

COMMERCIAL BANKING

Brexit & Financial Risk: *An economist's perspective*

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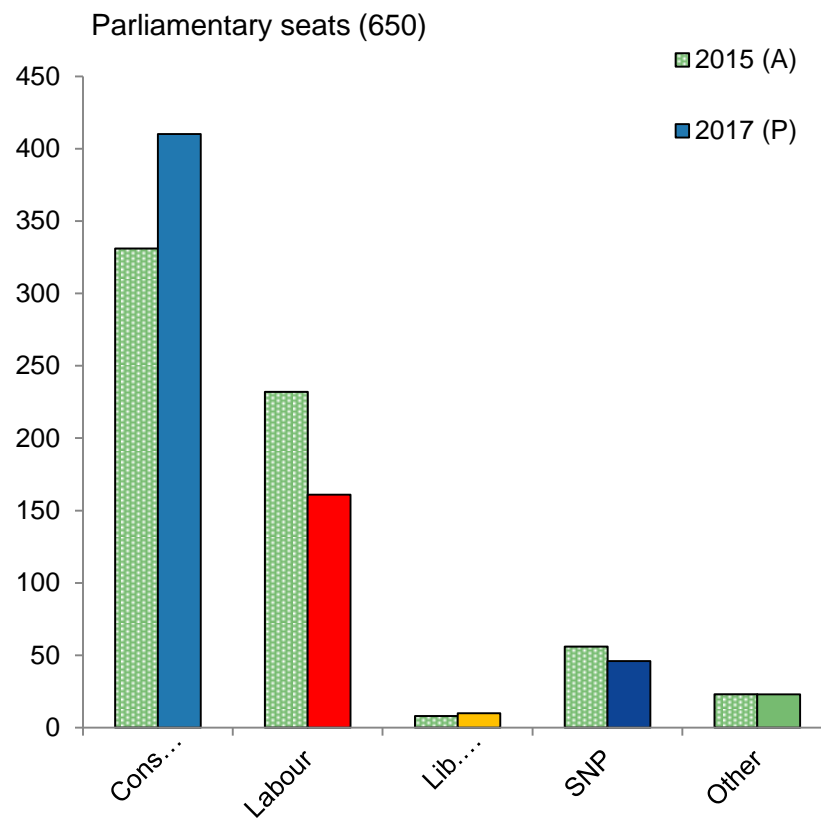
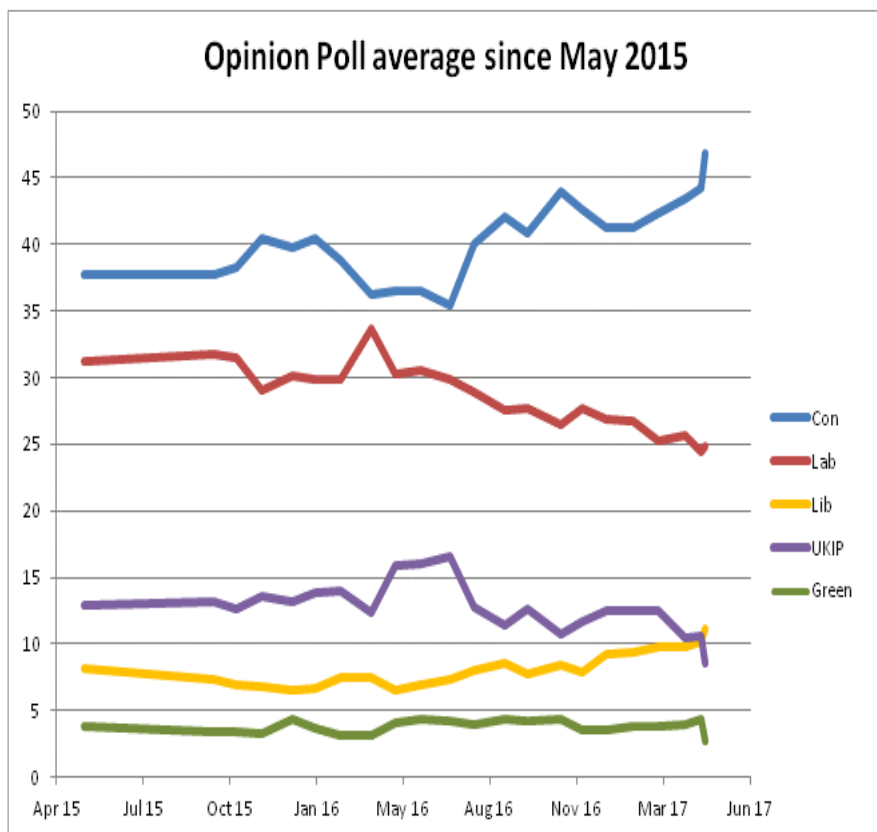


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YET ANOTHER ELECTION!

After a surprise announcement, the UK will go to the polls again on 8th June for a General Election. This time the deciding factor will be the handling of the future Brexit negotiations





UK'S 'BESPOKE DEAL' OBJECTIVE NOW CLEARER

	EU member	EEA (e.g. Norway)	Bilateral agreements (e.g. Switzerland)	Free Trade Agreement (e.g. South Africa, Canada)	Customs Union (e.g. Turkey)	WTO/'Most Favoured Nation' status (e.g. Australia)
Free trade with EU	Yes, part of Single Market	Yes, part of Single Market	Not full coverage 'Rules of origin' apply	Not full coverage 'Rules of origin' apply	Not full coverage 'Rules of origin' apply	Tariff and non-tariff barriers
Independent trade policy	No	No	Yes	Yes	No	Yes
Compliance with EU laws / regulations	Full compliance required Members can vote on legislation	Reduced voting rights	Regulatory equivalence required to secure passporting rights and access to single market (not currently achieved by any non-EEA country)			No – full independence
Independent border controls	Free right of passage across Schengen area		As negotiated	Yes	Yes	Yes
CAP subsidies	Yes	No	No	No	No	No
Contribution to EU budget	Yes - full	Reduced contribution	Reduced contribution	No	No	No

REGULATORY IMPLICATIONS WILL DEPEND ON DETAILS



Current regulatory regime should continue to apply in any transition period, but the government's appetite for implementation of EU regulatory initiatives in the pipeline has to be in doubt

Applicability of EU law under EU exit scenarios

STATUS QUO	EEA ('Norway')	FTA ('Canada')
Treaties (both EU treaties and where the EU is a signatory, e.g. trade agreements)	<p>Only EFTA free trade agreements apply</p> <p>Other treaties cease to apply</p>	Treaties cease to apply
EU Regulations	<p>Regulations under the EEA agreement still apply</p> <p>Regulations not under the EEA agreement cease to apply</p>	Regulations cease to be part of UK law, unless specifically transposed and any associated guidance ceases to apply
Case law of the Court of Justice of the EU (CJEU)	Case law of EFTA Court replaces that of CJEU, but it is largely aligned CJEU case law applies so far as it has been implemented by UK courts	Assumption that CJEU case law applies so far as it has been implemented by UK courts
EU Directives transposed into UK law	Required to retain Directives that apply under EEA agreement	Directives continue to apply unless repealed but associated guidance ceases to apply

SOME MAJOR COMPLEXITIES FOR TRADE NEGOTIATIONS



Short summaries of some key aspects of EU membership

EU SINGLE MARKET: Trade area with no internal tariffs or quotas. Supported by standardised regulation and a common currency for some members. Rests on four pillars: the free movement of goods, persons, services and capital. These are considered non-negotiable. The single market is an ongoing project and progress continues in both goods and services.

PASSPORTING: Allows institutions from one member state of the European Economic Area (EU 28 + Iceland, Liechtenstein and Norway) to conduct business across the EEA without requirement for local regulator approval. This is particularly important for financial institutions. Switzerland is not a member of EEA but can access in some areas based on bilateral treaties, e.g. general insurance.

CUSTOMS UNION: Differs from a free trade area (e.g. EU Single Market) in that as well as an agreement to customs free trade in goods between the members, this also requires members to apply a common customs tariff for goods imported from outside the EU. This limits the ability for individual countries to agree own trade deals. The EU has a customs union agreement with Turkey.

RULES OF ORIGIN: Relates to the 'economic' nationality of the goods. Movement of goods within a customs union is not based on their originating status but that they comply with regulations, standards. Some products fall out of scope of the customs union. If a product is entirely manufactured in the EU it may attract lower or nil rates. If not this case, the duty requirement will depend on arrangements between the country of assembly and country into which the good will be imported.

REGULATORY EQUIVALENCE: Ability of non-EU countries that have a recognised legal, regulatory and supervisory regime to operate in specific financial services in the EU. However, it is very specific in application and also not available in some key areas.

SCHENGEN AGREEMENT: Allows passport-free movement of people across member countries. There are 26 members (22 EU + 4 non-EU). The following countries are not members: UK, Ireland, Croatia, Cyprus, Romania and Bulgaria.

ARTICLE 50 – MORE QUESTIONS THAN ANSWERS



Article 50 – Treaty on European Union (TEU)

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.

A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

5. If a State which has withdrawn from the Union asks to re-join, its request shall be subject to the procedure referred to in Article 49.



FIVE KEY TOPICS

There is (far too) much to negotiate but the five headings below summarise the key aspects currently at the forefront of peoples' minds. The timing implied by Article 50 leaves little room for major disputes

- **Sequencing of negotiations**
- **Key withdrawal issues**
- **UK's future trading relationship**
- **Transitional arrangements**
- **In the event of 'no deal'**



UK EXPORT DESTINATIONS: DEPENDENT ON EUROZONE



Destinations for UK goods & services exports (%)

	2000	2005	2010	2015
	USA (17.2)	USA (16.4)	USA (15.9)	USA (18.6)
	Germany (11.0)	Germany (9.8)	Germany (8.8)	Germany (8.6)
	France (8.9)	France (8.0)	Netherlands (7.5)	France (6.2)
	Netherlands (7.3)	Ireland (6.9)	France (6.7)	Netherlands (5.7)
	Ireland (5.7)	Netherlands (5.9)	Ireland (6.2)	Ireland (5.0)
	Belgium (4.5)	Spain (4.4)	Belgium (3.8)	Switzerland (4.1)
	Italy (4.1)	Belgium (4.2)	Spain (3.4)	China (3.2)
	Spain (3.9)	Italy (3.8)	Italy (3.1)	Italy (3.2)
	Switzerland (2.9)	Switzerland (3.0)	Switzerland (3.1)	Belgium (2.9)
	Japan (2.6)	Gulf exc Saudi Arabia (2.7)	Gulf exc Saudi Arabia (2.6)	Spain (2.8)
Top 10	68.2	65.1	61.1	60.5
	2000	2005	2010	2015
	Eurozone (49.2)	Eurozone (46.7)	Eurozone (43.2)	Eurozone (37.7)
	USA (17.2)	USA (16.4)	USA (15.9)	USA (18.6)
	Switzerland (2.9)	Switzerland (3.0)	Switzerland (3.1)	Switzerland (4.1)
	Japan (2.6)	Gulf exc Saudi Arabia (2.7)	Gulf exc Saudi Arabia (2.6)	China (3.2)
	Sweden (2.2)	Japan (2.5)	China (2.3)	Gulf exc Saudi Arabia (2.8)
	Canada (1.8)	Sweden (1.9)	Other Africa (2.2)	Japan (2.0)
	Australia (1.6)	Australia (1.7)	Sweden (1.9)	Sweden (1.7)
	Saudi Arabia (1.4)	Canada (1.5)	Australia (1.8)	Australia (1.6)
	Gulf exc Saudi Arabia (1.4)	Singapore (1.4)	Japan (1.7)	Hong Kong (1.6)
	Hong Kong (1.4)	China (1.3)	Canada (1.7)	Other Africa (1.6)
Top 10	81.8	79.1	76.6	74.9
		EU member		EU single market access

Source: ONS and LBCB calculations

UK IMPORT SOURCES: UK WEAKNESS WOULD HIT EZ



Sources of UK goods & services imports (%)

	2000	2005	2010	2015
	USA (14.2)	Germany (12.2)	Germany (11.6)	Germany (12.8)
	Germany (11.3)	USA (9.7)	USA (9.8)	USA (10.8)
	France (9.5)	France (8.6)	China (6.6)	China (7.0)
	Netherlands (6.3)	Netherlands (6.4)	France (6.4)	France (6.8)
	Spain (4.9)	Spain (6.3)	Netherlands (6.3)	Netherlands (6.7)
	Ireland (4.4)	Italy (4.7)	Norway (4.5)	Spain (4.5)
	Italy (4.4)	Belgium (4.3)	Spain (4.2)	Belgium (4.2)
	Belgium (4.1)	Ireland (3.7)	Belgium (4.0)	Italy (3.8)
	Japan (3.9)	China (3.7)	Italy (3.8)	Ireland (3.2)
	Switzerland (2.4)	Norway (3.4)	Ireland (3.6)	Norway (2.6)
Top 10	65.3	63.0	60.9	62.6
	2000	2005	2010	2015
	Eurozone (49.6)	Eurozone (51.3)	Eurozone (44.0)	Eurozone (46.4)
	USA (14.2)	USA (9.7)	USA (9.8)	USA (10.8)
	Japan (3.9)	China (3.7)	China (6.6)	China (7.0)
	Switzerland (2.4)	Norway (3.4)	Norway (4.5)	Norway (2.6)
	Hong Kong (2.3)	Japan (2.7)	Switzerland (2.2)	Switzerland (2.3)
	Norway (2.1)	Hong Kong (1.9)	Japan (2.2)	Sweden (1.9)
	Sweden (2.0)	Sweden (1.8)	India (2.1)	Poland (1.8)
	China (1.8)	Switzerland (1.6)	Hong Kong (1.9)	Japan (1.7)
	Canada (1.8)	Russia (1.4)	Sweden (1.7)	India (1.7)
	Taiwan (1.3)	Canada (1.4)	Gulf exc Saudi Arabia (1.6)	Other Asia (1.6)
Top 10	81.4	78.9	76.8	78.0
	EU member		EU single market access	

Source: ONS and LBCB calculations

UK CONTRIBUTION TO EU BUDGET



Table 5. EU Budgetary Balances by Member State 2013-15

€ million, includes administrative expenditure

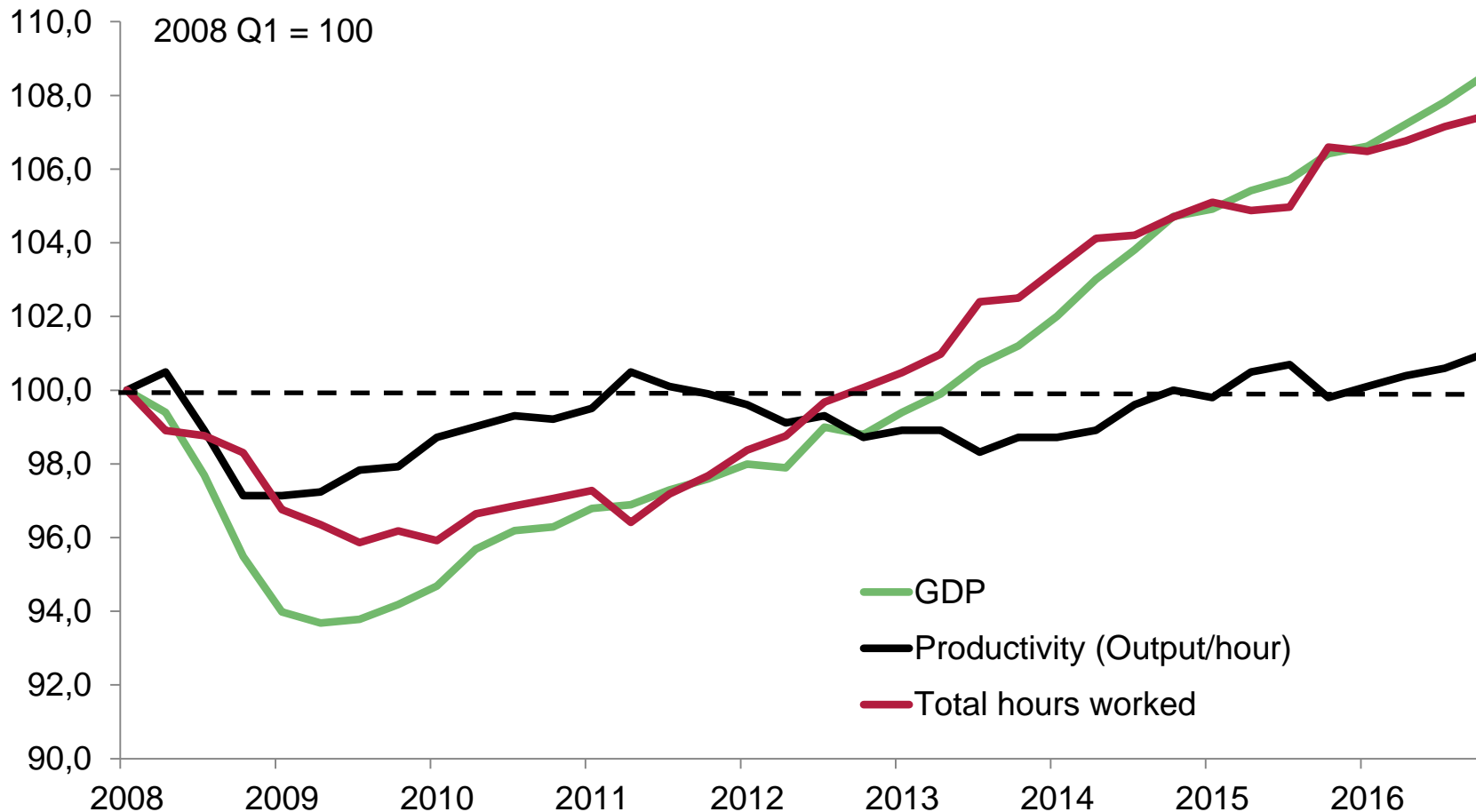
	Expenditure			Contributions			Net Contributions			Net contribution per head (in €)
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2015
Netherlands	2,264	2,014	2,359	6,552	8,373	7,947	4,288	6,358	5,588	331
Sweden	1,661	1,691	1,468	4,211	4,294	4,019	2,550	2,603	2,552	262
UK	6,308	6,985	7,458	17,068	14,072	21,409	10,760	7,088	13,952	215
Germany	13,056	11,484	11,013	29,376	29,143	28,125	16,320	17,659	17,112	211
Denmark	1,435	1,512	1,529	2,899	2,508	2,521	1,465	996	993	175
Austria	1,862	1,573	1,787	3,191	2,870	2,726	1,329	1,297	939	109
Finland	1,497	1,062	1,330	2,159	1,904	1,854	662	842	524	96
France	14,239	13,479	14,468	23,292	20,968	20,606	9,052	7,489	6,138	92
Italy	12,554	10,695	12,338	17,168	15,889	15,920	4,614	5,193	3,582	59
Cyprus	227	273	203	185	161	230	-42	-112	27	32
Ireland	1,874	1,563	2,009	1,731	1,651	1,839	-143	87	-169	-37
Croatia	290	584	605	238	430	397	-52	-155	-207	-49
Malta	174	255	134	86	76	104	-87	-179	-30	-70
Spain	13,752	11,539	13,696	11,369	11,111	10,089	-2,383	-428	-3,606	-78
Portugal	6,163	4,943	2,595	1,793	1,748	1,646	-4,370	-3,195	-949	-91
Belgium	7,209	7,044	6,952	5,291	5,233	5,471	-1,919	-1,812	-1,481	-132
Lithuania	1,881	1,886	877	405	385	390	-1,476	-1,501	-488	-167
Estonia	973	668	443	212	200	210	-761	-467	-233	-177
Poland	16,179	17,436	13,358	4,214	3,955	4,236	-11,965	-13,481	-9,121	-240
Romania	5,561	5,944	6,538	1,474	1,459	1,446	-4,086	-4,485	-5,092	-256
Slovenia	814	1,142	940	426	385	403	-388	-758	-537	-260
Bulgaria	1,977	2,255	2,730	478	461	484	-1,499	-1,795	-2,246	-312
Latvia	1,063	1,062	982	269	270	236	-794	-792	-746	-376
Greece	7,215	7,095	6,210	1,906	1,950	1,343	-5,308	-5,145	-4,867	-448
Hungary	5,910	6,620	5,629	1,011	996	1,074	-4,899	-5,624	-4,556	-462
Czech Republic	4,893	4,377	7,075	1,617	1,507	1,542	-3,276	-2,871	-5,532	-525
Slovakia	2,026	1,669	3,735	799	720	697	-1,227	-949	-3,038	-560
Luxembourg	1,598	1,714	1,649	322	246	367	-1,276	-1,468	-1,283	-2,278
Total	126,349	134,656	128,565	129,430	139,744	132,961				

Notes: Negative net contribution indicates Member State is a net recipient
 Figures include administrative expenditure (significant effect on expenditure in Belgium and Luxembourg)
 Sources: European Commission, *interactive graph on EU expenditure and revenue*, available at:
http://ec.europa.eu/budget/figures/interactive/index_en.cfm
 Eurostat (population data) downloaded 11 August 2016



BREXIT NOT THE ONLY CONCERN

UK productivity has disappointed since the GFC. Meanwhile, the labour market is increasingly running out of road after a strong performance. Both are affected by Brexit – both are fundamental to prospects



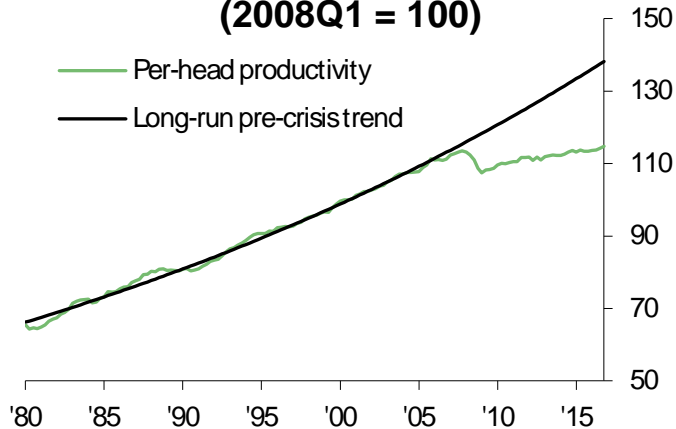
Source: Haver

WEAK SUPPLY SIDE LEAVES DEMAND SHORTFALL MODEST

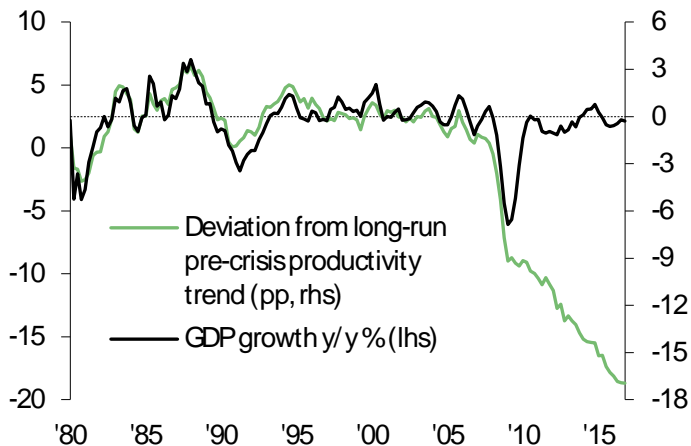


Notwithstanding successive data revisions and a continued upswing, recent productivity performance still looks soft in a longer term context; a weakening trend also lately seen in other economies

**UK productivity trend
(2008Q1 = 100)**

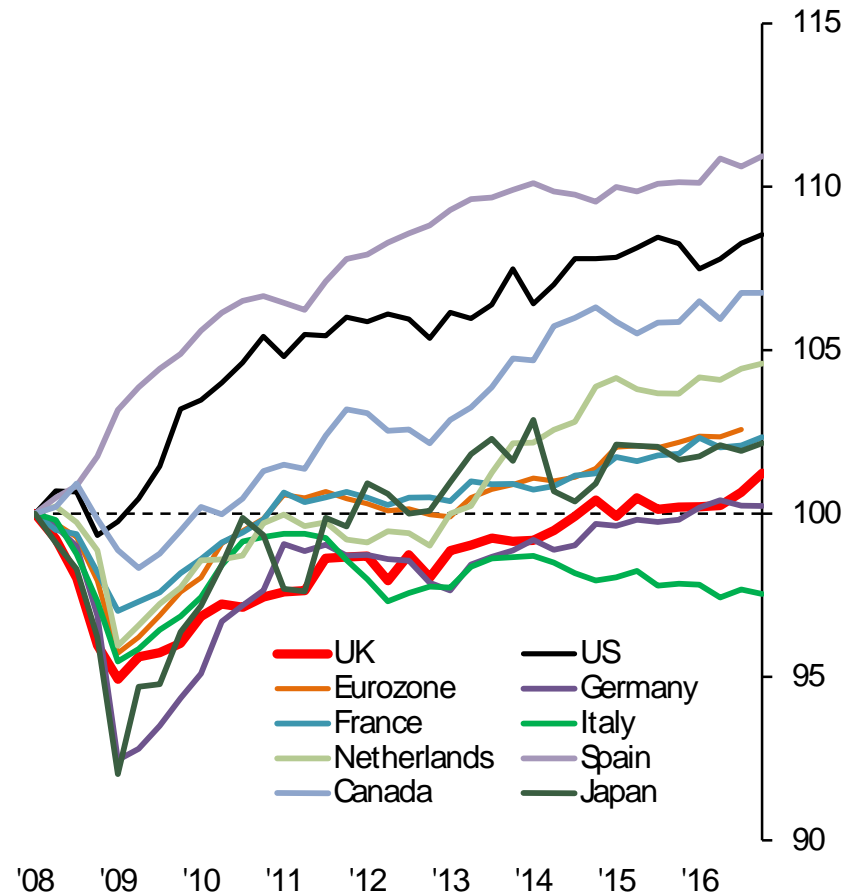


Deviation from long run trend



Source: ONS, LBCB calculations

**International productivity trends
(2008Q1 = 100)**



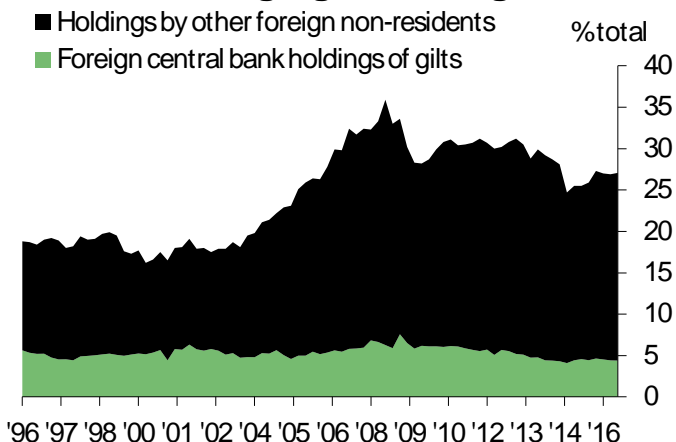
Source: Haver Analytics, LBCB calculations



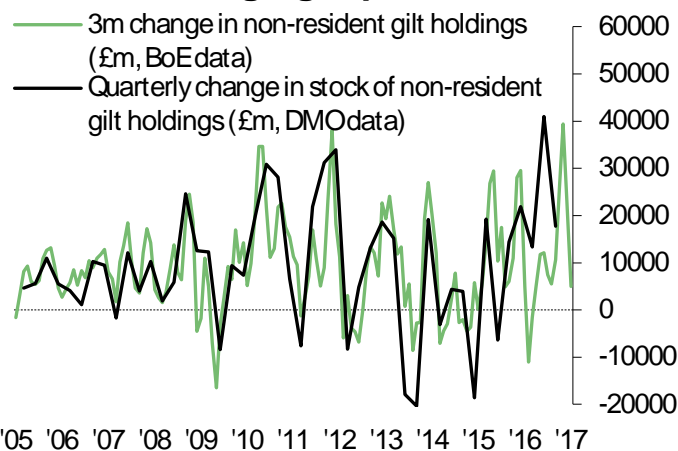
WILL INVESTOR DEMAND HOLD UP?

Foreign purchases of UK assets face uncertainty about future arrangements, but are holding up as UK's 'institutional quality' not really in doubt and a weaker exchange rate makes UK assets cheaper

Foreign gilt holdings

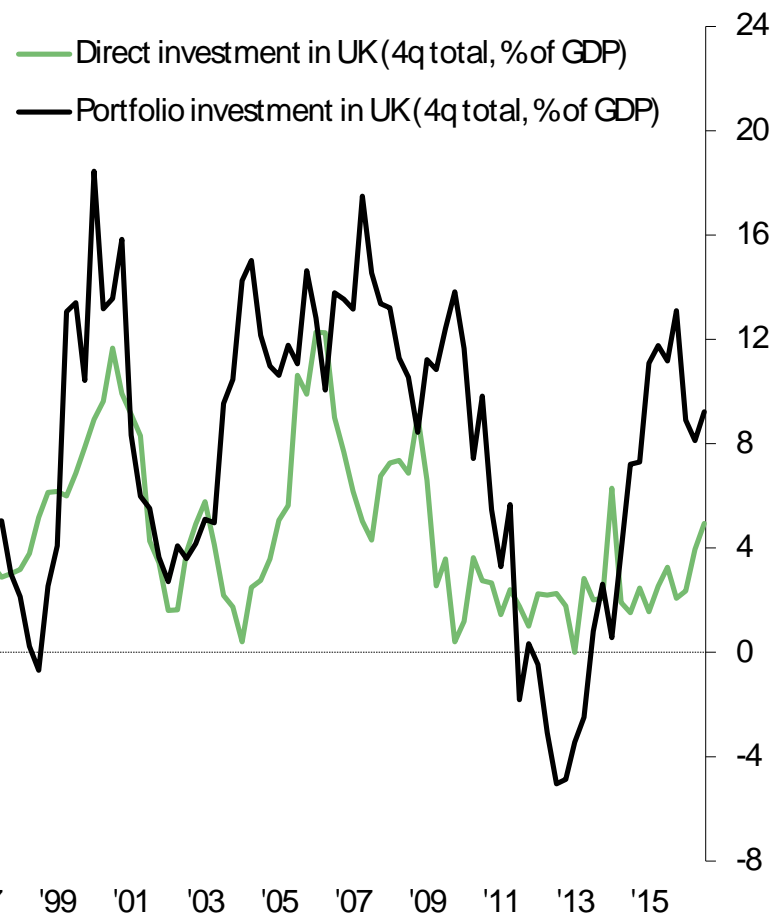


Foreign gilt purchases



Source: DMO and LBCB calculations

FDI and portfolio investment in UK



Source: ONS and LBCB calculations

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UK FX & RATES



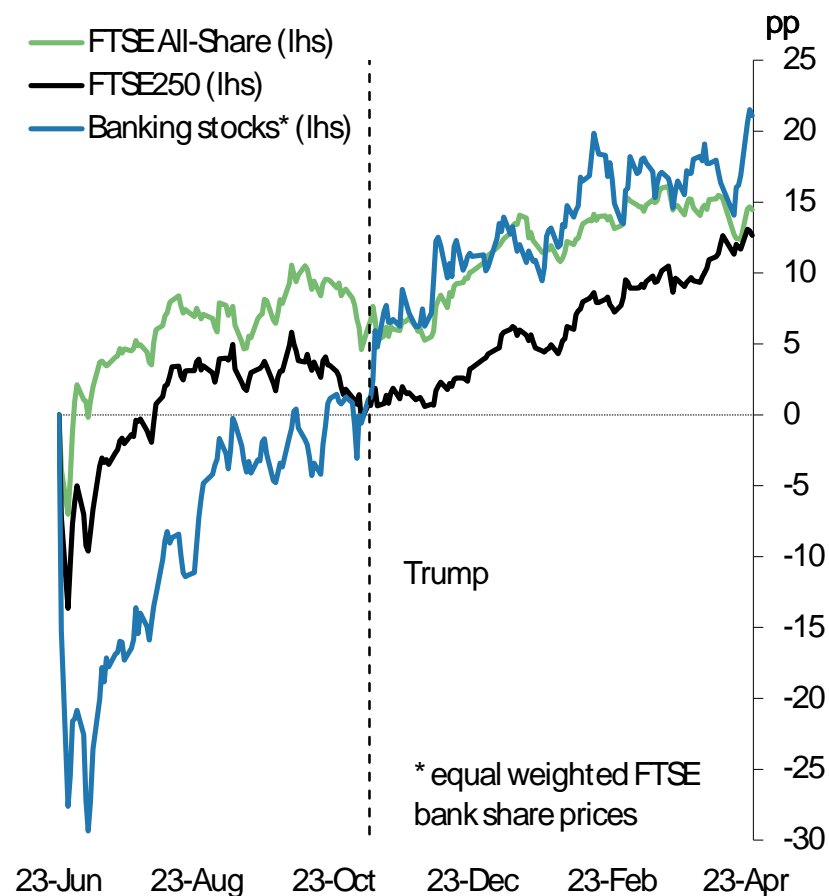
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IMMEDIATE 'BREXIT SHOCK' WEARING OFF...

Currency aside, the 'Brexit' shock has been navigated with little lasting impact; decoupling of FX and rates saw elevated anxiety about the UK's inflation target that has by now receded a little

Equities recover initial slump – in £



Source: Bloomberg, LBCB calculations

Sterling stays lower, but yields recover



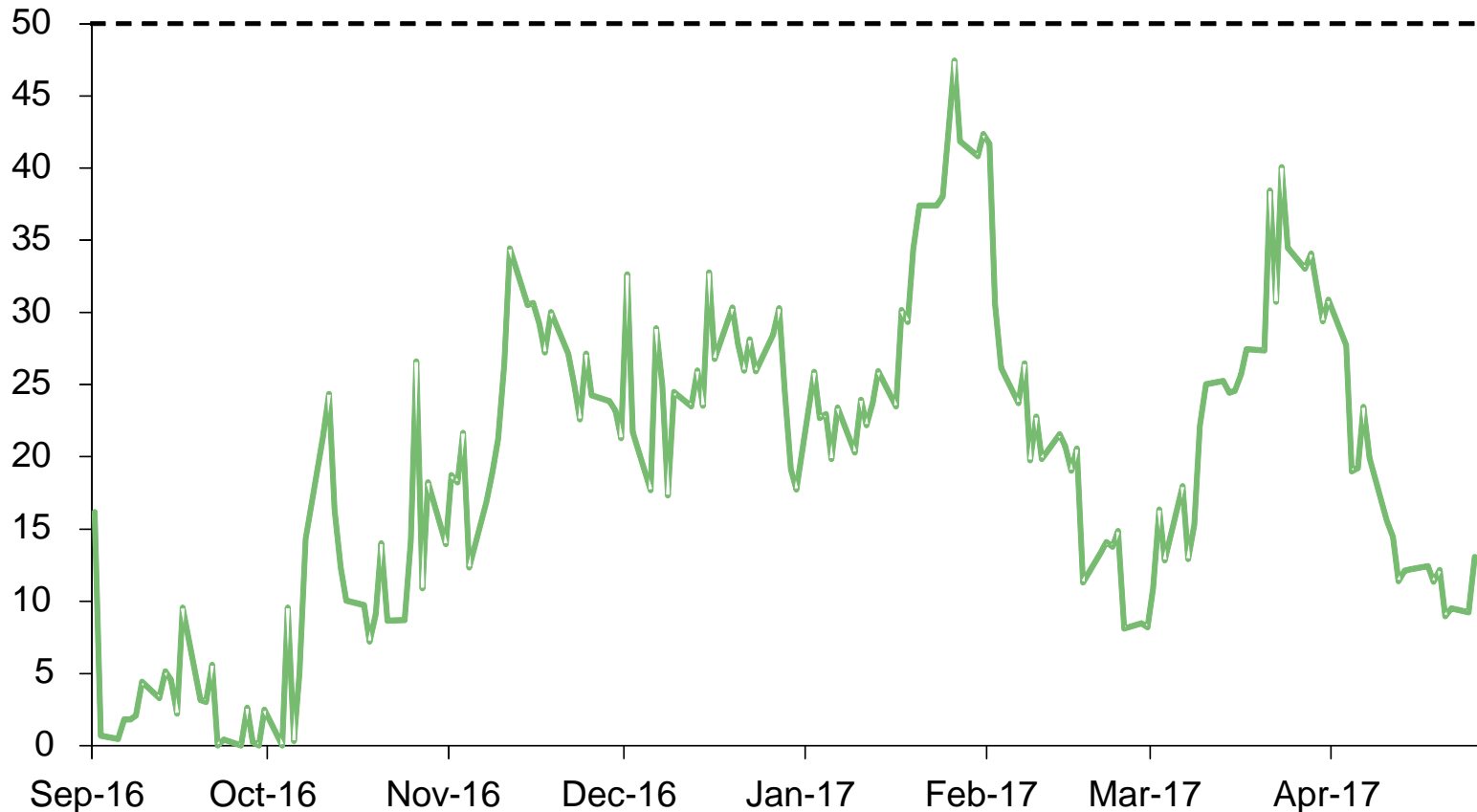
Source: Bloomberg, LBCB calculations

MARKET-BASED PROBABILITY OF UK RATE HIKE IS LOW



Growth is at the forefront of the BOE MPC's thinking, with risks in both directions. The economy has proven more resilient than forecast of late, leaving a significant degree of uncertainty to the outlook

% Probability of BoE hike by end-2017 (OIS curve)



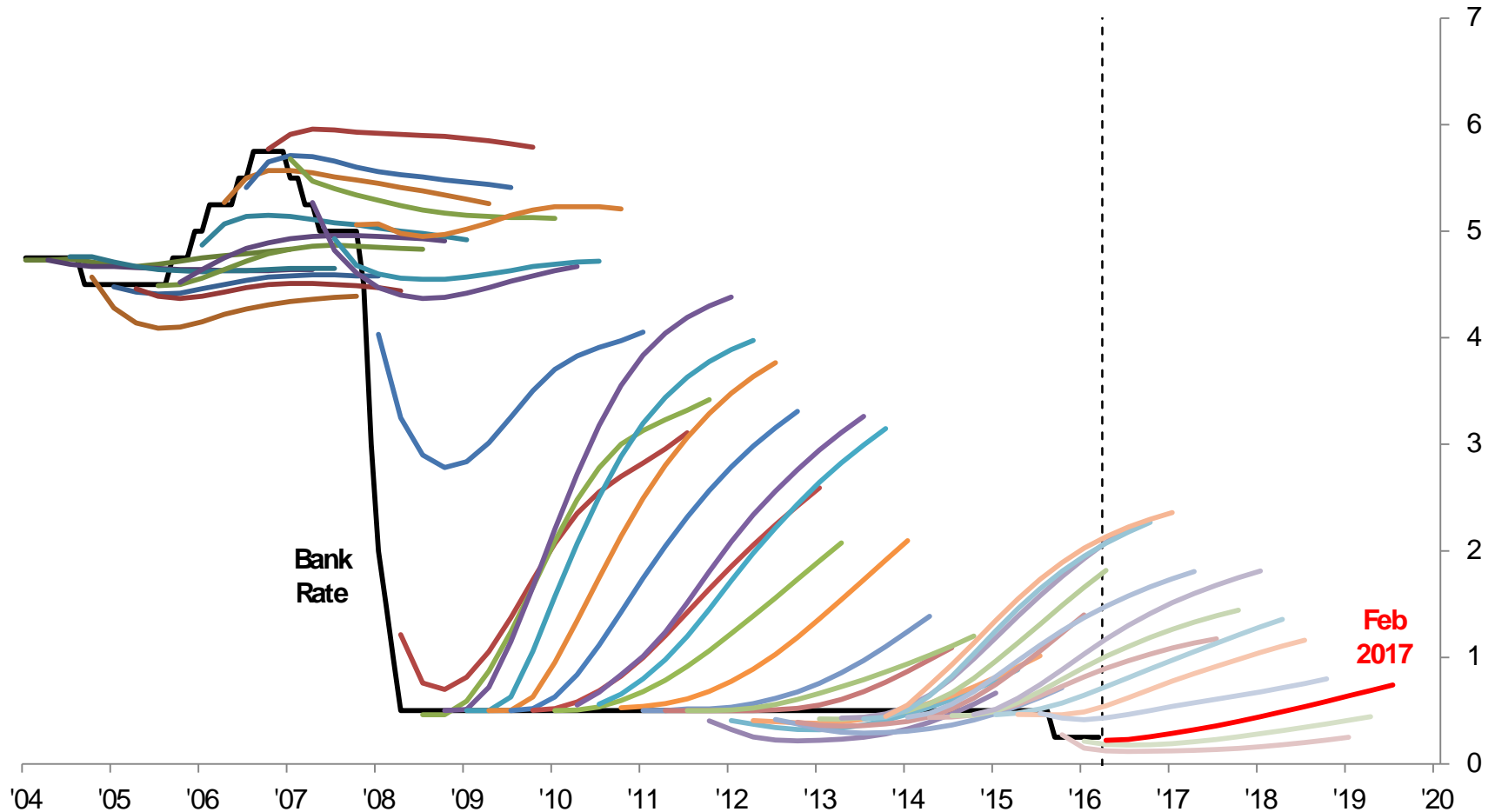
Source: Bloomberg, 25/04/17

BANK RATE HIKE FAR FROM BEING BAKED IN THE CAKE



We've been here before, notably in mid-2014: increased optimism around global growth raised UK hike expectations, aided by policymaker rhetoric, but which did not materialise

Past market rate expectations profiles at previous BoE Inflation Reports



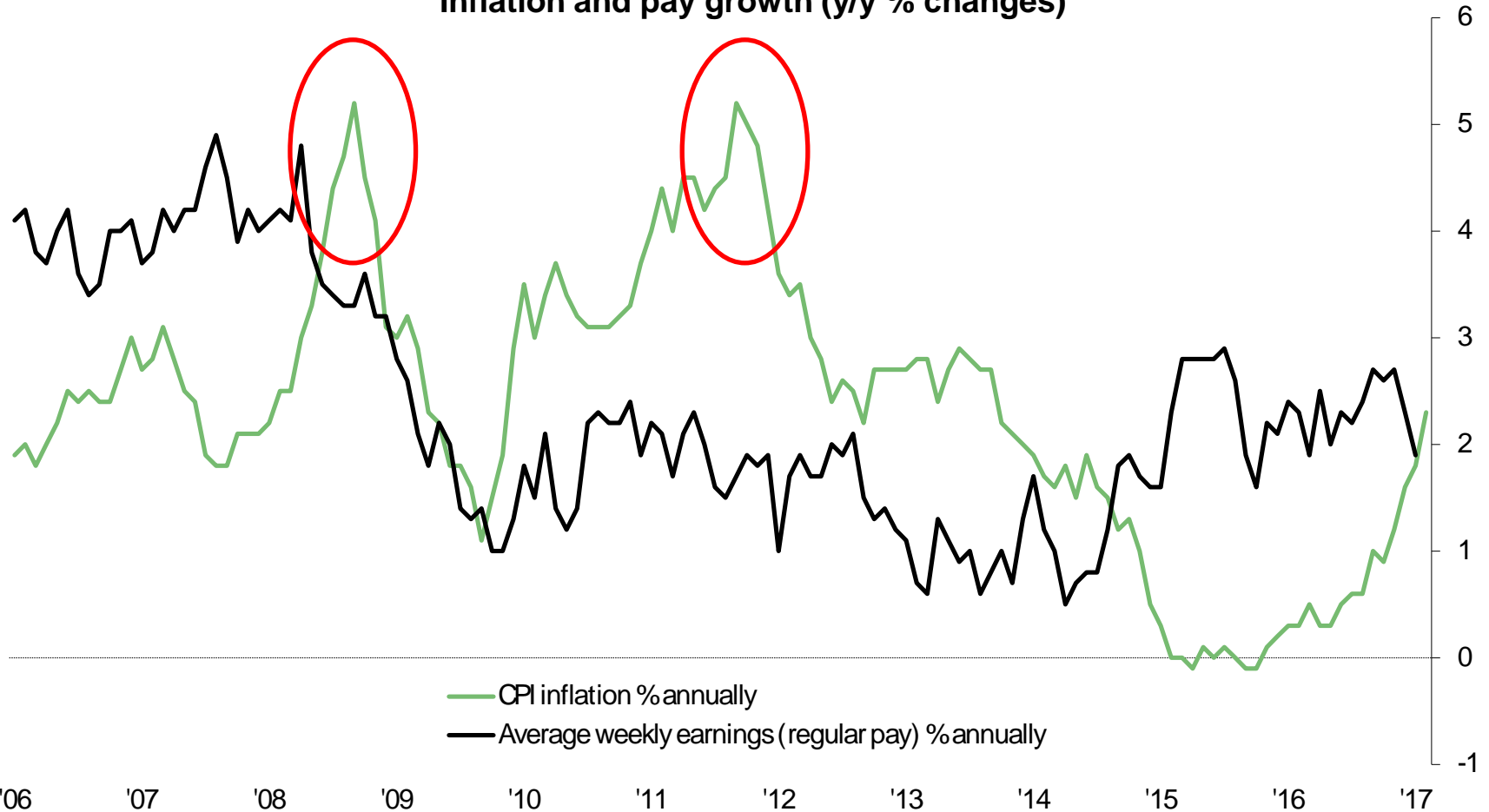
Source: Bloomberg, Bank of England

MPC HAS FORM IN LOOKING THROUGH INFLATION SPIKES



CPI peaked at 5.2% y/y in 2008 and 2011 but the BoE did not slam on the brakes; we expect a rise in UK inflation to 3.3% by 2017 Q4, but the BoE should stand pat unless wage inflation picks up as well

Inflation and pay growth (y/y % changes)



Source: ONS

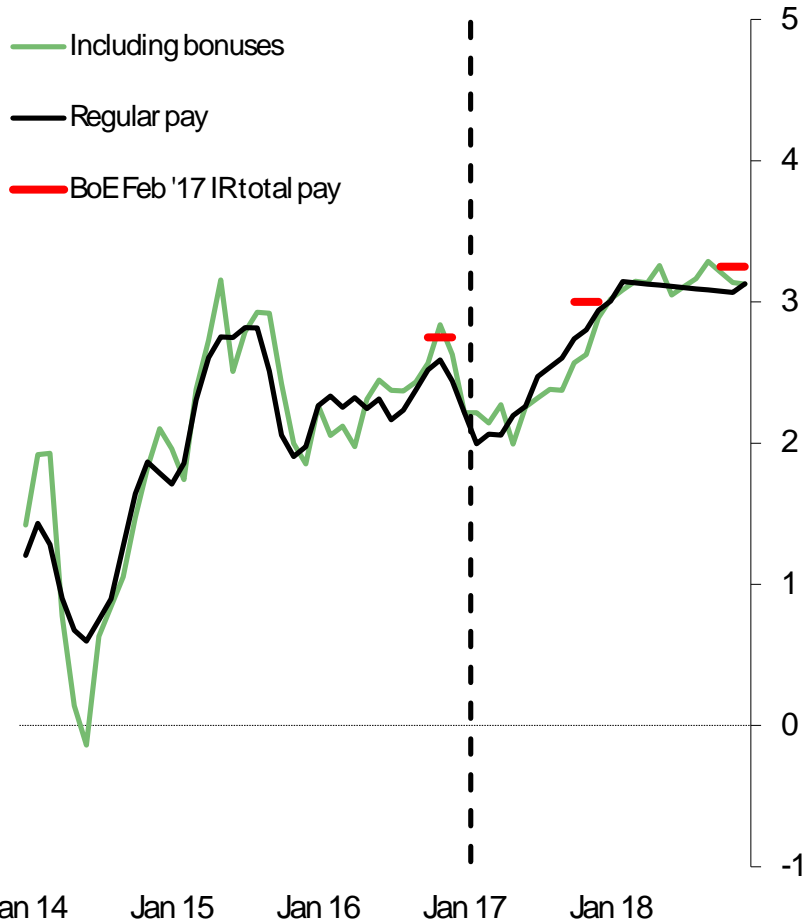
WAGES: STILL MUTED – DESPITE INFLATION PICKING UP



Forward-looking indicators do not give clear sight of pressure on wages from past tightness in the labour market; real income growth likely to suffer as inflation erodes purchasing power

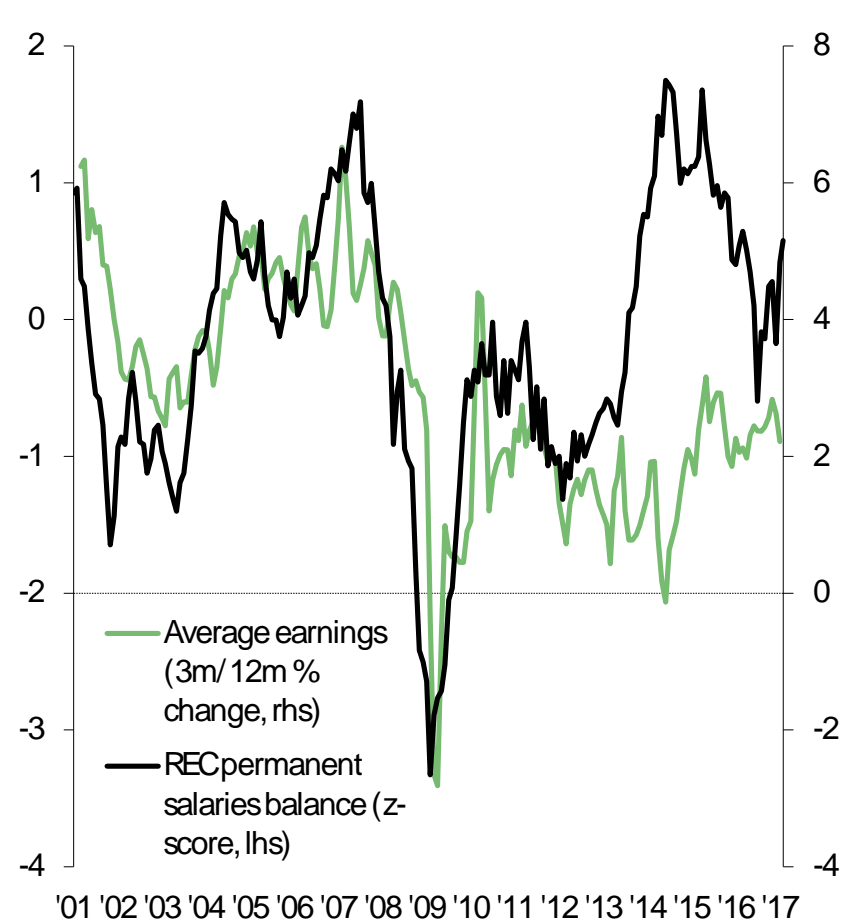
Earnings growth forecast

3m/12m % change



Jan 14 Jan 15 Jan 16 Jan 17 Jan 18
Source: ONS, Bank of England, LBCB calculations

Earnings growth official data vs REC survey

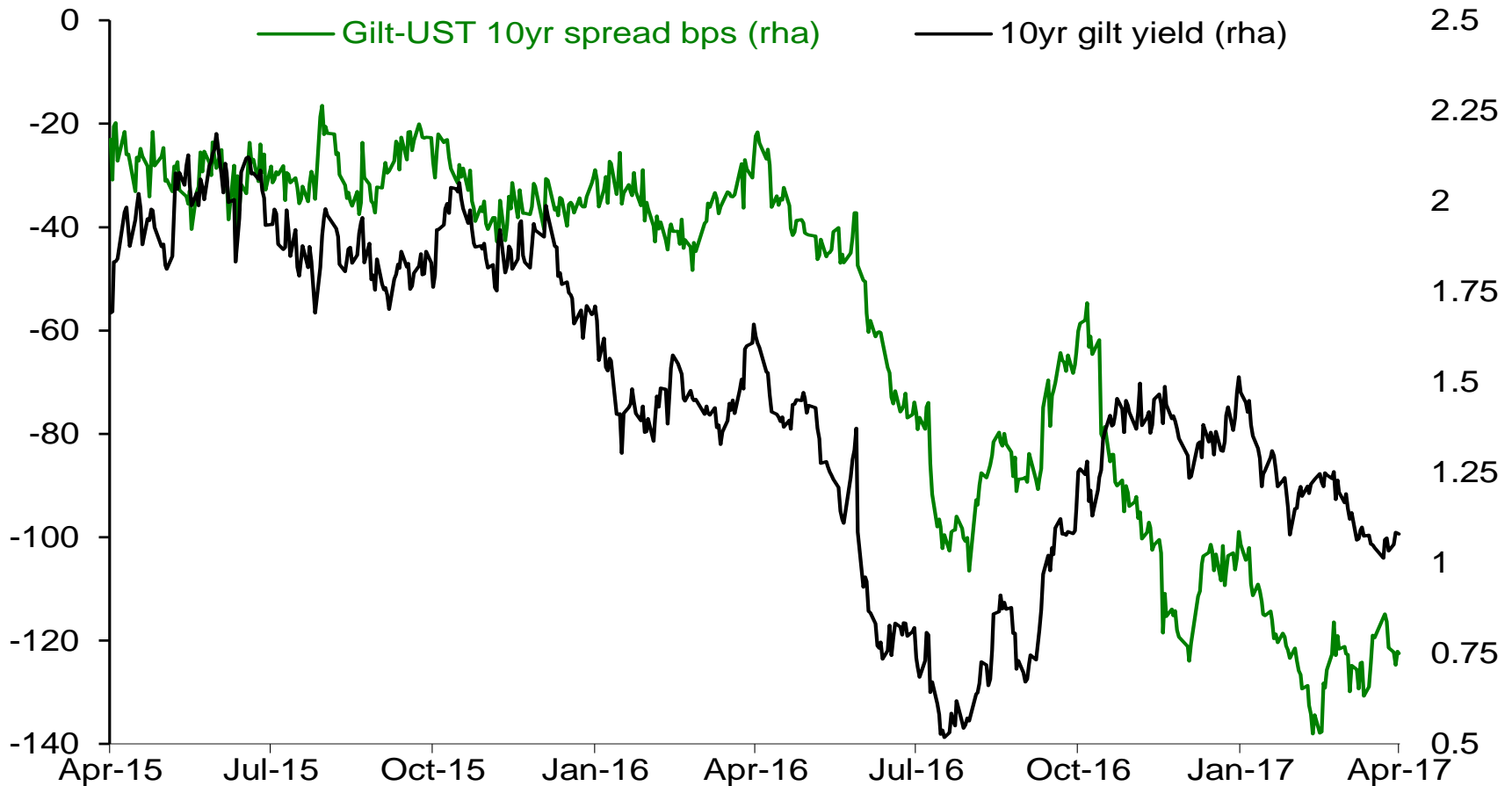


'01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17
Source: ONS, REC/Markit, LBCB calculations

CAN GILT OUTPERFORMANCE CONTINUE?



UK 10-year yields flirting with 1% again as global demand for safety returns. But with the BoE QE programme complete and inflation rising can the spread with the Treasuries remain so large





GBPUSD – Swing dynamics

Since peaking in 2014 at 1.7000, each of the swings lower have been in the magnitude of 15%, while the rebounds have been around 9% (bar 1). The latest rebound into important resistance around 1.30 has been a similar size.



Source: Bloomberg data, Lloyds Bank, Commercial Banking analytics as of 26/04/2017



GBPUSD, Monthly Chart

The cycle that started in 2007 at 2.1160 is in its last phase before a return to the 1.7000 mid-point in the long-term. Medium-term we believe a lower range around 1.2500 is likely through the negotiation process. 1.15-1.08 is major long-term support in this regard, while 1.30-1.35 is key resistance



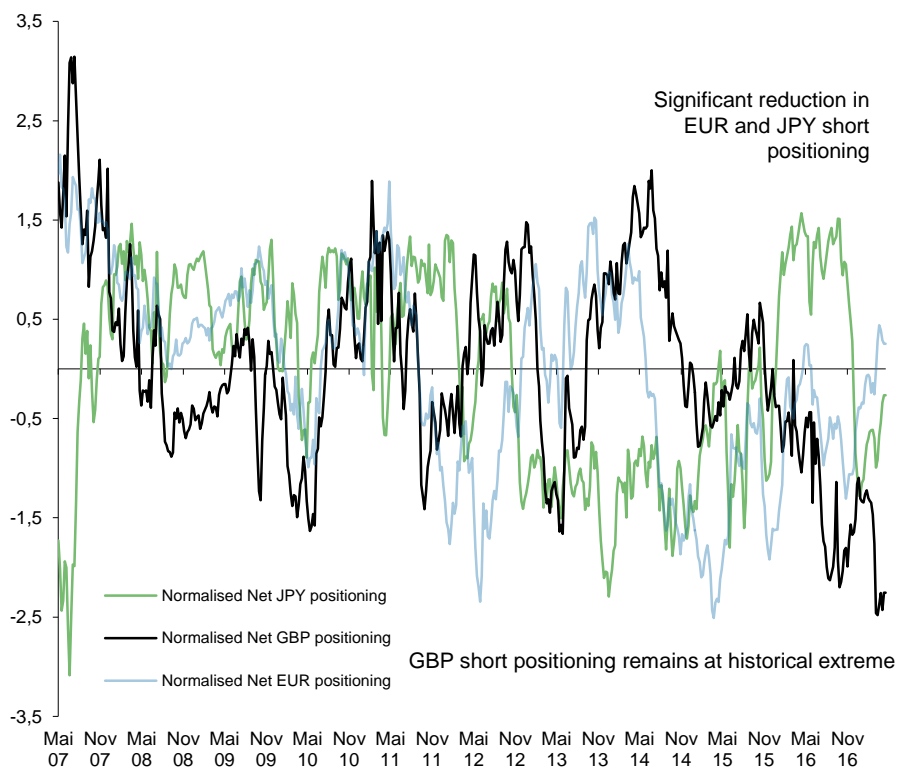
Source: Bloomberg data, Lloyds Bank, Commercial Banking analytics as of 26/04/2017



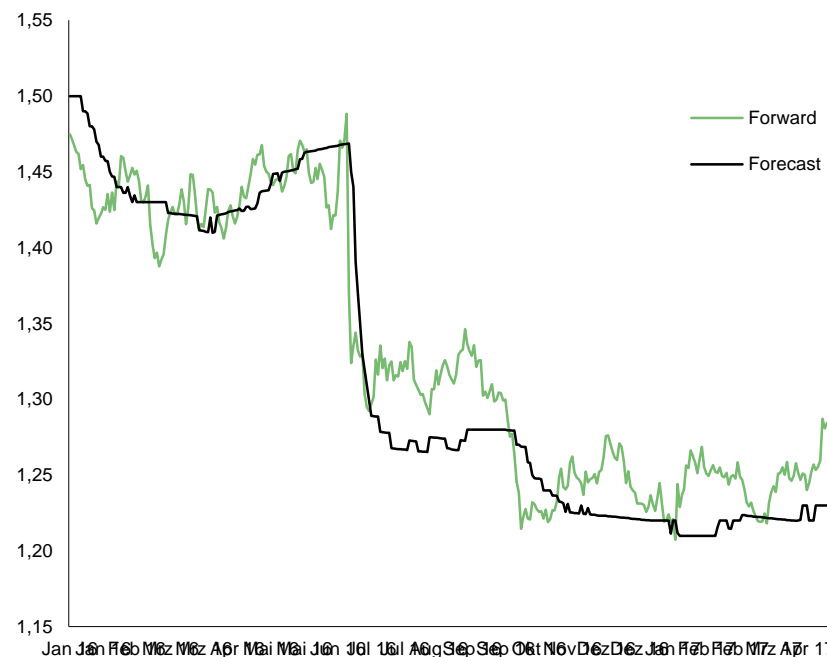
GBP SHORT POSITIONING STILL EXTREME...

Positioning suggests market is still short sterling. In spite of the recent rally, broader sentiment remains cautious, as reflected by analysts' expectations

Normalised CFTC FX Positioning



Mean of analysts' forecasts for GBP Currency

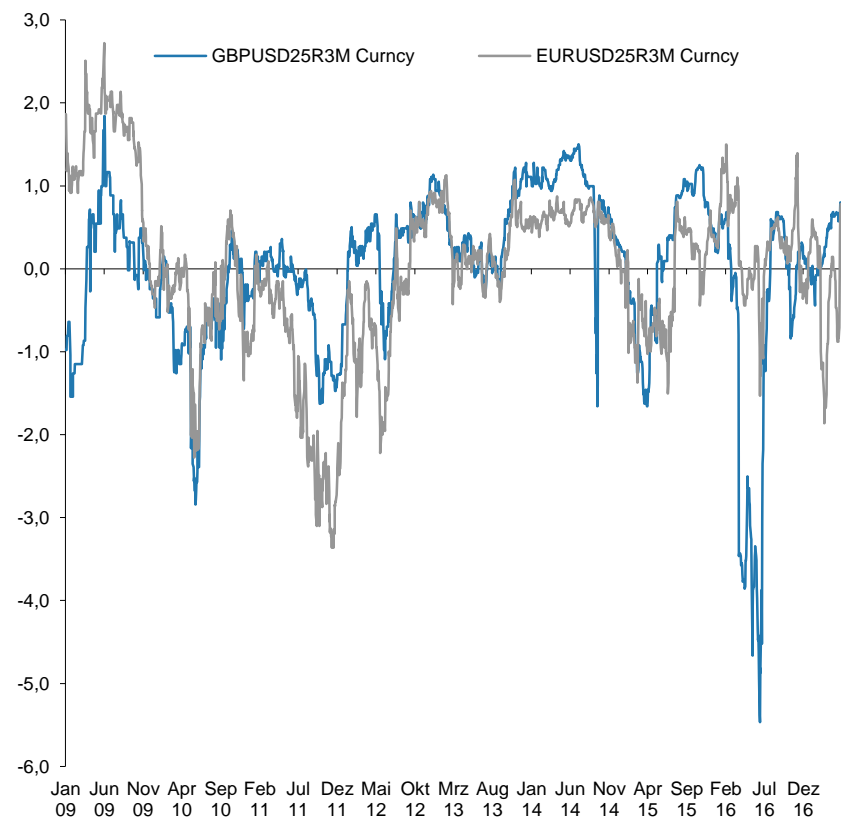
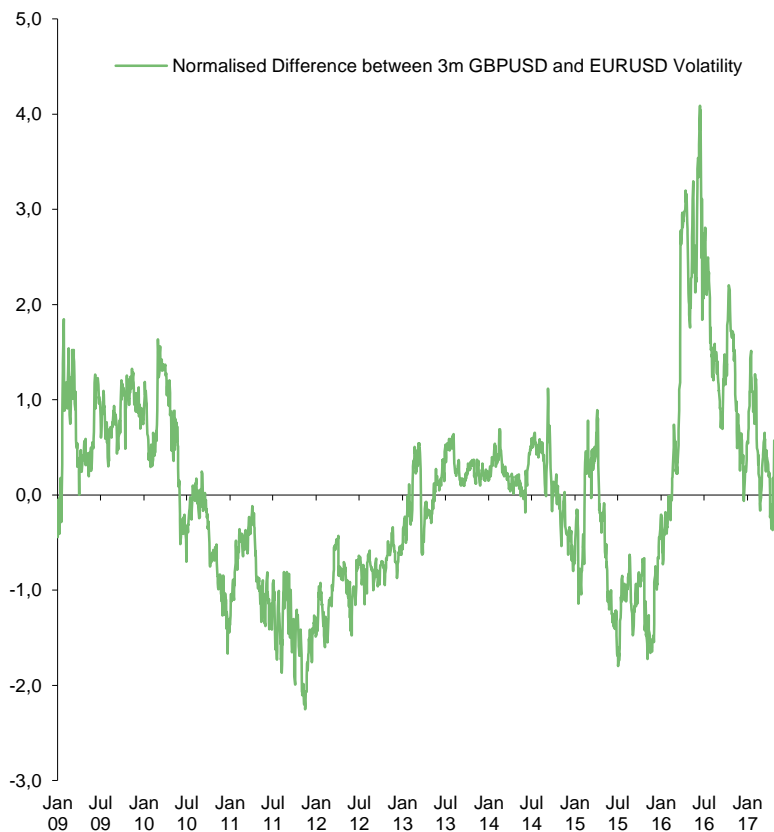


Source: Input data used with the permission of Bloomberg Finance L.P., Lloyds Commercial Bank Calculations as at 26-Apr-17. Past performance is not necessarily a guide to future performance



...BUT BEAUTY IS IN THE EYE OF THE BEHOLDER

Risk premium priced into GBP and EUR has declined. Option market more optimistic than analysts, with risk reversals on relative basis favouring GBP and EUR calls – suggesting spot may move higher

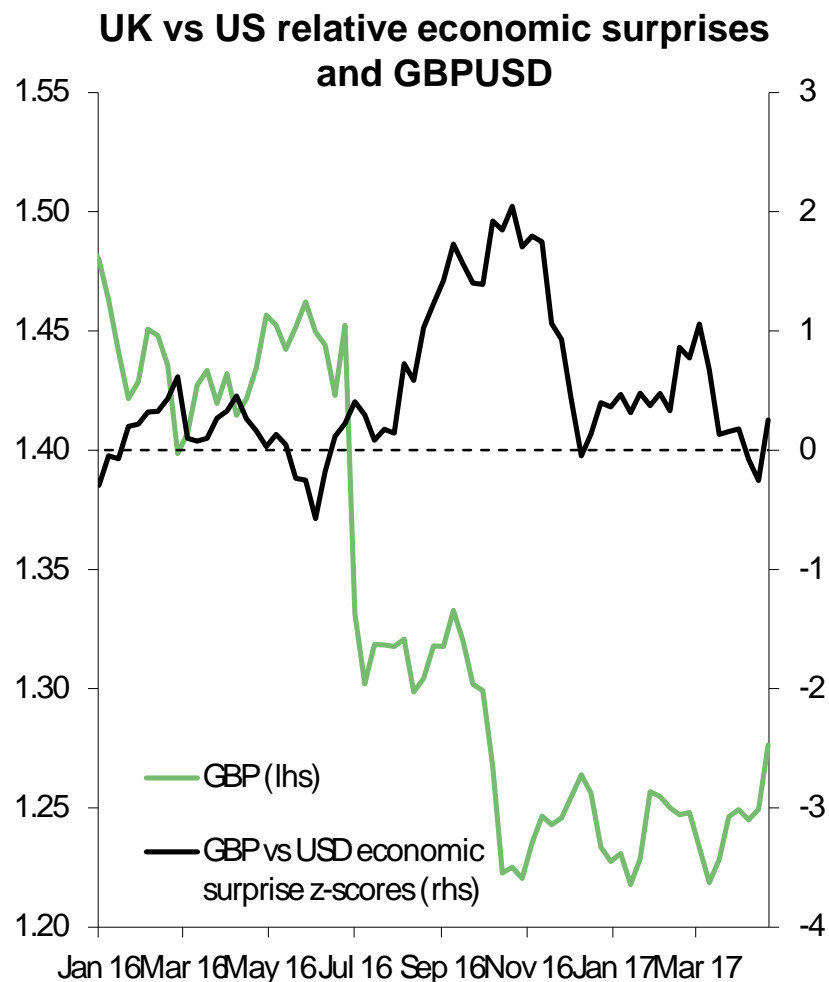


Source: Bloomberg data, Lloyds Bank, Commercial Banking analytics as of 26/04/17

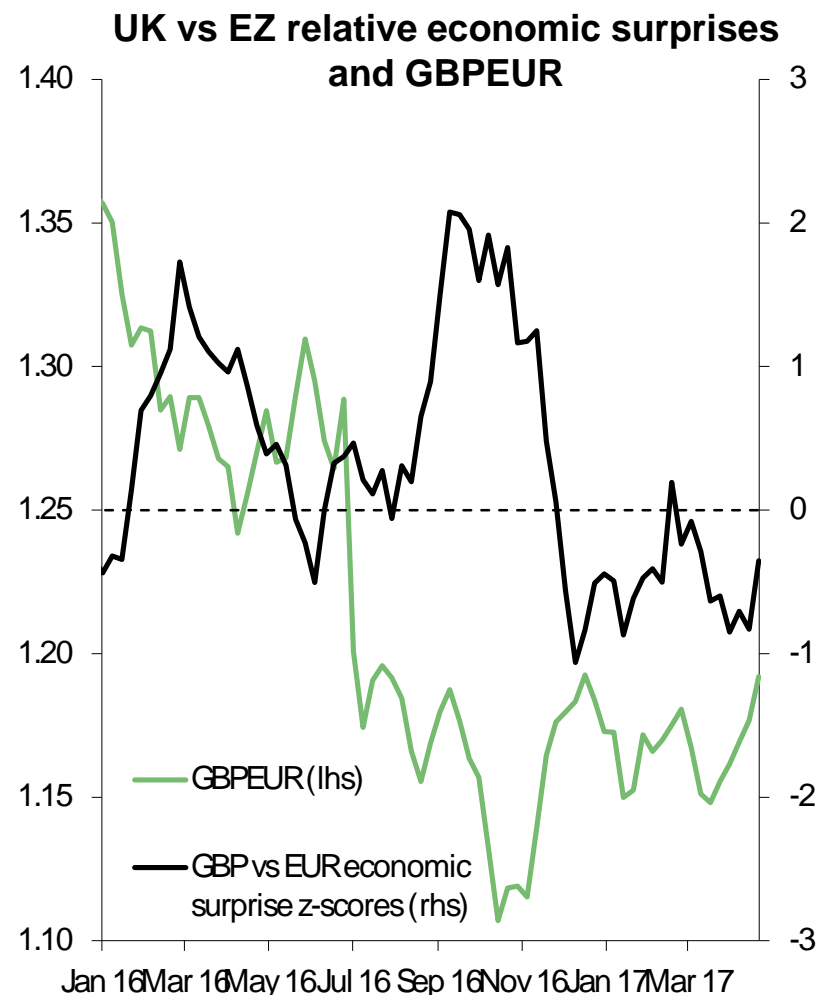
RELATIVE DATA TRENDS UNLIKELY TO FAVOUR GBP



Run of stronger UK data obviated the risk of further BoE easing, but with the support provided by positive economic news largely fading, it is unlikely to a major driver for the currency



Source: Citi, Bloomberg and LBCB calculations



Source: Citi, Bloomberg and LBCB calculations

KEY ECONOMICS VIEWS



- Global policy divergence: US tightens, Eurozone and Japan continue to loosen with UK on hold
- Inflation trends and capacity absorption warrant continued Fed tightening after the Dec 2015 'lift-off' – Trump presidency should presage a quicker pace, as post-election plans become clear
- Prompt monetary stimulus alongside fiscal easing and £ depreciation means the UK experiences only a modest growth deceleration – but still a slower eventual 'trend' rate after EU exit
- No further BoE stimulus in base case, with emergency loosening in August 2016 now looking overzealous; skew moving back to tighter policy amid inflation surge and growth resilience
- Scope for disappointment on consensus 'dollar strength' view if fiscal stimulus hopes fall short; but ongoing QE and testy EU exit negotiations pose downside risks for euro and sterling
- Eurozone fragmentation risks back in focus on EZ political event calendar: market consensus of no further political surprises looks sanguine, but 'upside' surprises of greater note
- Rising inflation rates and better growth dynamics should see term rates move higher as Fed normalises; increased fiscal stimulus could herald switch out of persistent low-rate world

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