, or markets that have flat or inverted yield curves, such as the United Kingdom. In these markets, intermediate maturities are expensive and they could be shortened.

Turning to FX markets, since October 2019 the pound sterling has moved closer to estimates of fair value, in a range of 1.28-1.35 to the dollar. **Given the renewed uncertainty, the UK currency is likely to depreciate in 2020**. Indeed, the BoE has pencilled in lower rates as a condition to meeting its growth and inflation targets, while stating a preference for a wait-and-see stance if recent improvements in business confidence do not filter into investment and real wages. In addition, the UK and the EU starting positions on any FTA agreement are far apart and the likelihood of negative news flows on the state of negotiations is high during the year. Overall, the GBP will likely be weighed down by all of these factors.

GBP vs. USD and EUR: risks are for depreciation of the GPB



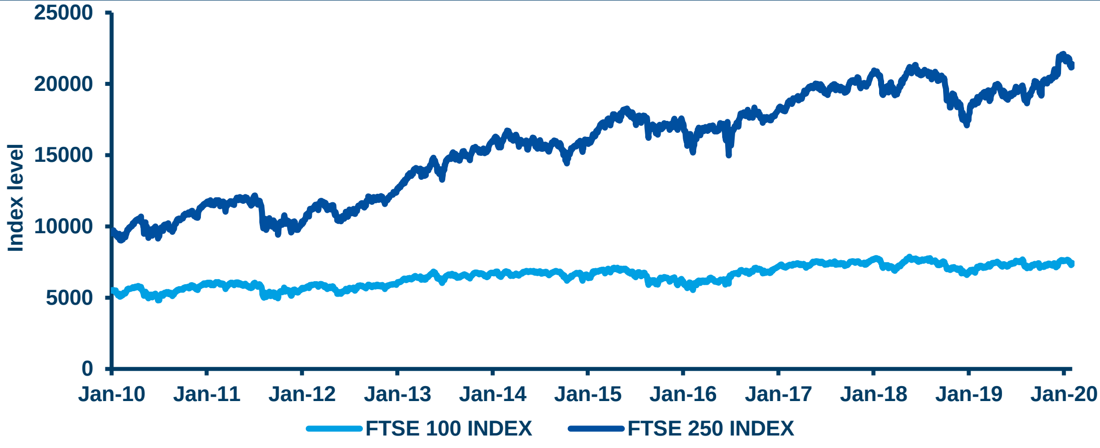
Source: Amundi, Bloomberg. Data as of 4 February 2020.

EQUITY MARKET VIEWS

UK equities are currently cheap. The continued uncertainty as to how Brexit will work out in detail is weighing on stocks, as is the uncertain economic growth outlook. There is a risk that UK equities could remain cheap compared with their fundamentals in the short term, but taking a long-term view, they do look attractive and we see this as an opportunity. Large global companies dominate the FTSE 100 index, while the mid-to-small cap indices – such as the FTSE 250 – are more domestic in nature**. We prefer domestic UK stocks** as this is the area where expectations are low and the risk/return profile is attractive, in our view. Among our preferred companies, there are some homebuilders, low-cost airlines and financial services companies.

"In the long term, UK equities look attractive and we see this as an opportunity, especially with domestic stocks."

The outperformance of 'domestic' stocks could continue in 2020



Source: Amundi, Bloomberg. Data as of 4 February 2020.

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Definitions

- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Carry:** The carry of an asset is the return obtained from holding it.
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Curve flattening:** A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates (bear steepening) or short-term rates dropping more than long-term rates.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Quantitative Easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Term premium**: The amount by which the yield of a long-term bond exceeds that of a short-term bond. Because one collects coupons on a long-term bond for a longer period of time, its yield-to-maturity will be more. The amount of a term premium depends on the interest rates of the individual bonds.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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