Economics & Strategy Weekly

No to no-deal Brexit

DBS Group Research

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- *The Brexit saga continues to unfold with one intrigue after another.*
- *After this week's developments, markets have been pricing in either a soft-Brexit with some delay or perhaps even no Brexit.*
- *PM May's narrative has shifted; the argument now is that saying no to her deal with EU would amount to no Brexit at all.*
- *The possibility for a long delay and the rejection of a second referendum could see a push for new elections and fresh volatility.*
- *In the unlikely event of a no-deal Brexit, the market impact would be extremely negative.*

The hard Brexit option fades

Global markets are largely focused on the developments on the China-US trade negotiations and China stimulus, while largely ignoring (especially global equity markets) a stream of weak economic data releases. The Brexit saga, meanwhile, continues to unfold with one intrigue after another. In line with the markets' buoyant sentiment, other than a volatile pound, the impact has been muted so far. Indeed, since British MPs voted resoundingly on March 14 in favour of taking a no-deal Brexit off the table, markets are beginning to price in either a soft-Brexit with some delay or perhaps even no Brexit at all after a possible second referendum.

While not entirely dismissing the possibility of a no-deal Brexit, we are inclined to go with the market in this instance. The stated position of PM May that no deal is better than a bad deal has unravelled in recent days, with her exhortation to Tory MPs shifting to the narrative that saying no to her deal with EU would amount to no Brexit at all. This narrative may just work in convincing sufficient number of her party members to vote in favour of a soft Brexit next week. Of course, UK politics has yielded many surprises in the past two years, so what might seem the right conclusion in a game theoretic framework in this context may not still be the ultimate outcome. Odds are however shifting in that direction.

With this backdrop, where do the markets go from here? In the event of a no- deal Brexit toward the end of this month, the market impact would be extremely negative. A soft Brexit is priced in, in our view. The possibility for a long delay and the rejection of a second referendum could see a push for new elections and fresh volatility.

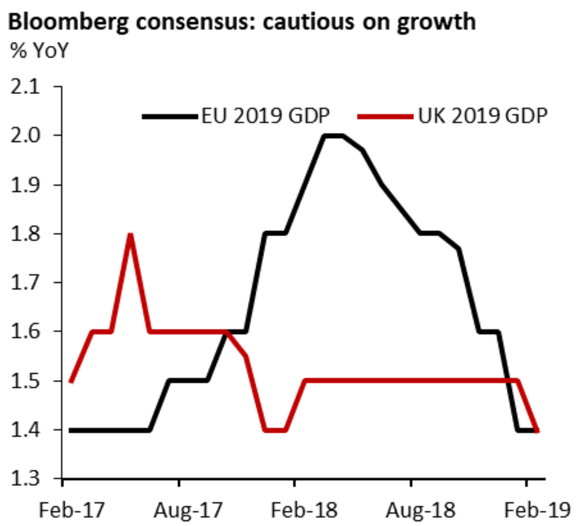
In this Weekly, Radhika Rao examines in greater detail the macro implications of the ongoing saga. Philip Wee weighs in on the FX implications. Eugene Leow considers the rates and monetary policy scenario.

Taimur Baig

Economics: Brexit stalemate continues

As this goes to print, the UK members of parliament have voted to delay Brexit beyond the end-March 2019 deadline. Next, Prime Minister May will request Brussels to approve this extension, which could go three-ways; a) a short delay till June 30; b) delay beyond June; in this case, the UK will not only need to participate in the upcoming EU parliament elections but also withdraw Article 50; c) Brexit occurs by end-month. There is a tail risk that Brussels is not convinced that UK has a viable deal and denies an extension, which in effect sees the UK leaves the union without a deal, either this month or three months hence. **The economic implications, understandably, will be less severe under b) and more protracted under c).**

If the 'no-deal' scenario is avoided through a longer extension, kneejerk gains are likely across the GBP, UK equity and bond markets, as Brexit-related uncertainty fades. For the real economy, growth has been steadily drifting lower since the 2016 referendum; from 2.4% in 2015 to 1.4% last year. Bloomberg consensus also dialled down growth expectations for the UK (and EU) in recent quarters. Activity is likely to remain subdued this year at 1-1.3% annual growth, before at the margin, next year.



Source: Bloomberg, DBS Group Research

With or without Brexit, the outlook for the UK economy for 2019 is weak due to a tougher global demand environment particularly slowing EU growth, weak trade, political impasse in 1H19 and a likely delay in UK investments. If the extension in the Brexit deadline is perceived as an opportunity for a soft-Brexit or no exit, business investments are likely to get a boost in the coming months, but modestly given the tougher external environment. Consumer spending is also likely to strengthen owing to pent-up demand, stronger labour conditions and fading uncertainty. With the UK still not technically out of the EU, trade and investment channels with the larger union will remain accessible. This could see the UK economy return towards 1.5%+ growth next year.

A strong sterling will be positive for the economy, through lower import prices and support to real incomes for households. This might also open the door for the Bank of England to reassess its bias for policy normalisation, as a stronger currency imparts some downside bias on inflation trends (2018 average 2.3% YoY), notwithstanding strong jobs data growth.

There is a tail-risk that the UK is unable to gain an extension and faces a 'No-deal' exit. The Bank of England ran several Brexit withdrawal scenarios late last year, which provided a bleak assessment in the event of a 'disorderly (no-deal exit) scenario': they foresee scope for as much as 8% fall in real output from Q119. We add, that risks of recessionary conditions also cannot be discounted. Inflation is also expected to spike above rise to as much as 6.5%, as a weak GBP feeds into price pressures and squeezes real incomes**.** Central bank policy is likely to put in a tough spot, caught between slowing growth but a sharp rise in inflation.

Brexit related concerns come at a vulnerable time for the EU. The latter is already in midst of a slowdown since early last year, initially driven by transitory domestic factors and weakness in sentiment-based indices. A tougher global environment has since magnified downside risks for 2019. This will push the European Central Bank's (ECB) to pull the brakes on policy normalisation plans, even as QE ended in December last year (see here and here).

Radhika Rao

FX: Stay vigilant against Brexit risks

We remain cautious on the market's optimism for a soft Brexit to fuel a British pound rally. This week's three parliamentary votes on Brexit (Table 1) do not guarantee that the United Kingdom averts a disorderly exit from the European Union on March 29. To prevent this, Britain still needs the support of the EU27 nations to delay Brexit. Thursday's vote against a second referendum suggests that UK lawmakers still want to deliver on first referendum and unlikely to push for a unilateral withdrawal of Article 50.

Table 1: UK House of Commons votes on Brexit

MPs vote whether to:	On	Yes	No
Reject May-EU deal	March 12	391	242
Reject Brexit without a deal	March 13	321	278
Delay Brexit	March 14	412	202

UK lawmakers will need to consider the political calendar (Table 2) in deciding whether Mrs May requests for a short or long extension at next week's EU Summit. Unfortunately, the path ahead is not without its twists and turns.

Table 2: The challenges posed by the political calendar in requesting an extension of Article 50

March 12-14	March 21-22	March 29
UK parliament votes on Brexit	UK's final summit as EU member	Brexit Day
April 18	**May 23-26**	**July 2**
Last voting session of EU Parliament	EU Parliament elections	First sitting of new EU Parliament

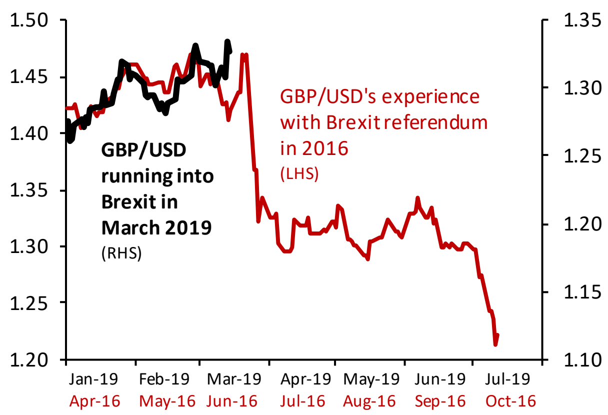
To avoid UK's participation at the European Parliament election in May, a short delay before the first sitting of the newly-elected EU parliament in July is preferred. But the EU requires UK lawmakers to accept the deal (agreed with Mrs May) that was overwhelmingly rejected a second time on Tuesday. A third vote has been set up on March 19 and it remains to be seen if Mrs May will be third time lucky.

Ironically, supporting the EU-May withdrawal agreement implies a softer Brexit is now possible on March 29 and questions the relevance of pushing for any delays. Rejecting the deal opens the door for a longer delay that requires the UK to participate in the EU Parliament elections in May. European Council Donald Tusk has pledged to appeal to the EU27 for a long extension if Britain needs time to rethink its strategy to leave the bloc.

The inability of the pound to recover its losses after the strong vote to delay Brexit warned against prematurely dismissing a no-deal Brexit, just as markets declared the EU-May deal dead after Tuesday's vote. While UK businesses welcomed parliament rejecting a no-deal Brexit, they are not convinced that any delay will not resolve the Brexit impasse and extend the uncertainties.

The major lesson from the Brexit referendum in 2016 was that markets underestimated the risks in favour of a favourable outcome. They pushed the sterling higher only to fall off the cliff thereafter.

Is the British pound rising only to fall off a cliff?



We remind mindful that if a hard Brexit takes place on March 29, the rating agencies will axe UK's sovereign debt rating on a major failure of UK's political institutions, increased prospect for a UK recession, higher joblessness, falling wages and lower property prices. Fitch, which has formally put the UK on negative watch in February, would probably be the first to lower UK's debt rating. Fitch's next scheduled update is on April 26.

Philip Wee

Rates: Brexit delay could lift Gilt yields

Brexit took centre stage this week with multiple votes (law makers voted down the revised Brexit deal, voted against no-deal Brexit and backing the motion to seek a Brexit delay) **roiling GBP assets**. Most of this is visible through the volatility of the GBP and to a lesser extent, fluctuations in Gilt yields. 10Y Gilt yields (1.22%) are now some 8bps off from the start of the month, hugging close to the bottom of its 15-month trading range. **Interestingly, the bond market is the most pessimistic compared to the currency and the stock market.** While Brexit uncertainties have stalled the stock market rally over the past month, there has still been a considerable bounce since end-2018. Comparatively, the GBP appears to be much more receptive to any positive news.

Gilt yields would most likely rise in the event of a soft Brexit deal or an extended delay in Brexit. At this point, the market appears to be leaning towards a Brexit delay and Gilt yields have risen modestly. As mentioned, rates are nowhere near as optimistic as stocks or the GBP. **A 10bps pop higher in 10Y Gilt yields would probably translate into around 5bps upside in equivalent UST yields.** In the unfortunate event of a hard Brexit (while the probability is lower, this possibility should not be dismissed just yet), we think 10Y Gilt yields would touch 1%, reversing rate hike expectations that came on the back of a resilient UK economy. Similarly, we think that 10Y UST yields can easily revisit the 2.55% low registered in the early part of this year**.** Within the G10, US Treasuries stand out as a safe high-yielder (with the 10Y tenor offering over 250bps in pickup over German Bunds) and would benefit inordinately if risk aversion hits.

For Asia, a Brexit delay (if confirmed) would reinforce our view that carry remains the key theme. **However, we should make the distinction across local currency versus USD terms.** While the backdrop for Asia central banks to ease appears intact, we are worried that USD strength could erase a chunk of the gains.

Running ideas:
-short Dec-2019 Fed funds futures (7th Jan)
-receive 10Y (or 5Y5Y) SGD swap vs pay 10Y (or 5Y5Y) USD swap (12th Mar)

Eugene Leow

Highlights of the week:

Shanghai trip notes: Weak demand; improving liquidity
Malaysia: Bank Negara turned marginally dovish
Understanding China: China-US: From trade war to tech war
India: Policy transmission, through banks and markets, will be key
Understanding China: Self-Sufficiency 2.0
SGD rates: Time to outperform

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018e	2019f	2020f	2017	2018e	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	7.1	6.7	7.1	7.4	4.5	3.6	3.5	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	2.5	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.2	3.9	3.8
Singapore	3.9	3.2	3.0	2.8	0.6	0.4	1.8	1.5
South Korea	3.1	2.7	2.6	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.5	1.5

* refers to year ending March ** new CPI series *** eop for CPI inflation

	Policy interest rates, eop							
	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.00	3.00
Philippines	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
Singapore**	1.80	2.05	2.30	2.30	2.30	2.30	2.30	2.30
South Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00
United States	2.50	2.50	2.75	3.00	3.00	3.00	3.00	3.00

* 1-yr lending rate; ** 3M SOR ; *** prime rate

	Exchange rates, eop							
	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
China	6.90	7.00	7.10	7.05	7.00	6.95	6.90	6.85
Hong Kong	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
India	72.0	73.0	74.0	73.5	73.0	72.5	72.0	71.5
Indonesia	14200	14600	14800	14700	14600	14500	14400	14300
Malaysia	4.10	4.20	4.30	4.25	4.20	4.15	4.10	4.05
Philippines	53.0	54.0	55.0	54.5	54.0	53.5	53.0	52.5
Singapore	1.38	1.40	1.42	1.41	1.40	1.39	1.38	1.37
South Korea	1140	1160	1180	1170	1160	1150	1140	1130
Thailand	32.0	33.0	34.0	33.5	33.0	32.5	32.0	31.5
Vietnam	23200	23300	23400	23350	23300	23250	23200	23150
Australia	0.70	0.68	0.66	0.67	0.68	0.69	0.70	0.71
Eurozone	1.10	1.08	1.06	1.07	1.08	1.09	1.10	1.11
Japan	111	113	115	114	113	112	111	110
United Kingdom	1.26	1.24	1.22	1.23	1.24	1.25	1.26	1.27

Australia, Eurozone and United Kingdom are direct quotes

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).