24 December 2020

Investment Event

UK and EU strike Brexit deal

The deal preserves tariff-free EU-UK trade for goods, and also covers issues such as security co-operation

The deal should limit the scope for further major disruption at the UK/EU border in the new year period

For now, the challenges posed by the pandemic remain substantial and overwhelm other economic and geopolitical considerations

Our views

We remain constructive on UK equities, which are relatively exposed to cyclical sectors and have lagged wider market performance this year. This implies scope for "catch-up" in 2021 as the global economy recovers

Furthermore, reduced Brexit uncertainty may boost investor appetite for UK assets

UK and EU agree terms of their future trading relationship

After months of difficult negotiations, the UK and European Union (EU) have agreed on the terms of a post-Brexit trade deal just days ahead of the end of the UK's transition period with the EU on 31 December.

Importantly, the deal preserves tariff-free EU-UK trade for most goods, and also covers issues such as security co-operation. However, there is little on trade of services. A "level playing field" for competition between the two sides would be guaranteed by a new arbitration mechanism, which would impose sanctions via tariffs if either side significantly undercut the other's regulations.

With time running out before the transition period ends, the deal will be adopted using an accelerated "provisional application" procedure. This only requires the consent of the UK and EU national governments with the European Parliament signing it off retrospectively in January.

Deal removes some downside risks to growth in 2021

The deal should limit the scope for further major disruption at the UK/EU border in the new year period, which would have hit trade and economic activity. Nevertheless, this week's events have shown how quickly a short border interruption can cause long delays, so some further disruption is possible.

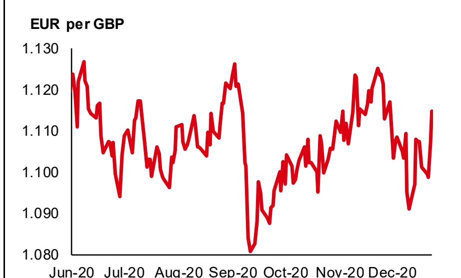
It is important to remember that even with a deal, the trading relationship between the UK and EU will change materially; the deal is far less comprehensive than imagined earlier in the Brexit negotiation process. There will likely be greater friction at the border (including customs checks and declarations) and, therefore, some economic costs such as upward pressure on prices. However, the starting point is that inflation in both the UK and eurozone is well below their respective targets.

For now, the challenges posed by the pandemic remain substantial and overwhelm other economic and geopolitical considerations. Both economies are facing major short-term headwinds amid a resurgence in virus cases and fresh restrictions, but the outlook for later in 2021 remains positive as the pandemic is likely to subside.

Investment implications

The immediate market reaction to news that a deal was imminent saw a rally in sterling (Figure 1) and selloff in UK gilts, although both remained within their recent trading ranges. Moves in other markets were relatively muted, with a broad risk-on tilt.

Figure 1: Pound sterling (GBP) versus euro (EUR)



Past performance is not a reliable indicator of future returns. Source: Bloomberg, as of 24 December 2020.

We **remain constructive on UK equities**. UK indices have lagged wider market performance in 2020, and are relatively exposed to cyclical sectors (financials, materials, industrials) and the health of the global economy (via multinationals). We think this implies significant scope for catch-up in 2021 with the global economy recovering from the pandemic as vaccines are rolled out (with the UK well positioned in this respect).

Meanwhile, reduced Brexit uncertainty may boost investor appetite for UK assets. As we argued in our Outlook for 2021 – *The Restoration Economy,* **policy uncertainty is ebbing away**, and further Brexit clarity can contribute to this trend continuing next year.

Nevertheless, we acknowledge significant near-term challenges to the global economy amid a surge in virus cases in many countries. There are downside risks to the current pricing of some risk assets, which have incorporated a lot of good news on vaccine developments in recent weeks.

HSBC

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