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Economics

Article 50: what’s next for investors?

On the day the UK prime minister triggered Article 50, beginning a two-year process that will see the country leave the EU, we find out from our economists what they expect now for the UK economy.

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Since the UK voted to leave the European Union the domestic economy has experienced a more muted reaction than expected, as has the UK stockmarket. Sterling, however, has declined.

Stronger-than-expected consumer spending has helped support the economy, while, in part, the resilience of the UK stockmarket has been the result of investor appetite for international stocks with foreign - particularly US dollar - earnings.

But now that the trigger has been pulled on Article 50, what next?

Azad Zangana, Senior European Economist & Strategist, said:

“The depreciation in sterling has largely been as expected and we are now seeing the inflationary effects of higher import prices feeding through into household inflation. We are trying to see how households will cope with this higher inflation. Real disposable incomes were growing at close to 5% at the start of last year, but by its end had actually fallen to zero as inflation picked up.

“Inflation has continued to rise and is currently at 2.3%. We forecast it to increase to up to 3.5% by the middle of this year, which implies disposable income will shrink further in the coming quarters, and should cause households to either reduce their spending or savings. As it happens, households have been reducing their savings for some time and the savings rate is as low as it was during the financial crisis. There’s very limited scope for households to cut back savings further to prop up consumption. We expect a slowdown in consumption and therefore GDP through this year.

“We expect the formal negotiations between the UK and the European Commission to begin in May this year and Michel Barnier, the European Commission’s chief Brexit negotiator, has said he thinks the deadline to complete them has to be around October 2018. In terms of the scope of the negotiations, the first area which will be debated will be the “exit bill”, the cost of leaving based on the existing liabilities of the UK. This issue does have the potential to delay negotiations on other aspects, which risks both sides running out of time to not only complete the negotiations but also to come to a fair conclusion and therefore a settlement for the UK.

“Beyond the immediate divorce proceedings, there will have to be a broad framework agreed for the future relationship. This should include a framework for trade but it will not be a trade deal. Instead, a transition agreement is quite likely between both sides which may last four or five years. Versus the current arrangement it is likely to be a step from full and free access, to something where there is going to be some restriction – maybe the UK gives up agricultural trade, in favour of the pharmaceuticals industry and financial services. There seems to be a desire to negotiate on a sector-by-sector basis, the EU will probably resist – it's unclear how the negotiations will play out.

"If no agreement is reached and they run out of time then we could find ourselves in a "Hard Brexit" situation, this would be the unilateral withdrawal from the EU, without any agreement on trade or any other aspect of the relationship. This is seen as a pretty negative outcome from pretty much all sides, except for a hardcore element within the current UK government. We believe it could potentially be quite damaging.

"Moving onto World Trade Organization rules would impose much higher tariffs than would otherwise be the case on goods. It wouldn't cover services at all, so the difficulty of exporting services would become much, much greater. And it would lead to a very poor outcome for future relations, be it co-operation on security or other elements."

Keith Wade, Chief Economist & Strategist, said:

"In terms of risks facing UK markets, we have seen the beginning of a slowdown in the domestic economy which would probably lead you to be more concerned about small caps. If Brexit negotiations are quite difficult then we could see bouts of weakness in the pound, and that would possibly provide further support for the market's overseas earners. The bigger issue is whether, in the event of political disruption for example, there was a loss of confidence in the UK and sterling. If we were to see repeated falls in the pound feed through into wages and price expectations then the Bank of England would have to tighten and I think that would create a very difficult situation for markets in the UK, particularly the bond markets."