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INVESTMENT CONSULTING

BriefingNote

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In brief

- Article 50 has been triggered, giving the UK a two-year deadline to agree the terms of departure from the EU
- Exit negotiations with the EU are likely to be challenging
- The UK economy has proved resilient since the referendum but there are reasons not to be complacent now

Action plan

- Trustees and employers should give careful consideration to diversification and risk protection levels within their schemes' investments

Negotiating departure from the EU

Nearly nine months on from Britain's vote to leave the European Union, Theresa May has now triggered Article 50 of the Treaty of Lisbon by formally notifying the European Council of its intention to leave.

What happens next?

Now the negotiations between the UK and the rest of the EU on the arrangements of its withdrawal can begin. Activation of Article 50 sets a two-year deadline for exit talks to agree the terms of departure, which means that Britain should officially leave the EU by no later than April 2019. The timescale can be extended, but only by the unanimous consent of every other member state, whilst any deal must be approved by a 'qualified majority' of EU member states and can still be vetoed by the European Parliament.

During the negotiations, the Treaties that govern membership will continue to apply to Britain, but Britain will not take part in any decision-making. Once Britain has left the EU, the government has said it will enact a Great Repeal Bill which will incorporate all EU legislation into UK law and allow the government to repeal individual laws over a period of time, as it chooses.

Negotiations

Britain's exit negotiations with the EU are likely to be difficult. Agreeing a new trading relationship, establishing what tariffs and other barriers to entry are permitted, and reaching agreement on obligations such as free movement of labour could be long and protracted, with some EU leaders predicting that the process could take another five years.

It has also been suggested that Europe's stance on the exit conditions may be brutal in order to discourage other states from following suit. However, European domestic industries are likely to lobby hard when faced with the prospect of trade barriers with the UK, given the extent to which many benefit from cheap UK imports.

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Although there was speculation about whether Britain will remain in the EU's single market, following Theresa May's speech on Brexit in January, we now know that the UK is not intending to stay in the single market. That would have meant allowing unlimited EU immigration, under the freedom of movement rules of the European Court of Justice, something the government is not prepared to countenance. However, the City of London is hoping for a "comprehensive free trade deal" which will give the UK significant access to the single market. Theresa May has said she wants the UK to reach a new form of customs union deal with the EU, which would mean that the UK and EU would not impose tariffs on each others' goods, whilst at the same time being free to strike trade deals with non-EU countries.

Impact on markets

What has been a surprise to many since the result of the referendum last June is the way in which the UK economy has performed. Few were predicting, at that time, growth of over 2% annualised in the second half of 2016 and equity markets moving to levels significantly higher than before the "leave" vote was announced. The UK exchange rate took the brunt of the negative reaction, with sterling still around 18% below mid-2015 levels on a trade-weighted basis and 7% below the pre-referendum level.

Even as the pound starts to regain some of its value, currency experts expect it to remain at least 10% below where it was on 23 June, in the long term. This means that imported goods will continue to be more expensive and will impact on UK consumers' purchasing power – with possible negative consequences for continued economic growth – unless wage growth can keep pace. The latest UK inflation figures reflect this effect, with the Consumer Prices Index ("CPI") up 2.3% in the 12 months to February 2017, driven in particular by significant price rises for food, clothing and homeware goods.

Consumer Price Index (CPI)

Having moved above its 2% p.a. target rate, the Bank of England could come under increasing pressure over time to bring forward an increase in the bank base rate. This, in turn, could lead to a correction in equity valuations and a shake up of fixed income markets.

This is just one element of uncertainty that will run alongside the Brexit process and there are many aspects of the negotiations themselves which could unsettle markets. We maintain our stance, therefore, that pension scheme trustees and sponsoring employers should ensure that their investment strategies are well-diversified and suitably protected against the risk that gilt yields remain at current levels or even move lower. Failure to do so could lead to yet more funding level misery for schemes that have been negatively impacted by the low rate environment of the last few years.

Conclusion

Since the decision to leave the EU was announced last June, we have not seen the damaging impact on markets that many had predicted. In fact, in many ways, market and economic growth figures have been surprisingly positive. This should not be taken as a signal for complacency, however; there are many ways in which the exit negotiation process could lead to a rapid change in market sentiment at a time when rising UK inflation is likely to lead to increasing challenges from a policy perspective.

Where can I get further information?

For specific advice, please get in touch with **Guy Plater**.

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Alternatively, please speak to your usual Punter Southall contact.

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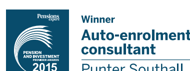

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