ARTICLE

For professional investors

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ROBECO
The Investment Engineers

UK triggers Brexit and starts divorce talks with EU

Léon Cornelissen, Chief Economist

- British PM finally sends EU letter informing of intention to leave
- Three issues likely to dominate two years of tough talks
- Pound set to weaken further though no major market impact

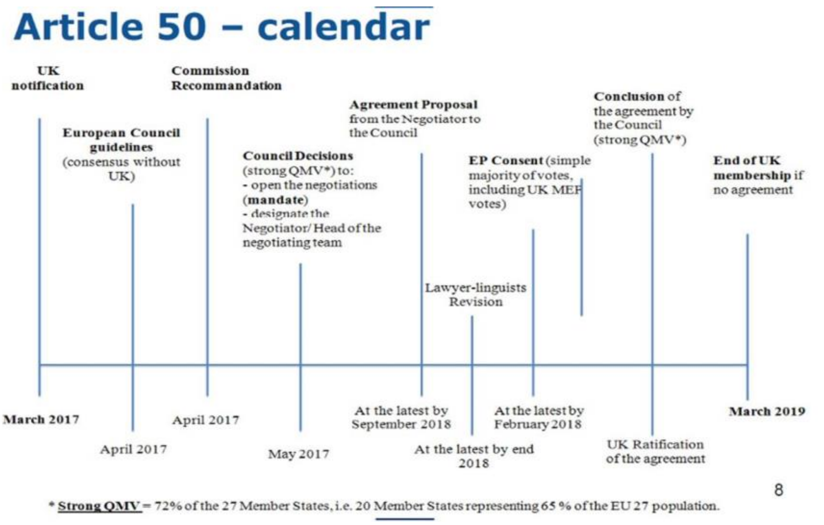
The UK government finally began the Brexit process for leaving the European Union, and now faces two years of tough talks.

Prime Minister Theresa May on 29 March triggered Article 50 of the Lisbon Treaty in a letter to EU Council President Donald Tusk, starting two years of divorce proceedings. Invoking the now legendary legal clause – which ironically was written by a British diplomat – had been mired in controversy since Britons stunned the world by voting to leave the EU in a referendum last June.

"Invoking it was no surprise of course after it was passed by Parliament with no strings attached, and the timing was diplomatic by waiting until after the Dutch elections and the Treaty of Rome anniversary," says Robeco Chief Economist Léon Cornelissen.

"However, the two-year timeframe will work against the UK. Tusk has said he will present negotiating guidelines within 48 hours, and the EU will need to give a full mandate for the negotiating stance at its Council meeting on 29 April – which falls in-between the two legs of the French presidential elections – and that will give us some indication as to how tough the stance of the EU will be."

'The EU first wants to get the divorce payments settled'



A bumpy two years lie ahead. Source: Vocal Europe.

"It's also important to note that UK is obsessed with Brexit but for Germany this is just a sideshow – they're much more interested in keeping the rest of the EU united while also worrying about Russia, China and the US. So I would expect the EU to adopt a tough negotiating stance in the interests of maintaining EU unity."

Cornelissen says he expects three issues to dominate the negotiations:

- •The cost of divorce proceedings as the UK settles legal liabilities
- •A trade agreement that implies the UK is outside the Single Market
- •Establishing the status of UK expats living in the EU, and vice versa

"The UK has net liabilities to the EU estimated at 60 billion euros to be paid as divorce terms, including things such as structural commitments to eastern Europe and the pensions to be paid to EU civil servants for which the UK is partly liable," Cornelissen says.

"The EU first wants to get the divorce payments settled, and then negotiate a trade deal, while the UK wants to do this with parallel negotiations, which probably won't be allowed. Any trade deal will very difficult to negotiate: leaving the Single Market and going back to using WTO rules would be highly unfavorable to the UK."

"But given the priority that the UK government gives to controlling immigration, it's hard to see how the UK won't lose access to the Single Market in one way or another. The EU will present red lines about things that aren't open to negotiation, such as over the free movement of people. So any deal would imply future tariffs on UK products exported to the EU."

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Expats expatriated

Meanwhile, there are 1.2 million UK nationals living in the EU – including over 300,000 in Spain – and 3.3 million citizens of EU member states living in the UK. Around one-third of all British expats in the EU receive UK state pensions.

'So what to do with all these people living or working abroad?'

"So what to do with all these people living or working abroad, including all the 'pensionados' in Spain?" asks Cornelissen. "The ongoing uncertainty has already led to labor shortages in some sectors in the UK, such as the hospitality industry, as EU nationals go back home against the backdrop of a strengthening EU economy."

And as the EU economy strengthens after years of stagnation, Cornelissen says the UK economy is becoming adversely affected by the weakness of the pound, which has fallen by 15% against the euro and US dollar since the original Brexit vote.

"The most recent figure for March was headline inflation of 2.3%, above the 2.0% target of the Bank of England, as the weak pound means higher import prices which are now feeding through," he says. "The Bank isn't in a hurry to hike rates because of the negative impact on growth now that Article 50 has been invoked. Rising inflation will damage household income in the UK, and there's already been a weakening of the UK real estate market."

Cornelissen says extending the negotiating period beyond April 2019 would be difficult because it would clash with European parliamentary elections due the following month. "This would make it doubly arcane as you would run into problems over whether the UK could field candidates. And such a deadline extension would need to be agreed by the other 27 states, and it's hard to see them allowing it."

Pound set to weaken

Triggering Article 50 is already priced in to financial markets, so the longer-term focus will be on how the negotiations develop, with the pound set to weaken further, says Lukas Daalder, Chief Investment Officer of Robeco Investment Solutions.

"This process has been well flagged and under normal circumstances should not have any market impact in the short term, though there might be a small risk of 'buy the rumor, sell the facts' with the unwinding of speculative positions as the process unfolds," he says.

"The general outcome is a weakening of both the UK and EU on the world stage, so this does mean that if investors have high exposure to UK domestic demand or EU exporters, there's a clear risk going forward. This is already reflected in most stock markets, which have priced in a discount linked to the whole Brexit process, and also to the French elections and other potentially destabilizing events. In the longer term though, we see the pound weakening further."

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