MyStratWeekly
Market views and strategy
Ostrum
ASSET MANAGEMENT

N° 010 // **15 February 2021**

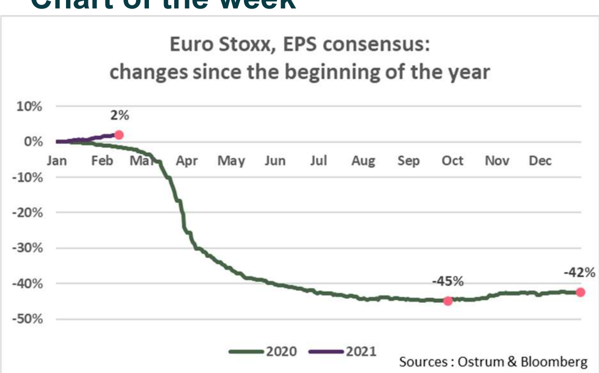
Topic of the week: The Brexit Shock

- **The United Kingdom has left the European Union since 1 January, putting an end to the free movement of people, goods, services and capital.**
- **The trade agreement concluded on 24 December does not prevent the return of customs controls at the borders, which are causing major disruptions in trade and are set to intensify.**
- **London lost its position as the leading European stock exchange to Amsterdam for lack of agreement on services, particularly financial services.**
- **Brexit is a shock to British growth with long-lasting consequences for the pound sterling.**

Market review: Equities crash higher

- **Large volumes and inflows in US equity space**
- **US yields creep higher by the end of last week**
- **Markets hail PM Draghi**
- **High yield spreads narrow further**

Chart of the week



Earnings per share (EPS) expectations collapsed last year with the Covid effect. Since the beginning of October, however, they have tended to be revised upwards, albeit slowly.

In 2021, analysts expected a 39% rebound in EPS. Again, while we are in the middle of the results season, these forecasts tend to go up slowly. Already 2% upwards revision since the beginning of the year.

One reason for market optimism is the resilience of companies' profitability. Even if these EPS revisions remain a bit meagre when compared to the performance of certain indices.

Figure of the week

30k

Source : Ostrum AM

30,000, the level reached by the Nikkei during the trading session Friday and at market close Monday. This is the first time that the Nikkei has reached this level since August 2, 1990. More than thirty years ago.

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Topic of the week

The Brexit Shock

London and Brussels reached a deal on a trade agreement in extremis to avoid the chaos of a "hard Brexit". This limited free trade agreement does not prevent the return of customs controls, which creates major trade disruptions. Beyond an immediate impact that is set to intensify, the consequences of Brexit will be long-lasting and significant for British growth.

In record time, only 9 months, London and Brussels finally managed to agree on a trade agreement on 24th December, a few days before the end of the transition period and the effective exit of the United Kingdom from the European Union. While the "Trade and Cooperation Agreement" aims to reduce the impact of the United Kingdom's exit from the single market and the customs union, this agreement covers only a limited number of areas and paves the way for a long period of negotiation.

What's in the trade agreement

A free trade agreement on goods

The main element is the free trade agreement on goods, which avoids the imposition of customs duties and quotas. However, a condition is necessary, as in all free trade agreements. In order to be exempt from customs duties, goods must comply with the rules of origin, that is, they must contain a certain percentage of components or materials manufactured in the United Kingdom and/or the European Union. This is to prevent third countries from benefiting from the agreement. This rule obliges certain companies to modify their production process by increasing the content produced locally or by relocating all or part of their production in the European Union so as not to suffer additional tariffs.

If this agreement avoids the introduction of tariffs and quotas, it cannot prevent a loss of fluidity in trade resulting from the fact that the United Kingdom has left the single market and the customs union. Since the first of January, customs controls have reappeared between the United Kingdom and the European Union. Companies must complete formalities (import declarations, export declarations, etc.).

These are more restrictive in the case of fresh products and live animals since sanitary and/or phytosanitary controls must also be carried out. Since there is no mutual recognition of the bodies responsible for these certifications, the European Union undertakes these checks in the United Kingdom. All these controls result in additional time and non-tariff costs that can significantly increase the price of a good.

Cooperation on fisheries

Access to British territorial waters, which are heavily fished, was one of the sticking points in the negotiations, while fishing accounts for less than 0.1% of British GDP. Boris Johnson made it the symbol of regained British sovereignty and the Europeans did not want a trade agreement at any cost. Finally, the European Union's fishing quotas will gradually decrease. Europeans will give back 25% of the said quotas over five and a half years, against 60% initially wanted by the British. Starting in the summer of 2026, quotas will be renegotiated annually.

Framework for competition rules

The United Kingdom and the European Union are committed to high common standards in the areas of social rights, labour rights, the environment, the fight against climate change. The European Commission has also set out a number of detailed principles on State aid. This aims to avoid the appearance of unfair competition by prohibiting the use of dumping and massive State aid. The European Union had to renounce a dynamic alignment of the rules which would have forced the United Kingdom in particular to follow the regulatory changes carried out by the European Union.

A governance mechanism

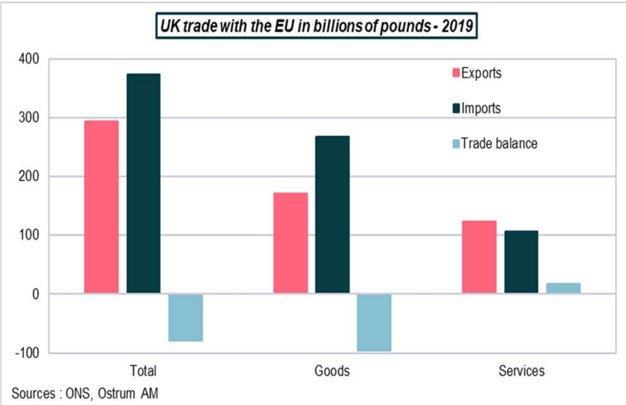
In the event of non-compliance with one element of the agreement, the injured party may impose customs duties on the other, provided that they are proportionate to the harm suffered. These customs duties may concern goods other than those not complying with the Agreement. An independent arbitration panel, in particular independent from the European Court of Justice, may be requested.

The trade agreement will be reviewed every 5 years. Both parties may request the renegotiation of a part of the agreement and a provision provides for its final termination.

What it does not contain

No agreement on services, including financial services

This trade agreement covers almost exclusively goods and not services, in particular financial services which represent 7% of GDP unlike fisheries. While the United Kingdom has a trade deficit with the European Union due to trade in goods (-£96.7 billion on goods in 2019), it has a trade surplus on bilateral trade in services. Exports of services in 2019 amounted to £123.7 billion compared to £106.1 billion for imports.



By leaving the European Union, British financial institutions lose the European passport that allowed them to have access to all the customers of the Old Continent. In order for them to operate on the EU market, they now have two options resultingin a much more limited access than before. To sell their services in an EU country, British financial institutions must relocate their head office or establish a subsidiary there and comply with the regulations in force in the country. Transfers in this direction have been made since the June 2016 referendum, particularly from the major banks, which are proving to be of a limited scale (7,500 jobs, according to the Ernst & Young firm, or less than 2% of jobs in the financial services).

Fall in trade and loss of influence of the London financial centre.

The second possibility is to obtain equivalences. They are decided unilaterally by each of the two parties and aim to recognize whether a sector meets the regulatory standards in force in the economy. Unlike the European passport, these only cover a limited range of services and the European Union can put an end to them at any time, with a month's notice, which is a source of uncertainty and volatility. For the moment, the EU has granted only two equivalences, out of 39 existing, to avoid major disruptions following Brexit. In particular, it concerns the London clearing houses so that they can continue to process transactions carried out in the EU for a period of 18 months. This is quite meagre compared to the number of equivalents given to other trading partners (23 for the United States). On the other hand, the United Kingdom granted several dozens to the EU last November.

By the end of March, the United Kingdom and the European Union are expected to issue their conclusions on a memorandum of understanding on regulatory cooperation in financial services. On the other hand, the European Union is not in a hurry to grant equivalences to British financial institutions. It said that it would only grant it if it was in her best interests. Before deciding on 28 equivalences, the European Union would also like to have more details on how the British intend to change the regulations in the future. The United Kingdom, for its part, has indicated that it is not prepared to accept this mutual recognition at any cost. Bank of England Governor Andrew Bailey said last week that the EU's demands were unrealistic. For the British, it is a question of not being imposed the rules of the Old Continent.

The consequences are already visible

UK exports to the EU fall

According to the association of road haulers, exports to the European Union decreased by 68% over the month of January due to restrictions on the movement of goods caused by customs controls. This figure was considered consistent by the director of the Association of British Ports. In addition, 65% to 75% of heavy goods vehicles returning from the Old Continent would return empty to the European Union due to supply difficulties and the fact that some companies have stopped their exports to the EU.

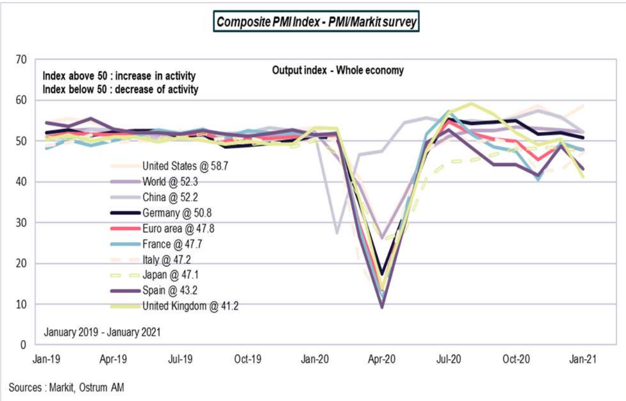
The association highlights in particular the lack of qualified staff at the borders to help companies to complete the various formalities (10,000 agents available against 50,000 necessary).

The British Chamber of Commerce also revealed that half of the exporters (49%) were experiencing difficulties related to Brexit. This translates into red tape, delays, additional costs and a lack of clarity about the rules to follow. Small businesses are the most affected.

However, these difficulties are set to intensify in the coming months. A 6-month derogation was granted to British companies in order to give them time to adapt. From 1 July, the United Kingdom will carry out full customs controls on imports from the EU, which will lengthen delivery times. Companies are concerned that the infrastructure needed to carry out these checks as quickly as possible may not be ready in time. In addition, the volume of trade was further reduced in January due to massive storage at the end of the year by companies, in anticipation of Brexit-related disruptions, and a new strict containment introduced by the government. The lifting of health restrictions will be accompanied by a rebound in activity and trade at a time when customs controls will become stricter, likely to generate strong tensions. In particular, the British Chamber of Commerce has asked the government to extend this exemption period and to provide additional aid to businesses. The government has just announced a £20 million fund for small businesses affected by Brexit constraints and to help them cope with the controls on British imports that will take place from the first of July.

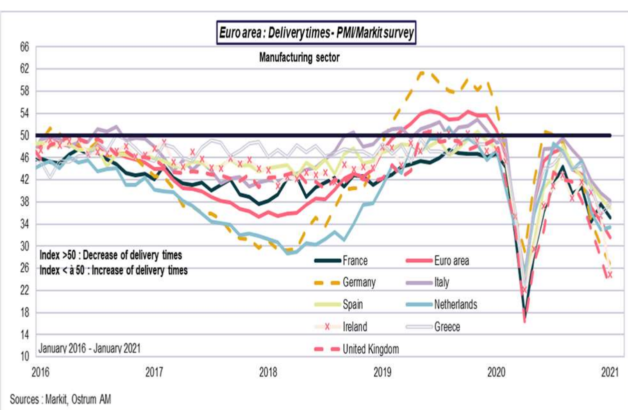
Faced with these additional costs, some companies have indicated that they will no longer export to the European Union or the United Kingdom, others will have to relocate all or part of their activity to avoid the constraints related to Brexit. Ireland, for its part, is significantly increasing direct maritime links to the European Union so that heavy goods vehicles no longer pass through the United Kingdom and thus avoid the administrative burdens of border controls.

The latest PMI/Markit survey is very informative in this respect. It shows that the United Kingdom recorded the largest contraction of activity among all major regions in January. The British activity index is well below the threshold of 50, at 41.2, signaling a fall in its activity.



Sources : Markit, Ostrum AM

Unsurprisingly, the services sector is contracting more strongly, affected in particular by the consequences of health restrictions. But unlike other countries, especially those in the Eurozone that are also suffering from health restrictions, the UK manufacturing sector has not reduced the impact of the pandemic on growth. Its activity slowed sharply and indeed stagnated in January. New foreign orders fell and delivery times reached a second all-time high after that of April. As the following graph shows, delivery times have increased significantly in all countries (the reading is reversed) but in a much stronger way for Ireland and the United Kingdom. In addition to the supply difficulties related to the shortage of certain components and materials, the lack of containers and sanitary restrictions, the additional constraints related to Brexit were added. SMEs are most affected by Brexit-related supply difficulties according to this survey.



Sources : Markit, Ostrum AM

London loses its status as the leading European stock exchange in favor of Amsterdam

The adjustment was violent for financial services, as they were not covered by the trade agreement and the equivalents remained in abeyance. Half of London's stock market trading volume moved to the European Union in January, according to the CBoE. This movement has greatly benefited Amsterdam which has become the leader in Europe and to a lesser extent in Germany and France.

London loses significant market share in euro derivatives

The United Kingdom's market share for euro-denominated swaps also fell sharply in January from 40% to 10%. This was to the benefit of Amsterdam and to a lesser extent Paris, according to Markit.

Difficulties in complying with the Irish Protocol

In order to avoid the appearance of a physical border between Northern Ireland, a part of the United Kingdom, and Ireland, belonging with the European Union, the divorce agreement stipulates the establishment of a specific mechanism. It allows Northern Ireland to remain in the customs union and the single European market and customs controls are carried out in the Irish Sea on goods coming from Great Britain. The Irish Protocol thus aims to respect the Good Friday Agreements of 1998 which put an end to 30 years of violence.

As warned by the National Audit Office, trade between the United Kingdom and Northern Ireland has been severely disrupted since the beginning of the year due to a lack of preparedness to carry out the necessary controls. In addition to the very short lead time to prepare, there were delays related to the pandemic. Some supermarkets in Northern Ireland have had difficulty obtaining supplies, particularly fresh products from the rest of the United Kingdom. In view of the tensions, customs personnel did not work for a week out of concern for their safety because of the threats they were facing.

The difficulties are set to increase from the first of April with the end of the derogation period easing controls on certain products between Northern Ireland and Great Britain. This comes in a particularly tense climate following the European Union's attempt on 29 January to block exports of vaccines from Northern Ireland, produced in the European Union, so that they do not come to supply the rest of the British market. To this end, the EU intended to trigger Article 16 of the Irish Protocol allowing its application to be susp-ended if it causes serious economic, societal or environ-mental difficulties. In the evening, the European Com-mission quickly reversed its decision by acknowledging that this was a mistake and that it would ensure compliance with the Irish Protocol.

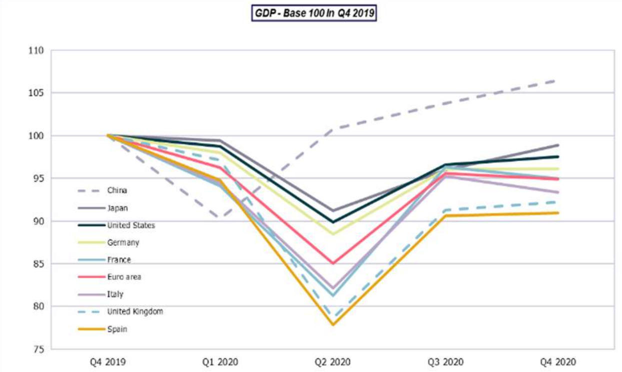
After this incident and at the urgent request of the entrepreneurs, Boris Johnson asked the European Union for an extension of the period of exemption until 2023, which was refused by the European Union. The United Kingdom and the EU are committed to taking action to address these issues.

Impacts on growth

Short-term

While the British economy was one of the most affected by the Covid-19 crisis in 2020, it is now facing the disruptions related to Brexit and the strict containment put in place by the government. The United Kingdom recorded its strongest recession in over 300 years, with GDP shrinking by an average of 9.9% in 2020, compared to a decline of 6.8% in the Euro zone and 3.5% in the United States. At the end of 2020, this means that it remains well below the pre-crisis level, as shown in the following graph (-7.8 percentage points).

GDP - Base 100 in Q4 2019



Sources : Datastream, Ostrum AM

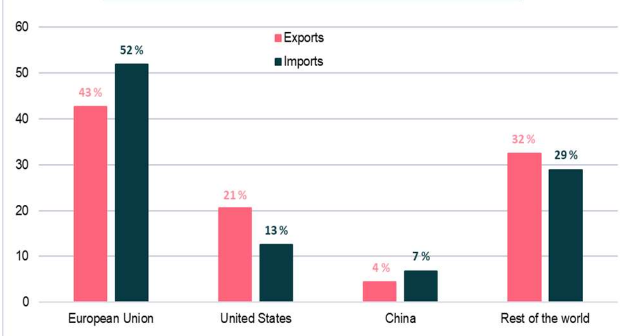
According to the Bank of England (BoE), the GDP is expected to contract by 4% in the first quarter of 2021, of which 1% is linked to Brexit through its impact on exports and supply chains. This justifies the maintenance of a very accommodating monetary policy via rates close to zero (0.1%) and the continuation of massive asset purchases, whose size of the program was raised to 895 billion pounds last November. The BoE does not rule out the use of negative rates in the future, if necessary. This is not the main scenario since the BoE expects a sharp rebound in activity, notably as a result of the success of the vaccination campaign in containing the epidemic and thus considerably reducing uncertainty concerning the prospects of business leaders and household confidence.

Even greater long-term impact

Beyond the short-term impact, the impact of Brexit on long-term growth will be stronger. A report by the Office for Budget Responsibility estimates the impact of Brexit on long-term growth at 4%, in line with previous estimates, compared to 6% in the case of "hard Brexit" (without a trade agreement).

This is linked to the consequences of the end of the free movement of goods, services, people and capital inherent in Brexit and this with its main trading partner. 43% of British exports are to the European Union, against 21% to the United States, and 52% of imports come from the Old Continent (against 13% from the United States).

United Kingdom : Distribution of trade in goods and services in 2019 - %



Sources : ONS, Ostrum AM

Non-tariff barriers will weigh on trade in goods and generate additional costs that will limit the dynamics of activity and investment.

The United Kingdom will no longer be a gateway to the European Union for third countries and should thus suffer a decrease in direct investment flows. Financial services that are not part of the agreement and do not currently have equivalences should also suffer a loss of activity.

Persistent long-term effects and therefore potential growth will be slower due to lower productivity gains.

In this context of lower trade and investment, productivity gains will be more limited.

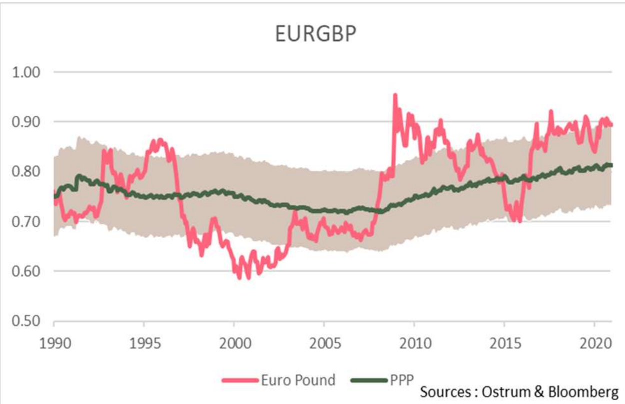
Potential growth will be slower due to lower productivity gains and lower labor force growth due to lower population flows from the European Union.

These growth losses will not be offset by trade agreements signed or to be signed by the United Kingdom with third countries. The terms will remain close to the agreements enjoyed by the United Kingdom when it was part of the European Union as indicated by the agreement signed with Japan.

Markets have already penalised the UK

The market has already penalized the UK due to uncertainty related to Brexit but also related to concerns about growth. While the yield curve is heavily manipulated by Central Banks, the exchange rate market and the equity market both send a very cautious message.

The following chart shows the exchange rate of the Pound against the Euro, as well as our estimate of purchasing power parity (PPE). While at the end of 2015 the level of the pound at 0.70 was very high, it quickly depreciated after the referendum of June 2016 and has settled on a level close to 0.90 since. Meanwhile its fundamental value is closer to 0.81 according to our calculations. The persistence of the lack of visibility and the impact on growth of the Brexit do not allow us to expect a return to this fundamental value. The risk premium on the pound should persist.



Same thing on the stock market. While the performance of the UK indices benefited from the depreciation of the pound, the relative valuation of the said indices deteriorated considerably. In the case of the FTSE 100, about three-quarters of the turnover of listed companies are outside the UK, so the index is less sensitive to Brexit. In the case of small caps, which are much more exposed to domestic dynamics, the discount is more spectacular. Here too, it is difficult to imagine a rapid return to normal history.

Conclusion

Six weeks after the effective exit of the United Kingdom from the European Union, there have been major disturbances in trade in goods, compliance with the Irish Protocol and the activity of certain financial services. London is no longer the leading European stock market, it has lost significant market share in euro derivatives and exports fell by nearly 70% in January, according to the association of road haulers. These disruptions are set to intensify in the coming months with the end of temporary exemptions easing border controls for certain products and the rebound in activity related to the upcoming lifting of the lockdown. The European Union is also in no hurry to grant equivalences to the United Kingdom with regard to financial services, and the United Kingdom is reluctant to accept them if conditions are too restrictive. These tensions will thus affect the dynamics of trade and limit the rebound of British growth following the deconfinement. This will generate expectations of lower key interest rates from the Bank of England, or even negative interest rates, and will weigh on the pound sterling.

Aline Goupil-Raguénès

Market review

An upward Krach?

Unprecedented flows into US equities, tensions on Treasury yields.

The trend remains undoubtedly quite supportive of risk-free assets. The S&P 500 index is trading at record-highs above 3900. Technology and US small-cap stocks keep pulling equity indices higher. Cyclicals and banks outperform in European markets. Compression push US speculative-grade yields below 4%. The dollar resumed its decline ahead of the Chinese New Year.

On political grounds, Europe is still faced with Brexit-related issues. Brussels points to the UK's failures in controlling the flows of goods between Northern Ireland and Great Britain. Th Northern Ireland protocol is central to the December agreement, which by the way will only be ratified by European institutions in April. In the meantime, negotiations continue regarding UK access to European financial services BoE Governor Mathew Bailey openly worries about the consequences of a City lock-out arguing that it would result in market fragmentation. In Italy, it seems that Mario Draghi will enjoy broad Parliamentary support. His reform agenda will be facilitated by the availability of European funds which add up to €220b over years to come.

As concerns economic releases, the final estimate of euro area inflation will be published on January 23rd. The sector composition effects of the harmonized index have likely contributed to outsized price gains. In the US, the core CPI was unchanged in January and decelerated slightly to 1.4% from a year ago. Service inflation stripped out of its energy components fell further. Housing costs (in particular the owner-equivalent rent component) are however a highly dubious statistical construct that will have to take account of current pressures on house price (+9.5%y). Measured inflation will rise well beyond expected base effects linked to past declines in commodity prices. Furthermore, shortages of semiconductors have become a political hot topic in Europe and the US. Chip shortages have had a considerable impact on the auto industry for instance, in the context of a sharp recovery in demand from hardware producers.

In fixed income markets, the T-note yields consolidated about 1.15% as the new 10-year bond benchmark was auctioned, before drifting higher again towards 1,20%. Likewise, 30-year bond yields hover about 2%. Monthly bond auction sizes from February-April left unchanged following the quarterly refunding announcement could have eased upward pressure but ongoing stimulus talks highlight the risk of a second wave higher. In turn, 10-year inflation swaps traded sideways last week although the reflation theme (including upward pressure on commodities) fans investors' interest for long breakeven strategies in 2-5y maturity segment. Short-dated breakeven inflation rates will have to take account fully of the increased housing costs mentioned above. That said, crude prices are now close to levels consistent with a recovery in investment spending in the shale oil industry. Expectations of wells spudded have picked up significantly (Texas, Dakota) in the shale oil industry. Furthermore, the unilateral decision of Saudi Arabia to cut production won't be prolonged indefinitely.

In the euro area, the yield on 30-year Bund has reverted to positive territory after nearly five consecutive months below the 0% line. The syndications of sovereign bonds with maturities beyond 10 years have weighed on the back end of the curve. Peripheral spreads still weathered the increase in bond yields. The Draghi government was hailed by market participants so that BTP spreads already shrunk to 90bp, which happened to be our year-end target. As concerns corporate credit, spreads have been quite stable in the investment grade group as non-financial bond issuance slowed somewhat last week.

Spread compression continue unabated to the benefit of high yield investors. Outperformance of the speculative-grade group can be observed in both the US and European credit markets. High yield spreads are indeed trading at similar levels about 325bp vs. their respective risk-free rates. The scarcity of positive-yielding bonds scarcity and significant cash to be put to work should continue to underpin the riskier part of corporate bond markets. As a side remark, there is notable recovery in investor interest for bank loan ETFs.

Equity markets remain extremely resilient to the rise in bond yields. Record flows into US equity funds ($36b in the week to February 10th) targeting in particular the technology sector. Monetary fund have undergone significant outflows to fund equity investments. The FANG index (big Tech) and the Small-cap Russell 2000 gauge have been leading the charge higher amid very large trading volumes, which are usually seen in liquidation/capitulation phases. This time round, the market looks to be experiencing a Krach to the upside. Market exuberance is such as market dynamics may have become the main downside risk factor. We hence will monitor trading volumes and the participation of retail investors. That being said, the earnings season is quite upbeat so far with 6.5% annual profit growth for the S&P 500 and a 22% rebound in growth for the Russell 2000 universe. In Europe, 4q20 earnings releases are also quite reassuring. The main European banks have posted higher revenue growth and lower provisions for loan losses. Increased profitability should result in higher dividend and stock repurchases in spite of cautious guidance from the ECB.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	15-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.7 %	+1	+2	+0
EUR Bunds 10y	-0.38%	+6	+16	+19
EUR Bunds 2s10s	31 bp	+5	+14	+18
USD Treasuries 2y	0.11 %	0	-2	-1
USD Treasuries 10y	1.21 %	+4	+12	+30
USD Treasuries 2s10s	110 bp	+4	+15	+31
GBP Gilt 10y	0.58 %	+10	+29	+38
JPY JGB 10y	0.08 %	+1	+4	+6
€ Sovereign Spreads (10y)	**15-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	23 bp	+1	+0	0
Italy	91 bp	-5	-25	-21
Spain	64 bp	+6	+4	+2
Inflation Break-evens (10y)	**15-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	100 bp	+1	+5	-
USD TIPS	223 bp	+2	+14	+24
GBP Gilt Index-Linked	315 bp	+1	+11	+15
EUR Credit Indices	**15-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	88 bp	+0	-1	-4
EUR Agencies OAS	39 bp	+0	+1	-2
EUR Securitized - Covered OAS	31 bp	0	+1	-2
EUR Pan-European High Yield OAS	321 bp	-6	-27	-37
EUR/USD CDS Indices 5y	**15-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	47 bp	-1	-4	-1
iTraxx Crossover	238 bp	-7	-21	-3
CDX IG	50 bp	+0	-1	+0
CDX High Yield	286 bp	+1	-16	-8
Emerging Markets	**15-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	341 bp	+3	-15	-10
Currencies	**15-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.213	+0.7	+0.41	-0.77
GBP/USD	$1.391	+1.22	+2.35	+1.89
USD/JPY	¥105.34	-0.14	-1.41	-1.94
Commodity Futures	**15-Feb-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$63.3	$2.7	$8.1	$11.4
Gold	$1 821.3	-$11.6	-$7.2	-$73.1
Equity Market Indices	**15-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 935	1.23	4.42	4.76
EuroStoxx 50	3 730	1.75	3.62	4.98
CAC 40	5 781	1.67	3.02	4.14
Nikkei 225	30 084	4.53	5.49	9.62
Shanghai Composite	3 655	3.92	3.50	5.24
VIX - Implied Volatility Index	19.97	-4.31	-17.95	-12.22

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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