The Silver Bullet

The High Price of a Hard Brexit

"I want it to give British companies the maximum freedom to trade with and operate within the Single Market – and let European businesses do the same here.

But let's state one thing loud and clear: we are not leaving the European Union only to give up control of immigration all over again. And we are not leaving only to return to the jurisdiction of the European Court of Justice. That's not going to happen."

UK PM Theresa May, 5 October 2016

In her speech to the Conservative party last week, PM Theresa May spelt out her vision of "*a global Britain*" and "*a fairer economy that works for everyone*". Behind the slogans, there is a huge gap between promises and reality.

May's unelected government has promised a country and an economy that works for everyone, more fiscal spending, a normalisation in monetary policy and swift action to reduce immigration while at the same time remaining in the single market. We believe these objectives, together, are simply unrealistic and unachievable.

European leaders have reacted strongly against an EU membership *a la carte*, asserting that freedom of movement and freedom of trade cannot be separated. We expect this stance to stay unchanged. This means the UK will likely face a common front line against bilateral negotiations. Meanwhile, by announcing she will trigger Article 50 by the end of March and ruling out a parliamentary vote, PM May has burned her ships after landing in an unknown economic territory.

What happens next? Investors have already spoken. The verdict on May's confusing ("*Brexit means Brexit*"), hard-nosed negotiating strategy has been undoubtedly negative. The first victim is Sterling; Gilts could be next. We expect a long and tough negotiation period for the current government, both with the EU and domestically. We believe the lack of a realistic plan will hurt the UK economy through more currency depreciation, higher inflation and a potential loss of investment and jobs. In a Hard Brexit scenario, we estimate the *direct* economic cost at £140bn for the UK economy, equal to 7.5% of GDP.

The UK and the EU may eventually find an agreement, but without structural reforms the many problems mentioned in May's speech – inequality, a lack of economic restructuring, too-loose monetary policy – will remain.

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Hard Brexit Becomes the Base Scenario

PM May has promised to trigger Article 50 by no later than the end of March 2017. In our view, there are three possible scenarios ahead:

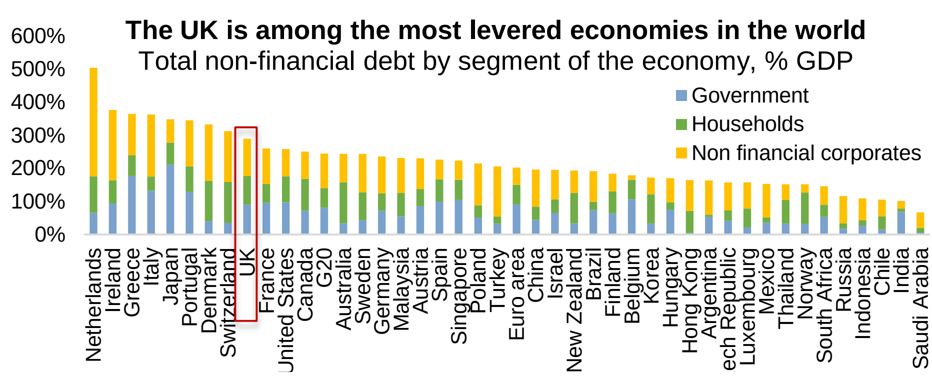
Scenario	Chance	Impact on the UK economy	BoE response	Political spill-over to Europe
Hard Brexit	60%	Recession. Loss of EU passporting rights. Job losses in finance-related sectors.	Rates cut to negative	EU breakup fears resurface
Soft Brexit	30%	Medium term weaker growth, until EEA or EFTA status is approved.	One more cut to zero	Anti-EU protest parties gain ground
Bremain	10%	Article 50 not triggered. New elections. Short term weaker growth.	Lower for longer	Contained

Source: Algebris Investments (UK) LLP

We think the probability of a Hard Brexit has gone up considerably, given PM May's strong statements about immigration control and a plan to withdraw from the jurisdiction of the European Court of Justice. In order to retain access to the Single Markets, the UK needs to join the European Economic Area (EEA) like Norway, Iceland and Liechtenstein or join the European Free Trade Area (EFTA) like Switzerland. Both the Norwegian model and the Swiss model would require free movement of people – the fomer due to EEA membership requirements and the latter under bilateral agreements in return for free trade benefits. It is unlikely for the UK to win exceptional terms. To the contrary, other EU countries are likely to form a common-front in the negotiations in order to set a tough precedent and deter other potential exiters. In addition, triggering Article 50 before the French Presidential and German federal elections could mean even less leniency towards the UK, as the incumbent governments are likely to act tough to appeal to their respective electorates.

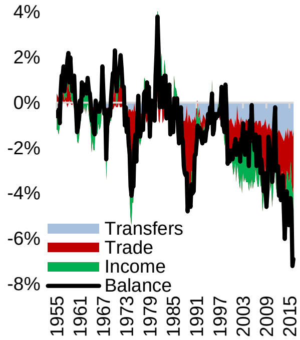
Soft Brexit is now less likely. It would require the PM to soften her stance on immigration and EU laws. This could happen following a Parliamentary vote against Brexit. PM May so far has agreed to a Parliamentary debate, but stopped short of promising a Parliamentary vote (FT). Meanwhile, a legal challenge has been brought against the government's plan to invoke Article 50 without a Parliamentary vote. The High Court is due to hear the challenge in London on October 13th and 17th (Bloomberg).

A U-turn to a Bremain decision might only be possible with an overwhelming parliamentary vote against Brexit or new elections. This seems highly unlikely, as we do not expect MPs to vote against their constituents and new elections will likely again result in a Conservative majority government led by May.



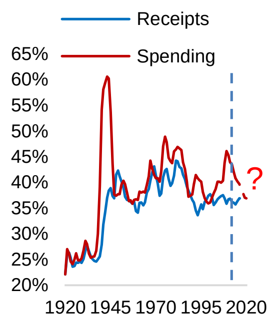
Source: Algebris Investments (UK) LLP, Bank for International Settlements (BIS)

Rising current account deficit
% GDP



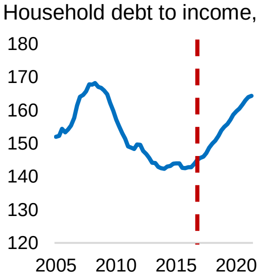
Source: Algebris Investments (UK) LLP, Office of National Statistics (ONS)

Fiscal gap is still at 5% GDP



Source: Algebris Investments (UK) LLP, Office of Budgetary Responsibility (OBR)

Debt continues to rise
Household debt to income, %



Source: Algebris Investments (UK) LLP, Office of Budgetary Responsibility (OBR)

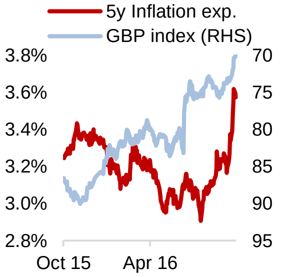
Unrealistic Expectations Likely to Meet the Reality of a Hard Brexit

In her speech, PM May promised more public investment, less reliance on monetary policy, measures to address inequality and humanitarian support for refugees. However, the reality is the UK still suffers from among the highest deficits in Europe and rising public and private leverage, while economic imbalances and social imbalances are deeply rooted across the country. With the costs of a Hard Brexit starting to kick in, the same parts of the electorate who voted for Brexit will be the most hurt.

Expectations: What PM May wants to do	Reality: What the UK can / will do
Monetary Policy: *"Because while monetary policy – with super-low interest rates and quantitative easing – provided the necessary emergency medicine after the financial crash, we have to acknowledge there have been some bad side effects."*	The BoE is unlikely to tighten rates as: - A recessionary or lower-growth environment will warrant continued monetary easing - Higher rates will make overlevered households even more financially vulnerable (OBR projects 164% household debt to income in 2020)
Fiscal Stimulus: *"[…] we need to do: take big, sometimes even controversial, decisions about our country's infrastructure"*	The government cannot afford a large-scale fiscal stimulus plan as: - The UK had the second largest fiscal deficit (at 4.9% GDP) amongst EU countries in 2015, and the government aims to achieve a fiscal surplus by 2020-21 - To fund a large fiscal stimulus, the government will need to seek private investments. Foreign sources of capital will be less forth coming until there is clarity on the status of the UK's trade relations with the EU and rest of the world
Inequality: *"Advancement in today's Britain is still too often determined by wealth or circumstance. By an accident of birth rather than talent. By privilege not merit"*	The government is unlikely to make major strides in tacking inequality as inequality in the UK is deeply structural. Two thirds of Britons believe that who you know is more important than what you know, an opinion supported by the fact that while Oxbridge graduates make up only 0.8% of the adult population, these graduates account for 75% of Senior Judges and 38% of the Lords.
Humanitarian Aid: *"Providing humanitarian support for refugees in need."*	The government is unlikely to approve further humanitarian aid as: - The UK's contribution has declined in $ terms due to currency depreciation, and any disbursement increases will now have a lower net impact - PM May has previously advocated for a stricter asylum system (while the UK has accepted 8,000 Syrian refugees since 2011, Germany accepted around 1m refugees in 2015 alone)

Source: Algebris Investments (UK) LLP, PM Theresa May October 5th Speech at Conservative Conference, Elitist Britain?" UK Gov, OBR, BOE, Amnesty UK, Sky News, The Independent

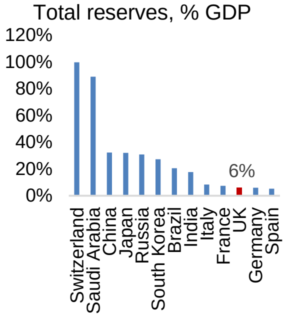
Depreciation brings inflation



Source: Algebris Investments (UK) LLP, Bloomberg. Deutsche Bank GBP Trade Weighted Index Spot. Inflation rate is 5-yr,5-yr forward.

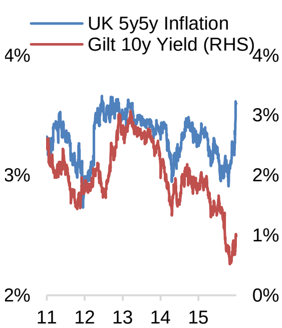
BoE: limited dry powder

Total reserves, % GDP



Source: Algebris Investments (UK) LLP, IMF

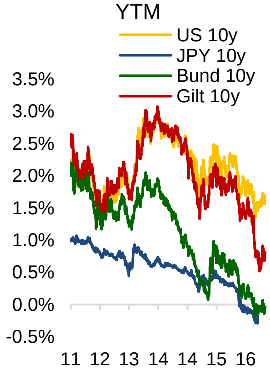
Gilt yields look vulnerable



Source: Algebris Investments (UK) LLP, Bloomberg

Gilt yields near record lows

YTM



Source: Algebris Investments (UK) LLP, Bloomberg

Estimating the Cost of a Hard Brexit

In a Hard Brexit, the UK could lose its passporting rights for financial services and face tariffs for exports of goods to the EU. Sterling will likely depreciate further, potentially to parity with the Euro. In our view, the UK will face direct costs in three areas: loss of jobs and investment, loss of tax revenues and erosion of wealth due to inflation.

		Low loss estimate		**High loss estimate**	
	Background	**Assumption**	**£bn**	**Assumption**	**£bn**
1. GDP losses					
Household (HH) Consumption	Last 12m = £1152bn. HH consumption declined by -3.5% per annum during the last recession (Q3 2008-Q4 2009)	-2.5% decline in consumption	-29	-5% decline in consumption	-58
Foreign Direct Investment (FDI)	Total outstanding FDI: £1,065bn 44% from the EU	5% of EU FDI leaves the UK	-23	10% of EU FDI leaves the UK	-47
Exports of financial/insurance services	Annual GVA = £126.9bn Annual exports to the EU = £28bn	Half EU fin. services relocate	-14	All EU fin. services relocate	-28
Exports of manufactured goods	Total annual exports = £230bn 50% to the EU Assuming -0.6 price elasticity	5% tariff	-3	10% tariff	-7
Total GDP losses			**-70**		**-140**
As % GDP			**-3.7%**		**-7.5%**
2. Tax revenue losses					
Losses due to GDP losses	UK tax revenue is around 25.5% GDP		-18		-36
Income tax losses due to job relocation	Financial services jobs = 1.3mn Manufacturing jobs = 3.0mn Average wage for financial services workers = £32k Average wage for manufacturing workers = £30k	10% jobs relocate	-3	20% jobs relocate	-6
Total tax revenue losses			**-21**		**-41**
As % GDP			**-1.1%**		**-2.2%**
3. Savings erosion due to inflation	BoE estimates: 10% GBP depreciation (dep.) = 2-3% rise in inflation Total private savings = £136bn	20% dep. 2% rise in inflation per 10% dep.	**-5**	20% dep. 3% rise in inflation per 10% dep.	**-8**

Source: Algebris Investments (UK) LLP, ONS, BoE, Eurostat, World Bank, IMF, UK Trade & Investment, UK Parliament

Rising Inflation + Higher Deficits = Short Gilts

UK government bonds are amongst the most vulnerable assets to a Hard Brexit, in our view. Under a Hard Brexit, the UK is likely to enter a period of stagflation, as Sterling's depreciation will push import costs higher: the UK imports nearly 46% of its energy and 50% of its food. Inflation expectations have already risen (to 3.6% for the 5-year, 5-year forward), yet 10-year Gilt yields remain well below at around 1%.

Gilts are currently anchored by QE-expansion expectations which, in our view, cannot be delivered by the BoE. First, global monetary policy is shifting against negative interest rates, as we wrote earlier in September (The Silver Bullet | Central bankers: the tide is turning). Second, the BoE will have to deal with higher inflation soon. Third, many UK firms are now under pressure on rising pension deficit, made worse by low long-term Gilt-yields. This means at most another rate cut to zero, which is becoming increasingly unlikely as Sterling depreciates. Fourth, a fiscal stimulus would imply more issuance: the OBR had forecasted £72.2bn in government borrowing in 2015-2016 vs BoE additional purchases of £60bn over 6 months.

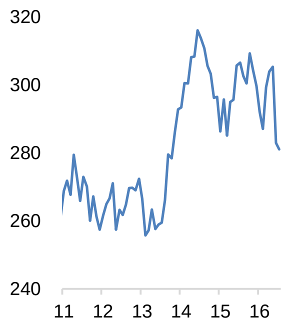
Real Solutions: Re-engineering the UK Growth Model

The UK has become a Divided Kingdom, after decades of imbalanced growth, fiscal and monetary policies aimed at boosting asset prices and a lack of long-term investment. These issues call for a deep economic restructuring.

Below are some of the real solutions that we think could make a real difference.

Prevent another rise in household leverage, by increasing the supply of housing and tightening macro prudential measures. The UK has been in a net-housing deficit since 2008, with the number of new households exceeding the number of new homes built. In England alone, 232k to 300k new units are needed each year, or around two to three times current supply, according to the UK Parliament. While the government may be unable to increase subsidies for new affordable housing due to fiscal restrictions, housing supply could be increased through building on the UK's Green Belts. Additionally, the Bank of England could tighten macro prudential policies through tighter thresholds on loan-to-income mortgages, while limiting subsidies on mortgages extended under the Help-to-Buy scheme.

UK homes: a wealth illusion
UK avg. house prices in $, 000

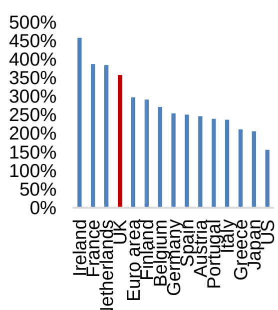


Source: Algebris Investments (UK) LLP, Bloomberg

Encourage private investment in the real economy, including in infrastructure. Over the past three decades, the UK has spent less on infrastructure than the OECD average of around 2.5 - 3% GDP. As a result, while the quality of UK's infrastructure is close to the OECD average, it is lower than the G7 average (OECD). The largest infrastructure spending needs are in electricity generation, air transport and road (for example, Heathrow operates at nearly 99% capacity every day, according to reports). The UK needs infrastructure investment at 3.5% of GDP to maintain Britain's competitiveness and Britons' quality of life, according to the OECD (UK Parliament). However, public sector infrastructure spending was only around 1.5% of GDP in 2015 and may average around 1.3% GDP between 2016-2021 even if the government's ambitious £100bn infrastructure commitment is executed.

Reduce inequality, increase access to education, consider a reform in taxation. Inequality in the UK has been rising steadily over the past decade, as declining interest rates have supported asset prices. In more recent years, global QE has further bolstered the wealth of asset owners, thereby contributing to the rise in inequality, in our view. Simultaneously, tighter fiscal policy has penalised income relative to assets, as while the top income tax rate is 45%, capital gains tax is only 28% (and 0% for primary residencies). Implementing tax on property or wealth values– which the UK does not apply, unlike most other developed markets – could help rebalance the rise in inequality while also helping reduce the fiscal deficit and incentivising asset owners to reallocate funds away from UK property and towards real-economy assets such as stocks and bonds. Conversely, stamp duty is an inefficient form of taxing property, penalising transactions yet incentivising forms of parking cash.

Still over-banked
Bank asset size/GDP



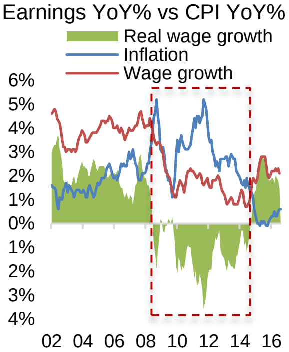
Source: Algebris Investments (UK) LLP, ECB, FRED, BoE, BoJ

Access to education is key to increasing social mobility. In the UK, 0.8% of the population who graduate from Oxford and Cambridge account for 75% of Senior Judges and 38% of the Lords (Social Mobility and Child Poverty Commission).

Diversify the financial system away from banks, towards financial markets and other alternative sources of funding. Relative to the rest of Europe, the UK is less reliant on bank funding, and its financial system is among the largest in the world, compared to GDP. However, as UK banks may constrain new lending following Brexit, the BoE could encourage alternative forms of corporate funding through bonds, private placements and securitisations.

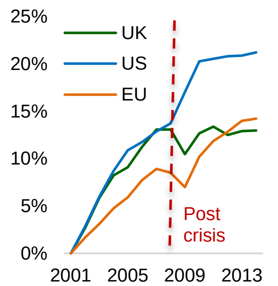
Redefine immigration policy. There is little or no evidence that immigration has lowered wages or taken away jobs from British workers (LSE research). Tightening immigration policy, on the other hand, would have a negative impact on UK services and on the housing market itself.

Inflation eroded real wages
Earnings YoY% vs CPI YoY%



Source: Algebris Investments (UK) LLP, Bloomberg

Productivity stalled post-crisis
Cumulative productivity growth



Source: Algebris Investments (UK) LLP, OECD

Inequality is deeply rooted

6th highest income inequality amongst OECD members

7% privately educated Britons are:
- 71% of senior judges
- 55% of Permanent Secretaries
- 53% of Senior Diplomats
- 50% of Lords
- 44% of the Sunday Time's 'Rich List'
- 43% of Columnists
- 35% of the National Rugby Team

Top 1% of earners pay 27% of tax

45% of Britons from the top income quartile remain in this bracket

12% only of those in the lowest income quartile ever migrate to the highest quartile

Source: Algebris Investments (UK) LLP, "Elitist Britain?" UK Gov

Conclusions: More Pain Ahead as Expectations Meet Reality

As Theresa May's strategy emerges from the fog of confusing slogans and self-validating statements ("*Brexit means Brexit*"), markets are pronouncing their hard and unappealable verdict: Brexit will severely hurt the UK economy.

The Pound has slid again to 1.2 against the Dollar and inflation expectations for the next five years have reached over 3.5%. In a few days, the illusion that a divorce from the EU would be painless has been suddenly dispelled.

The question now is how long it will take May's government to realise the ship is about to run aground, and whether it will then be too late to change tack.

So far, both politicians and regulators appear in complete denial. Former BoE Governor King cheered the arrival of inflation, while the current board members continue to discuss potential easing.

Meanwhile, investors are likely to continue to flee UK assets. The first casualty has been the Pound. Gilts, which the UK Treasury needs to continue issuing to fund its wide deficit, could be next. The result will be stagflation: a combination of import-led inflation and lower growth due to loss of investment and jobs.

PM May will eventually realise that her half-hearted negotiating strategy is doing more damage than good, and that the public purse is becoming increasingly empty. The UK already lost its triple-A ratings and is heading for 90% debt to GDP by the end of this year. And while past governments were able to use incentives to stimulate private credit and boost consumption, like the Help-to-Buy, these have pushed households to revisit pre-crisis records in debt levels. But while debt has boosted asset prices in local currency and created a paper wealth effect, living standards haven't grown, and real wages are lower today than they were pre-crisis.

In conclusion, there is no shortcut. Blaming immigration may secure a consensus among citizens who see little hope for themselves, but it is a mere political expedient. The UK has widely benefited from its status as Europe's services hub, while there's little or no evidence that immigration has resulted in job losses for Britons.

At the heart of the problem, we believe, is Britain's deep-rooted inequality, its unbalanced growth model, centred on London and financial services, and a lack of social mobility.

What the UK needs is wider access to education, investment in infrastructure, a strategy to gradually diversify away from financial services and a reform of its tax system to reduce tax evasion and rebalance the tax strain on income vs wealth accumulation. It also needs a plan to build new homes, rather than boosting debt and prices of the existing ones.

Exiting the EU was never the solution to the UK's economic and social issues. Theresa May needs a plan to re-engineer her country's growth model. So far, she has shown she doesn't have one.

Alberto Gallo is Head of Macro Strategies and Partner at Algebris Investments (UK) LLP, and is Portfolio Manager for the Algebris Macro Credit Fund (UCITS), joined by macro analysts Tao Pan and Aditya Aney.

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