Countdown to Brexit: The Deadline for a Trade Deal Looms

Significant differences between the two sides remain.

July 2020

The UK formally left the European Union (EU) on January 31, but that was far from the end of the matter. Until the end of this year, the UK will remain in the Brexit transition period, during which it will no longer be a member of the EU but will continue to be subject to EU rules and will remain a member of the single market and customs union.

Negotiations over the post-transition period trading relationship between the UK and the EU have been severely curtailed by the coronavirus pandemic. However, in early June the UK declined to seek an extension to the transition period, so the December 31 deadline remains. Face-to-face meetings to discuss the post-Brexit trade deal finally began on June 29, with sources from both sides indicating that a great deal of work remains to be done before a deal can be agreed.

In the ninth of a series of updates, Quentin Fitzsimmons and Tomasz Wieladek, T. Rowe Price's resident Brexit specialists, provide an overview of the current state of play.

What Are the Potential Scenarios?

With regard to the post-transition period, we believe there are four main potential outcomes:

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1. A full trade deal
2. A mini-trade deal, covering trade in some areas but leaving other areas subject to further negotiation
3. A no-deal exit
4. A formal extension to the transition period

What Has Happened Since Our Last Update?

On March 11, on the day the World Health Organization declared the coronavirus a global pandemic, UK Chancellor Rishi Sunak unveiled the ruling Conservative Party's first budget since its victory in December's general election. In a bold move, Sunak turned on the spending taps

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> *Fixed Income Portfolio Manager*

with a GBP 30 billion package, of which GBP 18 billion was set aside to deliver Prime Minister Boris Johnson's election promise to "level up" the UK's post-Brexit economy and GBP 12 billion was targeted specifically at coronavirus measures.

Barely a week later, Sunak announced a further GBP 330 billion package of loans to protect the UK economy against the impact of the coronavirus and promised that the government would go even further if necessary. The bailout fund amounted to 15% of UK gross domestic product and sent the UK's borrowing up to levels not seen since World War II.

Negotiating a future UK-EU trade deal by the end of the transition period was going to be a huge challenge even before the onslaught of the coronavirus; with the pandemic ravaging the global economy, that task was made even more difficult. After formal discussions began in March, several further rounds of talks took place via video link before the two sides met face to face again at the end of June.

Little concrete progress seems to have been made so far, despite both sides having indicated that a deal would probably need to be in place by October to stand a chance of being ratified by the end of the year. After days of face-to-face talks in early July, UK chief negotiator David Frost said: "The negotiations have been comprehensive and useful. But they have also underlined the significant differences that still remain between us on a number of important issues."

These differences include the EU's insistence that a "level playing field" in areas such as state aid, the environment, and employment rights is maintained post-Brexit in order to prevent UK businesses from gaining an advantage over their EU-based competitors. Other sticking points include fisheries (where the EU wants continued access to British waters but the UK wants greater control) and finance (where the UK wants continued access to the EU market but the EU wants to impose strict conditions).

Based on Events Over the Past Few Weeks, What Are Your Views on the Likelihood of the Various Outcomes?

With time running out, the prospect of the EU and UK agreeing to a comprehensive trade deal covering all goods and services seems remote given the sticking points mentioned previously. At the same time, the UK government has insisted it does not want to extend the transition period beyond December 31, and while it could still change its mind, this seems unlikely given the political cost of any delay in implementing Brexit.

A no-deal exit was never an ideal outcome and has become even less attractive since the coronavirus struck. This is particularly the case for the EU given that countries such as Spain and Italy, which have been particularly hit hard by the pandemic, are heavily reliant on British tourism. While a no-deal Brexit would still hurt the UK more than the EU, the coronavirus has likely strengthened the UK's position a little.

The UK's position has also been strengthened by indications that U.S. President Donald Trump is keen to strike a trade deal with the UK. It will be difficult for the EU to bully Boris Johnson in negotiations if he has the support of the leader of the world's biggest economy. However, this may change if Trump loses November's presidential election.

In our view, the most likely outcome is therefore a mini-deal that covers trade in some goods and services but leaves difficult areas, such as fisheries and finance, subject to further negotiation.

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> *International Economist*

This would enable the UK government to claim that it has made good on its promise to deliver Brexit while providing breathing space for the two sides to negotiate on areas where agreement will be harder to achieve.

Our current estimation of the likelihood of each outcome is as follows:

A comprehensive deal covering all goods and services	10%
A mini-deal covering some areas but leaving others subject to further negotiation	65%
A formal extension to the transition period	5%
A no-deal Brexit	20%

What Are the Current Prospects for UK Financial Assets?

Stocks: The performance of UK stocks has been driven by the coronavirus since February. However, while the S&P 500 Index has recovered to within 10% of its pre-crisis level, the FTSE 100 Index remains just under 20% below its level prior to the crisis. This leaves scope for UK stocks to rebound significantly, and there is plenty of government stimulus in the system to support this. Therefore, it is likely that the UK stock market will perform well over the next few months if fears over the coronavirus abate and there are signs of progress in Brexit negotiations.

Fixed income: The UK bond market is more difficult to call. Gilt yields remain extremely low despite a huge expansion in issuance, suggesting that investors are not yet too concerned about the huge debt the UK government has taken on to tackle the coronavirus crisis. However, the economy could take a hit in the autumn when government support for jobs and businesses is wound down. At the same time, the government apparently remains committed to its ambitious post-Brexit spending plans. That is a lot of debt to take on at a time when the economy may be very fragile, which could dent investor confidence in gilts, pushing yields higher.

Sterling: Like stocks, sterling has been heavily affected by the coronavirus crisis, especially so given the fact that the UK has been the worst-hit country in Europe. As such, the currency remains undervalued and is likely to rebound at some point. How quickly this occurs will depend on the government's progress on getting on top of the coronavirus and the direction of UK-EU trade negotiations. If there is positive news in both these areas, sterling should appreciate; if there is a second wave of the virus and/or trade talks go badly, the currency's recovery will take longer. The likelihood that the coronavirus crisis in the U.S. will get worse before it gets better will likely strengthen sterling against the dollar.

What We're Watching Next

We will continue to closely monitor UK-EU negotiations for any indications of how much progress is being made. Although both sides have suggested that a deal would need to be agreed upon by October to be ratified in time to implement on January 1, in reality discussions may drag on until the last minute, with any deal agreed to being transitional until backed by law at a later date. The strong probability of brinkmanship on both sides means that a continuation of negotiations until the end of December is a very real possibility.

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