

# Managing the rising risk of a no-deal Brexit: Global Britain or Little England?

A paper from Invesco's Global Market Strategy Office

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Invesco's Global Market Strategy Office analyses a range of Brexit scenarios: No-Deal risk is high and rising; early elections are possible but may not prevent a no-deal Brexit on 31 October and the UK itself may eventually split. Uncertainty will continue to depress UK growth, gilt yields and sterling. We prefer non-UK assets, including UK equities exposed to overseas earnings.



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## Summary

- **The new, now twice-extended Brexit drop-dead date is 31 October 2019;** and further delays are possible to accommodate an early general election.
- **The risk of an eventual no-deal Brexit is rising by the day and divining the implications of Brexit is crucial** for both the UK economy and financial markets, the Eurozone (EZ) and the wider world, in our view.
- **New Deal or No Deal!?** The UK's approach to Brexit has changed radically under new PM Boris Johnson. He is shifting both the domestic discourse and dialogue with the EU from tweaking the existing deal that repeatedly failed in Westminster, toward a fundamental reboot. By making new negotiations contingent on re-opening the Withdrawal Agreement to remove the Irish "Backstop" (an insurance policy to avoid the re-emergence of a national "hard border" on the island of Ireland) – a non-starter for the EU – he risks a no-deal Brexit.
- **The odds of an early election are rising sharply** because of Johnson's wafer-thin majority in Parliament and resistance in Westminster to a no-deal outcome. We would expect the EU to accede to any UK request to further delay the Brexit deadline to accommodate an early election, in the hope of a new UK approach. However, it is possible that the election would occur after the UK leaves the EU on 31 October.
- **Any campaign during a pre-Brexit election would be fought primarily on the battleground of Brexit,** today's defining UK political issue. It could also prove to be an existential risk to the UK: Brexiting from the EU might also entail eventually exiting from the union of Great Britain and Northern Ireland. Johnson may end up as the last PM of the UK as we know it...
- **The Brexit train could conceivably rush headlong towards a no-deal Brexit on Halloween or come to a shuddering halt with another extension and election.** We expect this persistent uncertainty to weigh on business and consumer confidence, imposing a sustained drag on investment, big-ticket consumption and growth in both the UK and EZ, amid rising UK recession risk.
- **Beyond these Brexit event horizons lie profound questions of where UK politics and policy are headed,** including the EU relationship; the US "special relationship"; the financial and economic relationship of London with the rest of the world; as well as internal UK relationships – of England with the other countries of the Union.
- **We therefore expect renewed downward pressure on sterling, gilt yields and UK domestic equities and would prefer global bonds and UK globally-oriented equities.** The Brexit uncertainty, as a microcosm of unsettled global economic and financial inter-relationships, is likely to reverberate throughout the world.



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## Revisiting Brexit Britain, Global Britain ... and Little England

In recent years, the United Kingdom has delivered repeated political earthquakes and aftershocks, following decades among the most politically stable economies. The market consensus is that these disruptions are idiosyncratic, arising from a mix of domestic political/economic issues and interlinkages with the EU. With the UK a modest contributor to global growth, serving mainly as an entrepot for global capital flows and foreign direct investment into the EU, most observers expect little direct global impact from Brexit, despite major cyclical and structural downside risks for the UK itself.

Though true of the direct global impact of Brexit, we believe such an outlook underestimates what Brexit means. Political shifts in the UK find echoes in the US and across the EU. They also reflect worldwide political, policy and economic themes, spanning cross-border migration, trade and investment. Brexit has UK particularities but is also a signifier of worldwide shocks.

In what follows, we first concentrate on political shifts in the UK and examine potential Brexit scenarios, with financial market implications. We conclude with an analysis of the UK in worldwide economic and political systems and look at how the Brexit phenomenon could propagate beyond the UK.

### Political shift 1: New Deal or No-Deal, "Do or Die"?

According to current plans, the UK will exit the European Union on 31 October 2019. The actual time available to the UK parliament is closer to six weeks, given the 25 July – 3 September parliamentary recess, the UK political party conference season (second half of September) and the next EU Summit on 17-18 October.

Sterling and gilt yields have recently fallen toward multi-decade lows as markets price in the rising likelihood of a no-deal Brexit, a risk seemingly elevated by the selection of arch-Brexiter Boris Johnson as Prime Minister (see figure 1). The UK's new Prime Minister has set out three priorities, which are likely to impact UK growth and financial risk premia for several quarters to come, if not longer:

1. Deliver Brexit by 31 October;
2. Pressure the EU to give ground on the Northern Ireland backstop (see box "Backstop Background" on page 3).
3. Prepare for no-deal, both to persuade the EU that he is serious and in case no agreement is reached.

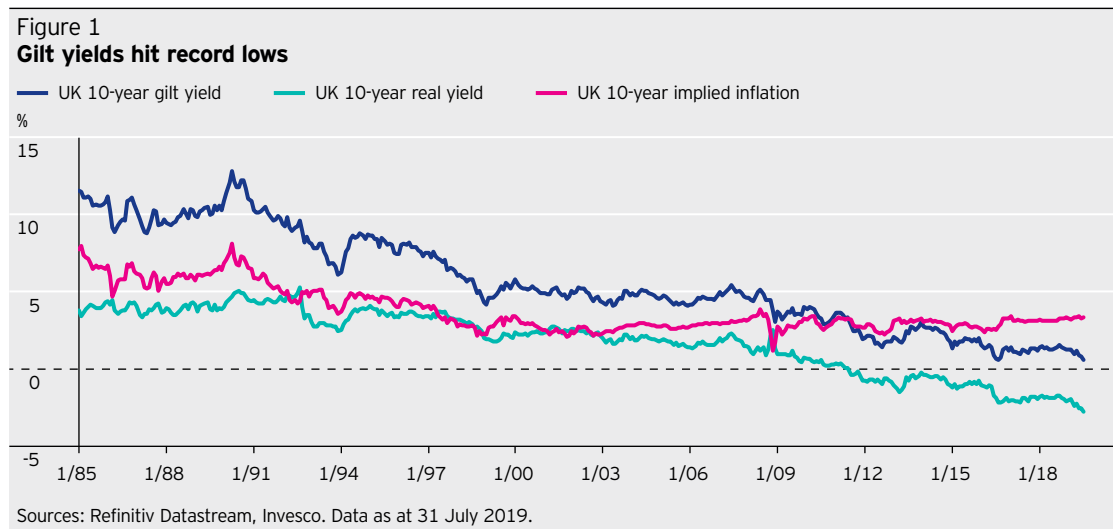
Investors can expect a new, perhaps noisier flurry of Brexit activity between now and Halloween. Not only is Johnson setting up for a showdown with the EU – he says he will not negotiate if the Irish backstop is not removed, while the EU says that is not possible – he is also quietly preparing the stage for a general election, in the event he loses a parliamentary lack-of-confidence vote in September.

Johnson currently wields the slimmest of parliamentary majorities – just one vote, even including the votes of Northern Ireland's Democratic Unionist Party (DUP) that come with the "confidence and supply agreement". The DUP is strongly committed to keeping Northern Ireland within the union of the United Kingdom. This slim majority may persuade him to call an election in the hope of securing a workable majority but we doubt he will do this voluntarily and certainly not until after Brexit has been delivered.

More likely, we believe, is that parliamentary opponents of a no-deal outcome will launch a no-confidence vote in early September, in an attempt to bring about a change of government via an election. However, this is not guaranteed to succeed in blocking "no-deal": the timing of any election would likely be the choice of Prime Minister Johnson and he could conceivably choose a date on or after 31 October. Opponents are no doubt also seeking a legislative way to block a no-deal outcome but, as of now, we are not aware of any available mechanism.

In the best Brexit – and wider EU – tradition, kicking the can down the road remains a possibility, despite Johnson's "do-or-die" commitment to Brexit by Halloween. Any extension beyond 31 October would run into the complication of changes to EU and Eurozone (EZ) leaderships. Halloween is Mario Draghi's last day as President of the ECB; he will handover to Christine Lagarde, former head of the IMF and Finance Minister of France. We agree with the consensus view that Lagarde is likely to maintain Draghi's dovish tilt, which we suspect will result in more support for financial markets before the end of 2019.

At the same time, Ursula von der Leyen, former Defence Minister of Germany, will take over leadership of the new EU Commission. Though a pro-EU federalist, she has hinted at a slightly more accommodating stance towards the UK. However, we do not expect the EU to re-open negotiations on the backstop within the Withdrawal Agreement (WA,



### **Backstop Backgrounder: Answers to the Northern Ireland question may affect the UK's global role**

The "backstop" is another crucial layer of Brexit with political and economic import. It was designed as an insurance policy to avoid the re-emergence of a "hard border" on the island of Ireland, in line with the 1998 Belfast Agreement (also known as the Good Friday Agreement). As originally proposed by the EU, Northern Ireland would have remained within the EU customs area and subject to Single Market rules. However, the UK Government objected since that would have required imposing customs and regulatory checks within the union of Great Britain and Northern Ireland. Instead, Theresa May proposed a temporary UK-wide customs territory (to which hard-line Brexiteers objected) and continued regulatory alignment between Northern Ireland and the EU (to which the Democratic Unionist Party objected).

Despite the harder line of the new UK Government, there is no indication that the EU will give way on the backstop; like the UK and Ireland, it is a guarantor of the Belfast Agreement. US support is also central - President Clinton intervened directly in the Northern Ireland peace process and dispatched a special envoy to chair the crucial negotiations. The US-UK "special relationship" involving security and intelligence cooperation would probably not be undermined, given the almost continuous synchronisation of security policy, intelligence gathering and sharing operations, which by all accounts has not even been affected by UK prevarication on Huawei, despite Trump Administration warnings. Even so, more pedestrian issues likely including sections of a post-Brexit US-UK trade deal might face higher hurdles and require deeper UK concessions, given bipartisan US Congressional support for peace and stability in Ireland, a reflection of concentrations of Irish-American voters in many voting districts. Nevertheless, the Johnson cabinet has discussed re-imposing direct rule over Northern Ireland in a no-deal Brexit scenario.

Boris Johnson seemingly intends to rebalance from Europe to focus on the US special relationship, post-Brexit, so it is conceivable that a post-Brexit UK will shift away from the recent constructive ambiguity over Huawei or other trade issues and move closer to the US position in order to fortify the special relationship. Such a shift might improve US-UK relations but could come at further cost to the UK's role as a global intermediary in the traded goods sector between the world and the EU, as well as to the role of the City of London as a global financial intermediary, vis a vis both the EU and China.

If these risks materialise, they would justify a lower equilibrium fair value for sterling and possibly higher risk premiums for UK domestic equities and gilts, since the UK would very likely need to run lower trade and current account deficits, given lower investment inflows into the traded goods and services sectors, in turn implying lower potential growth. Inflation might run higher if a combination of immigration, trade and investment barriers did materialise - consistent with the Brexit narrative - and if UK governments of the future tried to run policy "hot" to sustain accustomed growth rates, pointing to potentially higher gilt yields.

a legally binding international treaty that would settle the terms of Brexit), though changes remain possible on the "Political Declaration" - the non-binding statement of intent about the future relationship.

The only certainty is uncertainty (we fear). Accordingly, the UK economy appears set to suffer further declines in business and consumer confidence, with the risk of corresponding weakness in investment and consumer spending.

### **Political shift 2: From playing a weak hand crisscrossed with red lines, to playing poker with fire?**

Boris Johnson's words and actions point to a Brexit reboot, comprising a de facto "New Deal or No-Deal" Brexit ultimatum to both the EU and Westminster. If his Brexit strategy is blocked and Johnson is forced to choose between the two, we would expect another early election rather than a second referendum to establish a new personal and party mandate to renegotiate Brexit in a meaningful way - or realise a no-deal Brexit in 2020. Our thought process follows.

Former UK PM Theresa May, Johnson's predecessor, tried the impossible: to reconcile the views of Remainers and Brexiteers by trying to minimise damage to the traded goods and services sectors, while protecting the integrity of the United Kingdom via the backstop and securing sovereignty over trade in goods and over immigration. Compromise may have been a rational and honourable approach, but it repeatedly proved untenable.

Johnson, on the other hand, seems to be pursuing policies and using rhetoric that demand the EU change the terms of Brexit or accept an immediate

and hard no-deal Brexit. We doubt the EU will bend to that demand, which gives rise to the possibility that Remain-backing MPs will table a no-confidence vote and an early election. The EU would no doubt be willing to grant another Brexit deadline extension under such circumstances but it may not be given the chance if the election date falls after 31 October.

We suspect the outcome of any such election would depend upon whether it occurred before or after Brexit. If it happens after Brexit it would likely be dominated by the immediate fallout from Brexit, but the Brexit Party would no longer be a risk to the incumbent Conservative Party. Nor would there be any sense in a "Remain" coalition. Hence, we suspect it would be a three-way battle between Johnson, Jeremy Corbyn and Jo Swinson (the new leader of the Lib Dems). We suspect the Conservatives would win the largest number of seats but perhaps without a working majority (the Scottish National Party would remain a force, with Scotland pressing for independence - see below).

If the election were to occur before Brexit, then it would likely be dominated by that one issue. Nigel Farage and the Brexit Party would still have a voice and the outcome could depend critically upon whether some form of electoral arrangement between Farage and the Conservatives were to be reached. At the same time, the Brecon and Radnorshire by-election showed that Remain supporting parties could work together to good effect but whether they could (or would) include Labour in any such arrangement is far from certain (as is Labour's attitude to any such approach). In all likelihood, the major parties would choose to fight the election on their own merits and the outcome is far from certain.

Boris Johnson may be confident that he could win a pre-Brexit election, thereby winning enough of a mandate to persuade the EU to change its negotiating stance. However, allowing himself to be pushed into such a gambit would be risky: first, the EU may not back down and, second, he may not win the election, with a Corbyn led-government still an outside possibility (perhaps supported by Remain parties such as the Lib-Dems and the SNP).

It is also a risky strategy in light of the results of the Brecon and Radnorshire by-election on 1 August, in which the Remain-supporting Lib Dems took a relatively safe Tory seat (previous majority 8000+), in a Welsh constituency that had voted 51.9%/48.1% in favour of Brexit (according to data compiled by Dr Chris Hanretty of the University of East Anglia). Admittedly, the margin of victory was narrow, despite the Conservatives having the dual handicap of splitting the Brexiteer vote with the Brexit Party and of the Tory candidate being the previous MP who had been removed for an expenses-fiddling scandal. This election was thus highly idiosyncratic and it may be unwise to see it as a sign of a renewed Remain/centrist wave for the Lib Dems or a sign of things to come for the Brexiteer-led Conservatives (the combined vote for the Tories, Brexit Party and UKIP was 50.3%).

Either way, both the wafer-thin Tory parliamentary majority and the uncertain narrative being told by opinion polls, heighten the stakes for all key players – Brexiteers, Remainers and the EU. Johnson cannot expect a superficial tweak on the Irish Backstop to keep Tory Brexiteer MPs onside, whereas Remainers will continue to push for a second referendum in the hope of reversing Brexit. The UK tea leaves thus point to further confrontations in Westminster and, potentially, another bruising Brexit election campaign.

What's more, if and when it comes, the campaign could end up dividing the UK not just along the fault line of Brexit but also between the nations of the UK. Scotland remains a heartily Remain country, as does Northern Ireland, while Wales voted to Leave. England, beyond London and some other mainly metropolitan areas, remains in favour of Brexit. Generational divides may also come to the fore but the voting population is not expected to have aged enough to tilt the voting scales decisively towards Remain for another few years (we reckon the crossover would come by 2022 if everybody who voted last time were to vote again in the same way). Brexit might be easier to get done after a clear election result but managing the country afterward might be more difficult.

Along the way, financial markets would probably take further fright as the economy takes another leg down. The silver lining could be a shift towards a more liberal Britain in the event of a strong Tory performance that would help offset – or possibly outweigh – the rise in trade barriers with the EU. The downside risk is the possibility of a shift to a hard-left government should Labour win big either in an early election or in a later, post-no-deal Brexit, election. Hence, we fear that, politically, uncertainty is the only certainty...

### **Political shift 3: From United to Untied Kingdom? Fragmentation risk rising – Northern Ireland more than Scotland**

The UK chattering classes worry that Johnson may be the last PM of the United Kingdom as we know it – a fear we share. Market participants, firms and governments worldwide – including central bank reserve managers – need to consider the rising risk

of a UK break-up because both the Brexit referendum and its aftermath have exposed profound divergences of view among the four constituent nations of the United Kingdom of Great Britain and Northern Ireland. We see a higher chance that Northern Ireland would break off from union and join the republic of Ireland than of Scottish secessionism, for a variety of political and economic reasons.

A no-deal Brexit (without a solution to the Irish border problem) could in years to come force Northern Ireland to make a choice between being part of the United Kingdom outside the EU or becoming part of a united Ireland within the EU. Such a referendum, if not the precise circumstance, was envisaged in the Good Friday Agreement: if a sufficient proportion of the Northern Irish population wished to unite with the Republic, a poll would be held (opinion polls over the last 12-months suggest that such a referendum would be finely balanced). Of course, the final decision on calling such a referendum rests with The Secretary of State for Northern Ireland, that is with the British government.

It is also widely said that a No-Deal Brexit could lead to a second independence vote in Scotland (opinion polls in recent months suggest a narrowing of opinion versus the 2014 55%/45% vote against independence). We agree that this is a major risk that should also be factored into expectations about economic performance and financial assets but think it is less probable than for Northern Ireland: Scotland has already held an independence referendum; and an independent Scotland could not immediately be admitted to the EU (it would have to go through the usual, lengthy, accession process). Were the EU to treat Scotland as a special case, it could set an uncomfortable precedent for other breakaway regions of EU and EZ members, such as Catalonia.

Furthermore, Scotland is a major recipient of fiscal transfers from the rest of the United Kingdom, mainly England; these must either be replaced, which is inconceivable under the current EU / EZ framework, or there would need to be a major adjustment in the operation of the Scottish budget and welfare state.

We therefore believe that the risk of the UK breaking up is tangible and that it should be factored into the outlook for the UK over the coming years, especially if there is a no-deal Brexit or even a Brexit with a transition that makes a hard border more likely on the island of Ireland. That said, we find the risk of Scottish independence to be meaningfully lower. Nevertheless, coming on top of the shorter-term disruption implied by a No-Deal Brexit, these risks point to a difficult time ahead for the UK economy, and by extension for sterling and so-called “risk assets”.

### **Policy shift: From monetary and fiscal restraint to easing all around?**

The Bank of England's Monetary Policy Committee meeting on 1 August left rates unchanged as it presented new forecasts pointing to lower growth and acknowledging the difficulty of estimating the economic costs of a no-deal Brexit. This holding pattern and scenario uncertainty comes despite the BOE signalling for months that it was considering a gradual rise in interest rates to stop inflation rising above its 2% target, even as market participants had priced in at least 25bps worth of cuts by the end of the year.

We agree with the market that the BoE will join the global easing fray – if anything with greater gusto than other major central banks (the US Federal

Reserve now figures among 37 central banks that have cut rates during 2019). Mario Draghi, the ECB President recently said that the uncertainty over Brexit negotiations and global trade will likely cause the ECB to provide further stimulus (we expect a cut in policy rates that are already negative and a reintroduction of quantitative easing via asset purchases, both later this year).

We believe the BoE had signalled readiness to tighten monetary policy to discourage excessive speculation against sterling, whose depreciation episodes have been accompanied by surges in inflation. It is true that a no-deal Brexit could precipitate a “stagflation” shock, in which both aggregate demand and aggregate supply suffer, leading to further downward pressure on growth and upward pressure on inflation. Such shifts are arguably already occurring in the UK economy because of the uncertainties of Brexit and the successive downward legs in sterling, which result in “imported inflation”.

We believe the short-term threat to the UK economy would come from a combination of demand and financial conditions shocks. In addition, long-term growth potential would be threatened by the damage to investment. Our fear is that a no-deal Brexit could precipitate a potentially severe recession, during which we would expect the BOE to ease (and therefore be willing to look through any depreciation-driven inflation as a temporary effect – just as it did after the Global Financial Crisis and the Brexit referendum).

If the chances of a no-deal Brexit rise in the coming months, the Bank of England still has considerable ammunition in its monetary policy toolkit to combat any negative economic shock, even though at 0.75% the policy rate is historically low (the financial crisis was the first time since its inception in 1694 that the BOE had taken its policy rate below 2%). Gertjan Vlieghe, a member of the BOE’s Monetary Policy Committee, recently said that interest rates could be cut to nearly zero if Britain leaves the EU without a deal. At or near zero, we would expect the BoE to also resume quantitative easing but not to cut rates below zero (unlike the ECB, SNB or BOJ), given the additional challenges that negative rates can impose on the financial system. We would expect the BOE to again focus its QE activity on purchases of gilts.

Moreover, the Johnson government appears to be gearing up for important increases in public spending as part of no-deal Brexit preparations. The idea

seems to be to address the direct fallout from Brexit, to provide fiscal stimulus and perhaps even direct public spending to issues highlighted by the Brexit referendum, such as regional and socioeconomic inequality. And of course, any looming early election...

We believe the downward pressure on sterling and gilt yields reflects all the above – the rising chances of a no-deal Brexit, the likely negative effect on the UK economy and a significant easing in both monetary and fiscal policy. Accordingly, we see little reason for sterling or gilt yields to significantly rebound pending clarification on Brexit.

UK benchmark 10-year yields are now below 0.5% (as of 7 August 2019), lower even than during the aftermath of the initial Brexit referendum. European neighbours such as France, Germany, Sweden, Switzerland and the Netherlands show that 10-year yields can go negative but real 10-year gilt yields are already -2.85%, which seems extreme (see figure 1).

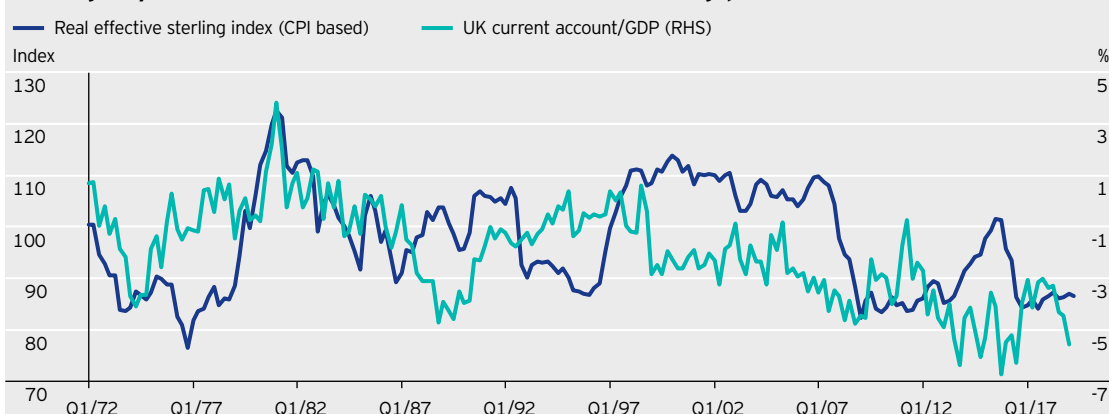
### Market implications: Rebalancing and risk-managing portfolios for a no-deal Brexit

UK/GBP-based investors seem to believe that domestic assets and currency are cheap; nevertheless, the UK current account deficit remains close to record levels (see figure 2) and is increasingly financed by the repatriation of resident holdings of foreign assets. UK investors seem to be buying from foreign investors, who appear to be divesting or at least ploughing less into the UK – very likely flip sides of the same Brexit coin. We would not be surprised to see this asset swap continue, especially if the Johnson government’s hints of economic reform and liberalisation crystallise (UK based investors may be encouraged by that while non-residents may worry about an abrupt ending of relations with the EU).

Like non-resident investors wrestling with low yielding UK fixed income assets, we are more attracted to US government debt and for even higher yields we turn to US high-yield credit and emerging market (EM) sovereign debt. Even the S&P 500 offers a dividend yield of around 2% per annum, though it is a more volatile asset class and by some valuation metrics is extremely expensive.

Rather than turn to US equities as an alternative to UK gilts, we find the 4.7% dividend yield available on UK equities (FTSE 100 Index) to be more attractive. Furthermore, FTSE 100 constituent companies are not representative of the UK economy, with most of their revenues and profits coming from overseas (the

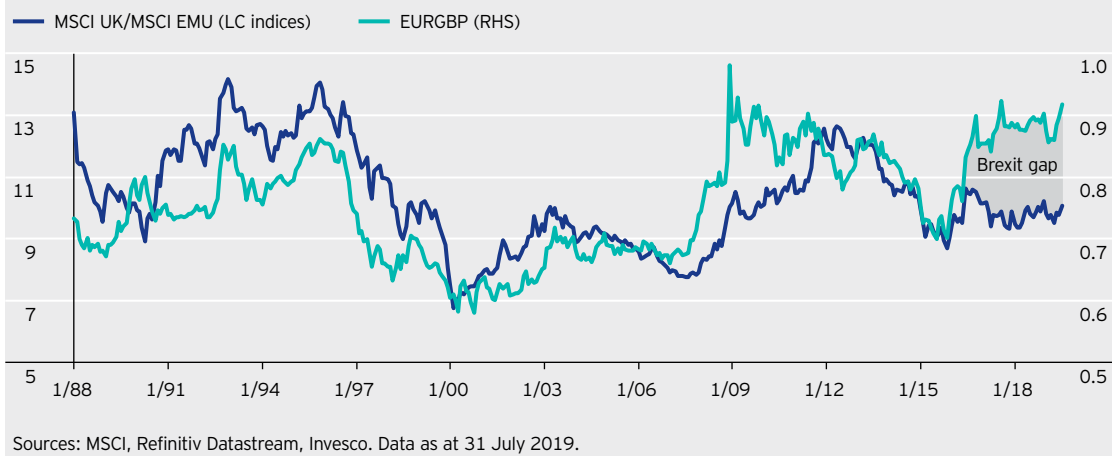
Figure 2  
**Sterling may be close to historical lows but the current account gap remains wide**



Sources: OECD, Refinitiv Datastream, Invesco. Quarterly data as at Q2/2019.



Figure 3  
**UK equities have outperformed Eurozone counterparts when sterling weakens**



translation effect into sterling is why UK equities tend to outperform other markets when sterling weakens – see figure 3 for a comparison with Eurozone stocks).

Of course, if we are buying UK equities because we believe sterling will decline, we are likely to lose more on the currency than we gain on the equities. Hence, the hedging of currency exposure becomes a valid option, in our opinion. Given that the cost of hedging is basically the interest rate differential over the period covered, we are currently paid to hedge into USD but pay a small price to hedge into euro, Swiss franc or Japanese yen. The risk of such a strategy is that sterling recovers, in which case UK equities may underperform other markets and we will enjoy no currency gain.

Another way to benefit from further declines in sterling (and concerns about the domestic UK economy), would be to take advantage of the fact that FTSE 100 companies tend to have more overseas exposure than the more domestically oriented FTSE 250. Figure 4 shows that since the 2016 referendum, the FTSE 100 has tended to outperform the FTSE 250 when sterling weakens. Using a long-short strategy is a way to capture movements in sterling via the UK equity market (long FTSE 100/short FTSE 250 has historically benefited when sterling weakens and vice-versa). Alternatively, favouring FTSE 100 when sterling is expected to weaken and the FTSE 250 when it is

expected to strengthen is a long-only way to capture this relationship.

#### Scenarios for the Brexit process and implications for financial markets

Over the coming weeks, we suspect that Brexit uncertainty will maintain the downward pressure on sterling and gilt yields, while at the same time raising concerns about the domestic economy. In such an environment, we prefer fixed income assets elsewhere (US and EM). However, the dual benefit of not being exposed to a weakening economy (if Brexit goes badly) and the negative correlation to a weakening sterling suggests to us that large-cap UK stocks are an attractive alternative to gilts (especially if hedged into USD or JPY).

Looking further ahead (toward 31 October), we consider three broad scenarios (see figure 5):

**Scenario A:** The UK crashes out of the EU without a deal on 31 October with no election (probability 10%).

**Scenario B:** The UK government loses a no-confidence vote and elections are held (probability 80%).

**Scenario C:** A new deal is negotiated with the EU and Brexit occurs in 2019/20 (probability 10%).

We prefer Scenario C to Scenario A from the point of view of the UK economy, sterling and UK risk

Figure 4  
**FTSE 100 has tended to outperform FTSE 250 when sterling weakens**

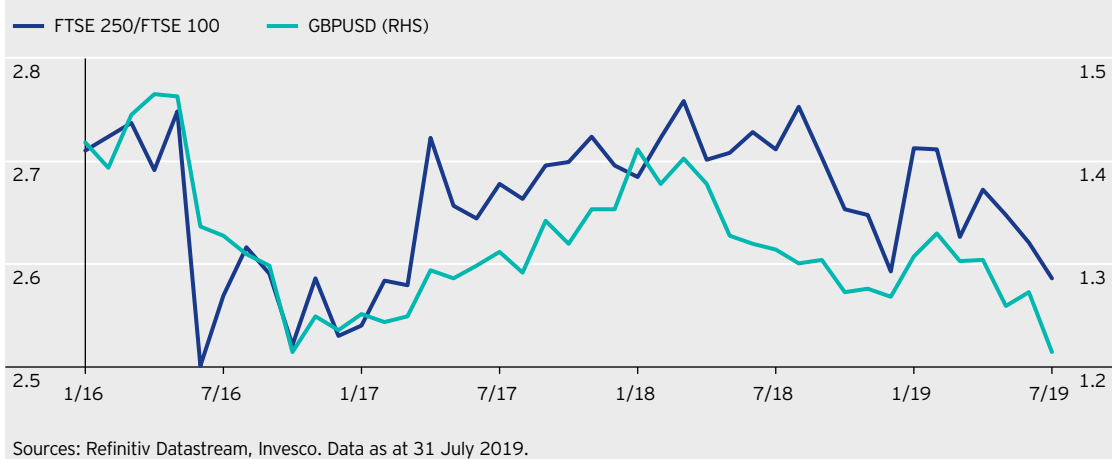


Figure 5

**Brexit scenarios: from the sublime to the ridiculous**

(subjective probabilities in parenthesis)

Scenario A	Scenario B					Scenario C
No-deal Brexit on 31 October; no election  (10%)	Government loses a no-confidence vote and elections are called (80%)  Election occurs after no-deal Brexit on 31 October (40%)	Election occurs before 31 October (40%)  Conservatives / Brexit Party win a majority (15%)	No clear majority can be formed (15%)	Remain coalition wins majority, referendum called  Leave (5%)	Remain (5%)	New deal with EU and Brexit in 2019/20  (10%)
<b>Short-term implications</b>						
<ul style="list-style-type: none"> <li>- UK recession;</li> <li>- EU decelerates;</li> <li>- GBP weakens;</li> <li>- UK inflation rises;</li> <li>- BOE eases;</li> <li>- UK fiscal easing</li> </ul>	<ul style="list-style-type: none"> <li>- UK recession;</li> <li>- EU decelerates;</li> <li>- GBP weakens;</li> <li>- UK inflation rises;</li> <li>- BOE eases;</li> <li>- UK fiscal easing;</li> <li>- Brexit Party marginalised;</li> <li>- Conservative majority more likely</li> </ul>	<ul style="list-style-type: none"> <li>- Brexit party supports Tory government;</li> <li>- No-deal Brexit on 31 October;</li> <li>- UK recession;</li> <li>- EU decelerates;</li> <li>- GBP weakens;</li> <li>- UK inflation rises;</li> <li>- BOE eases;</li> <li>- UK fiscal easing</li> </ul>	<ul style="list-style-type: none"> <li>- Uncertainty;</li> <li>- further election in 2020;</li> <li>- Brexit may still occur on 31 October;</li> <li>- UK recession;</li> <li>- EU decelerates;</li> <li>- GBP weakens;</li> <li>- UK inflation rises;</li> <li>- BOE eases</li> </ul>	<ul style="list-style-type: none"> <li>Initial relief but uncertainty about referendum outcome and then:</li> <li>- UK recession;</li> <li>- EU decelerates;</li> <li>- GBP weakens;</li> <li>- UK inflation rises;</li> <li>- BOE eases;</li> <li>- UK fiscal easing</li> </ul>	<ul style="list-style-type: none"> <li>Initial relief but uncertainty about referendum outcome (with BOE easing) and then:</li> <li>- GBP recovers;</li> <li>- UK inflation falls;</li> <li>- UK consumer spending and investment recover;</li> <li>- BOE reverses easing</li> </ul>	<ul style="list-style-type: none"> <li>- UK decelerates but less than in Scenario A;</li> <li>- GBP strengthens;</li> <li>- UK inflation falls;</li> <li>- Johnson calls general election in 2020</li> </ul>
<b>Long-term implications</b>						
<ul style="list-style-type: none"> <li>- UK supply-side reform may boost growth;</li> <li>- pressure for Northern Ireland and Scotland to leave UK</li> </ul>	<ul style="list-style-type: none"> <li>- UK supply-side reform may boost growth;</li> <li>- pressure for Northern Ireland and Scotland to leave UK</li> </ul>	<ul style="list-style-type: none"> <li>- Tension with Brexit Party;</li> <li>- possibility of new elections;</li> <li>- UK supply-side reform may boost growth;</li> <li>- pressure for Northern Ireland and Scotland to leave UK</li> </ul>	<ul style="list-style-type: none"> <li>- Depends on whether Brexit goes ahead and the outcome of the next election</li> </ul>	<ul style="list-style-type: none"> <li>- UK supply-side reform may boost growth;</li> <li>- pressure for Northern Ireland and Scotland to leave UK</li> </ul>	<ul style="list-style-type: none"> <li>- Future economic damage limited;</li> <li>- no pressure for Northern Ireland to leave but tensions would remain with Scotland;</li> <li>- the Leave campaign would continue</li> </ul>	<ul style="list-style-type: none"> <li>- UK supply-side reform may boost growth;</li> <li>- pressure for Scotland to leave UK</li> </ul>
<b>Assets we would favour</b>						
<ul style="list-style-type: none"> <li>- Non-UK debt assets (US and EM);</li> <li>- UK large-cap equities with little exposure to UK economy (FTSE 100) hedged into USD or JPY</li> </ul>	<ul style="list-style-type: none"> <li>- Non-UK debt assets (US and EM);</li> <li>- UK large-cap equities with little exposure to UK economy (FTSE 100) hedged into USD or JPY</li> </ul>	<ul style="list-style-type: none"> <li>- Non-UK debt assets (US and EM);</li> <li>- UK large-cap equities with little exposure to UK economy (FTSE 100) hedged into USD or JPY</li> </ul>	<ul style="list-style-type: none"> <li>- Non-UK debt assets (US and EM);</li> <li>- UK large-cap equities with little exposure to UK economy (FTSE 100) hedged into USD or JPY</li> </ul>	<ul style="list-style-type: none"> <li>- Non-UK debt assets (US and EM);</li> <li>- UK large-cap equities with little exposure to UK economy (FTSE 100) hedged into USD or JPY</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- UK assets, especially domestically exposed companies (FTSE 250);</li> <li>- no currency hedges out of GBP</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- UK assets, especially domestically exposed companies (FTSE 250);</li> <li>- no currency hedges out of GBP</li> </ul>
<b>Assets we would avoid</b>						
<ul style="list-style-type: none"> <li>- GBP;</li> <li>- small &amp; mid-cap UK equities with large domestic exposure (FTSE 250)</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- small &amp; mid-cap UK equities with large domestic exposure (FTSE 250)</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- small &amp; mid-cap UK equities with large domestic exposure (FTSE 250)</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- small &amp; mid-cap UK equities with large domestic exposure (FTSE 250)</li> </ul>	<ul style="list-style-type: none"> <li>- GBP;</li> <li>- small &amp; mid-cap UK equities with large domestic exposure (FTSE 250)</li> </ul>	<ul style="list-style-type: none"> <li>- Large-cap equities with overseas exposure (FTSE 100)</li> </ul>	<ul style="list-style-type: none"> <li>- Large-cap equities with overseas exposure (FTSE 100);</li> <li>- Gilts</li> </ul>

Source: Invesco. For illustrative purposes only.

assets. However, Scenario B is more difficult to categorise (we describe four sub-scenarios that have very different outcomes).

Figure 5 makes it clear that we believe the most likely outcome over the short-medium term is even weaker sterling, BOE easing, lower gilt yields and poor UK equity market performance, with overseas earners outperforming domestically oriented stocks (in index terms we would favour FTSE 100 over FTSE 250).

The outlook is complicated by the fact we believe UK assets have already priced in a lot of the bad Brexit news:

- By historical standards, the BOE is already very accommodative. First, the policy rate is 0.75% (a rate never seen prior to the financial crisis). Second, the BOE balance sheet is 23% of GDP (as of the end of 2019 Q1), below the 2018 peak of 28% but well above the 8% average that prevailed between WW2 and the financial crisis (see figure 6). Nevertheless, we expect the BOE to cut rates to close to zero in hard-Brexit scenarios and to resume gilt purchases. There could be some positive economic effect from this (especially from a UK household sector hooked on credit) but we doubt it would be enormous. We suspect a fiscal boost would be more effective.
- Gilt yields are at historical lows (see figure 1) but could go lower under the pressure of BOE purchases, perhaps into negative territory. However, real yields are already extremely negative and the risk of higher inflation (from sterling devaluation) could restrict/reverse any further downward movement in yields.
- Sterling is close to historical lows (figure 2 shows that in real trade-weighted terms it was only ever significantly lower during the sterling crisis of the mid-1970s when the UK needed help from the IMF). Versus the US dollar, it is now very close to the post-referendum low of 1.20. We suspect that confirmation of a no-deal Brexit would push GBPUSD (cable) into the 1.10-1.20 range but doubt that it would reach the all-time low of 1.05 seen when the dollar was extremely strong in 1985. Over the medium-to-long term, we expect cable to be centred around 1.40 (versus the 1.50-1.60 that we might have expected without Brexit).
- UK equity valuations are attractive, in our opinion, and figure 3 shows that UK equities have not benefitted as much as might have been expected

from the post-referendum dip in sterling. However, we suspect that fear of recession will depress domestically-oriented stocks in the event of a no-deal Brexit.

- It is possible that a no-deal Brexit would allow the UK to embark on deregulation and supply-side reform. This, along with new trade deals with non-EU countries, could improve long-term growth potential. However, offsetting those forces would be the negatives of lower current investment spending and the lower immigration flows that partly motivated the Brexit vote. If the net effect of all of this is positive, we fear it would too far into the future to impact financial markets over the coming year or so.
- Though UK assets would suffer the most from a hard-Brexit outcome, the suffering would spread. We would imagine the following hierarchy of vulnerabilities:
  - high: UK and Ireland
  - mid: rest of EU (especially those with close ties to UK, such as the Netherlands and auto companies)
  - low: rest of World

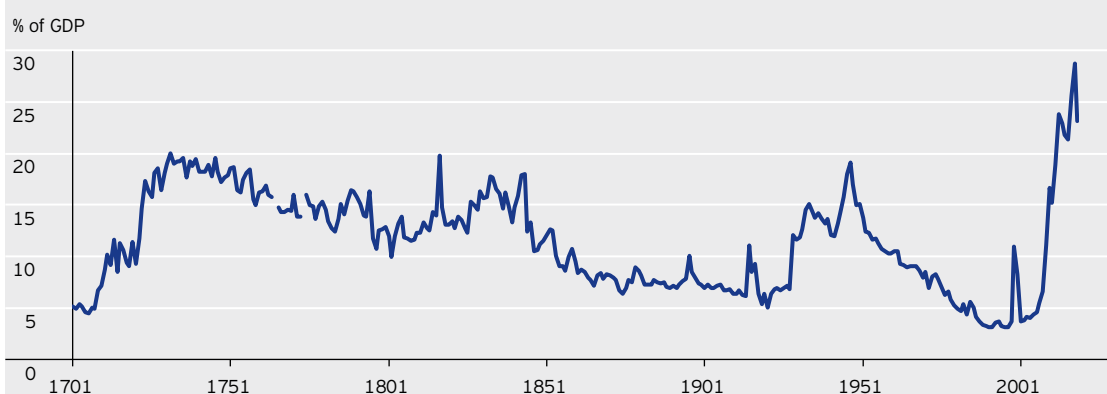
### Brexit calling: the broader global implications

Both the general themes and specifics of the Brexit referendum earthquake continue to reverberate throughout the world in the new protest politics gripping many countries: internal socio-economic divergences and inequality; the desire to “take back control” of national or local policies from supranational institutions like the EU, WTO or IMF, market forces or national capitals; dislocations due to globalisation, financialisation, immigration and technology.

The standout commonality is societal political pressure to shift the focus of policy away from growing the pie and lifting the average toward distribution, even at the cost of growth. Such a shift would tilt the balance of economic management from central banks to the more directly politically accountable institutions of state.

Consider the UK's front-and-centre role in globalisation – a factor which far from preventing Brexit seems to have precipitated it. The UK is among the most open major economies in the world: of about 65 million residents in 2018, more than nine million were born outside the UK or are not UK nationals (UK Office for National Statistics). The stock of FDI stands at about two-thirds of GDP (OECD data for 2018) in the world's sixth or seventh largest economy (depending

Figure 6  
**Bank of England Balance Sheet as % of GDP (1701-2019)**



Note: annual data (2019 ratio based on BOE balance sheet as of end-March 2019 and GDP in the four quarters to Q1/2019). Sources: Bank of England, UK Office for National Statistics, Hills, Thomas & Dimsdale, Refinitiv Datastream, Invesco.



on the value of sterling, based on IMF forecasts for 2019). The financial-sector balance sheet stands at over 370% of GDP (according to BOE data for monetary financial institutions as of 30 June 2019, using 2018 GDP from the UK ONS). Indeed, the UK can be characterised as the world's most important offshore hub of financial, corporate and human capital - with a G7 economy tacked on.

What's more, during the era of globalisation and liberalisation, the UK went from being the "the sick man of Europe" that needed an IMF bailout in the 1970s, to a leader in G7 growth performance, policy innovation and global impact by the 2000s. Not only did these factors fail to prevent the 2016 referendum result, the subsequent policy debate and paralysis has hardly changed Brexit opinions (according to opinion polls), even as public support for the two leading parties has plunged. The public debate has cleaved along Brexit lines, cutting across party lines.

We expect further global impact. It's worth recalling that for generations, UK political trends have preceded the direction of US politics and economic policy with a short lead, with continental Europe following later. For starters, the UK's Thatcher revolution of deregulation, privatisation, liberalisation and breaking the grip of labour unions was followed in short order by Reagan's US supply-side revolution, a very similar economic policy framework.

In due course, many of today's so-called emerging markets emerged from the aftermath of the Soviet collapse with liberalisation, privatisation and the introduction of market forces and market prices for goods, services and financial assets across the Former Soviet bloc, India and Latin America. China's reforms began in the late-1970s but its re-integration into the world economy accelerated after the Thatcher-Reagan revolution and the Clinton-Blair centrist consensus that followed. The EU reformed similarly, led by the Hartz reforms of labour rules under Chancellor Schroeder in Germany.

After the Thatcher-Reagan era, UK politics paved the way for what had been a "right-wing" liberal revolution to become a centrist consensus. UK Labour Party leader Tony Blair, often reviled as "Tory" Blair, reinvented his leftist party as "New Labour", taking on the liberal economic, financial and trade policies of the centre-right.

In the United States, the "Clinton Democrats" were similar to the "Reagan Democrats", as politically centrist, economically liberal and socially agnostic. Democrat President Clinton who campaigned against many of the provisions of NAFTA, negotiated under the Republican President Bush, ended up pushing NAFTA through Congress and championed China's WTO accession. The global political climate of

liberalisation enabled power to change from right to left and back again with little discernible change in economic policy or economic outcomes.

The UK now seems to be in the vanguard of many socio-economic and socio-political challenges that are linking increasingly tendentious domestic politics and geopolitics across the world, with major changes to the openness of the world economy. The centrist consensus seems to have become a target of hate around the world. The centre-left and centre-right had become politically indistinguishable and associated with establishment / elite politics and outcomes, crippling the credibility of the consensus when the Global Financial and Eurozone Crises hit. Growth was robust, returns were high but the rising averages masked severe divergences in the distribution of wealth and income which are now driving policy debates.

That centrist consensus, a strong and sustained tailwind for globalisation, liberalisation and financialisation, is giving way to a fundamental reassessment, the cutting edge of which is Brexit. Thus, the UK, which was among the biggest beneficiaries of the old order, has become a pivot around a global rethink - though not yet an actual reboot - of globalisation, liberalisation and economic orthodoxy.

The issues underlying the Brexit vote and the societal divides revealed in the referendum campaign and its aftermath are hardly unique to the UK. The surprise 2016 US election of President Donald Trump came just months after the June 2016 Brexit referendum, itself a surprise in the markets and establishment policy circles.

We believe the fallout from the Brexit referendum has and will continue to radiate from the British Isles, across the European economy and to the wider world, as such political and economic impulses have done for centuries. Political shifts in economic policy tend to gather momentum into waves that sweep across many countries for long periods; indeed, we see signs of similar effects across developed and emerging markets.

The United Kingdom, having cradled the first two Industrial Revolutions of steam and electrical power, and triggered the third Industrial Revolution of computing, has helped set the tone for the relationship between labour and capital around the world across economic epochs. Now, as the Fourth Industrial Revolution takes root, largely outside the UK but with significant impact everywhere, challenging the economic and social balance between human capital and technological capital, the above analysis of the Brexit risks to the UK can be applied to the broader world.

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## Risk warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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