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Investment Event

UK cabinet approves draft Brexit deal

The cabinet of the UK government has backed a draft withdrawal treaty outlining terms for the UK's departure from the European Union (EU)

This represents a significant milestone in securing a smooth Brexit. Nevertheless, there remain significant hurdles, including ratification by UK parliament

If the agreement is rejected by UK parliament, and the Article 50 negotiating period is not extended beyond next March, there could still be a "no deal" Brexit

Our views

There is still uncertainty over whether the UK parliament will ratify the agreement. For multi-asset portfolios, valuations point us to remain neutral UK equities, and underweight in gilts

HSBC
Global Asset Management

UK cabinet backs draft Brexit treaty

The cabinet of the UK government **has backed a draft withdrawal treaty** outlining terms for the UK's departure from the European Union (EU). This ends months of uncertainty over whether or not the UK and EU could agree the exit terms, ahead of the UK's scheduled exit from the bloc on 29 March 2019. Table 1 outlines some of the provisions contained in the draft agreement, based on initial media reports.

Table 1: The draft UK withdrawal agreement

Financial settlement	• UK fully pays into EU budget in 2019-20, and contribute towards liabilities thereafter • UK accepts liabilities incurred while it was a member
Citizen rights	• Maintains existing residence and social security rights of 3 million EU citizens living in UK, and 1 million UK nationals living in continental Europe
Transition period	• The UK retains EU membership rights until at least December 2020, as a rule-taker • This transition period can be extended by mutual agreement
Northern Ireland (NI)	• NI tied to goods single market/EU customs code as "backstop" against hard border • Mainland UK minimises regulatory divergence with NI to avoid trade frictions
Customs Union	• UK/EU remain in customs union to maintain frictionless trade/avoid NI hard border • UK follows EU competition rules & sticks to other existing laws (e.g. taxation, labour)

What next?

The confirmation of the draft agreement by the UK cabinet represents a significant milestone in securing a smooth Brexit. Importantly, it opens the way for a special Brexit summit of European leaders on 25 November where the agreement would be expected to be formalised.

Nevertheless, there remain significant hurdles. **Most significantly the agreement also needs to be ratified by UK parliament**. **This is far from guaranteed.** Theresa May's government has a slim working majority in the UK parliament (13). Implied in this calculation is full support from her party members and 10 Democratic Unionist Party (DUP) MPs, who are aligned to the government.

Full support from both these camps will be tricky to secure. **Pro-Brexit Conservative party members** have raised issue that the deal does not allow the UK to unilaterally exit the customs arrangement backstop. Other concerns have included that the UK will remain locked into EU rules and regulations, with no decision-making powers. Meanwhile, **pro-Remain conservative party members** may rebel against the government in the hope of securing a second referendum, or a deal which involves closer alignment with the EU.

There is also a significant risk that the **DUP** vote against the government because the agreement includes specific backstop agreements for Northern Ireland, which they believe undermines Northern Ireland's position in the UK.

If the agreement is rejected by UK parliament, and the Article 50 negotiating period is not extended beyond next March, there could still be a "no deal" Brexit. But if there is an extension, the UK could face a second referendum or a general election to try and break the stalemate.

Investment implications

Although the UK cabinet has agreed the draft deal, there is still uncertainty over whether the UK parliament will ratify it. With this in mind, and given that we think the prospective reward to bearing **UK equity** risk remains unattractive compared to other markets (such as Asia and the eurozone), we retain our neutral stance in this asset class in the context of multi-asset portfolios.

Meanwhile, uncertainty over the ability of the deal to be ratified will likely continue to weigh on the **British pound** (GBP). However, successful ratification would likely support a bounce in the currency, continuing to support our view of partially hedging GBP portfolios against this risk.

Finally, in terms of the outlook for the **Bank of England's (BoE) policy**, a fully ratified Brexit deal could imply a more rapid tightening cycle, particularly in the context of a recent pick up in wage growth amid modest fiscal easing in the coming year. This supports our underweight view on **UK gilts** in multi-asset portfolios, which offer us relatively poor prospective returns.

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