S&P Global Ratings

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Countdown To Brexit: No-Deal Risks Revisited

October 4, 2019

Key Takeaways

- Our base case remains that the U.K. will not exit the EU without a deal. However, the risk of a no-deal Brexit remains high.
- In a no-deal scenario, we forecast U.K. GDP would shrink by 2.8% in 2020. In 2021, output would be 4.7% lower than under our base case, in which the U.K. and EU agreed on a deal.
- We estimate the U.K. economy lost about 3% of GDP in the 10 quarters that followed the EU referendum in June 2016, compared to a remain outcome.
- A no-deal Brexit from the EU could lead to a few rating downgrades, negative outlooks, or CreditWatch actions on issuers with insufficient rating headroom to weather the related economic slowdown or disruption. We have taken 39 rating actions related to Brexit risks since we raised our no-deal risk assessment to "high" in October 2018.

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After three years of political debate in the U.K. that has almost paralyzed government policy-making, reaching a compromise with the EU remains a daunting challenge given the number of stakeholders, the complexity involved, and the tight timetable. A failure to reach an agreement in the coming weeks means that the likelihood of a no-deal Brexit remains meaningful and not to be discounted.

That said, in our view the risk of a no-deal Brexit on Oct. 31, 2019 is limited. In the EU (Withdrawal) (No 2) Act. 2019 (No. 2 Act), Parliament requires the U.K. government to request an Article 50 extension to Jan. 31, 2020, unless Parliament explicitly approves a deal or explicitly approves leaving the EU without one. We expect that the government will comply with that obligation and that the EU will grant a short extension. Meanwhile, we think the possibility of a snap general election, as early as November, has increased. A fresh election should make it easier to achieve the various possibilities, including a no-deal Brexit in 2020.

The key priority for S&P Global Ratings is to ensure that our ratings transition in a timely manner as and when credit risks materially change. On the assumption that a general election will be called in November, the main risks to ratings, as we currently see it, relate to two scenarios: either the present government having a renewed mandate to leave the EU, including, if necessary, on a no-deal basis; or, conversely, a Labour-led coalition government pursuing a less immediately disruptive Brexit policy and possibly radical shifts in economic policy, as well as new referenda on Brexit and Scottish independence.

In this context, our current risk assessment of a no-deal Brexit, incorporating our assessment of both likelihood and impact, remains high. What this means in practice is that, while not our base case, where rated entities have insufficient rating headroom to weather an economic slowdown related to a no-deal Brexit, or some inevitable short-term disruption to which certain sectors would be exposed, this may warrant a negative outlook, CreditWatch and, on occasion, a rating downgrade. This will vary across industries and will take account of the strengths and weaknesses of each rated entity. Indeed, we have already taken a number of rating actions related to Brexit risks, mainly in the U.K. corporate and public finance sectors, since we raised our risk assessment to "high" in October 2018 (see Appendix 1). We continue to track developments but, to be clear, we would not expect a no-deal Brexit to become our base case for rating purposes until it became almost certain.

In an update to our previous report titled "Countdown To Brexit: Rating Implications Of A No-deal Brexit," published Feb. 6, 2019, the main rating risks by sector are:

Sovereign. Our 'AA/A-1+' sovereign credit ratings on the U.K. already take into account a less predictable policy framework following the 2016 referendum. The outlook on the ratings is negative, reflecting the risk of sustained economic weakness and deterioration in government finances in a no-deal Brexit.

Corporates/infrastructure. Potential no-deal Brexit-related risks continue to be a factor in our ratings and outlooks on EMEA-based corporate and infrastructure companies. In a no-deal scenario we envisage a small number of issuers could face a downgrade, negative outlook, or CreditWatch. The most exposed sectors continue to be automotive, leisure, retail, real estate, aerospace and defense, and transport infrastructure.

Financial institutions. While U.K. banks have built resilience, a no-deal Brexit could change our broadly stable ratings assessment. Outlook revisions would be more likely than downgrades in the near term, specifically in the event of a downward revision in the trend for economic and/or industry risk in our U.K. BICRA to negative, from stable. Implications for non-U.K. banks would be limited.

U.K. public sector. Brexit uncertainty is already weighing on the housing market, as reflected in 11 downgrades or outlook changes on rated housing associations over the past 12 months. Even so, almost one-half the rated portfolio remains vulnerable to a downgrade in the event of a no-deal Brexit scenario. We would anticipate some further weakness in universities' financial performance as a no-deal Brexit could deter foreign students and academics from studying in the U.K.

Insurance. The most significant credit implications resulting from a no-deal Brexit for U.K. insurers are likely to come from the short- and long-term disruptions to the country's economy and financial markets. However, we believe the initial impact on U.K. insurers' ratings will be muted, with outlook revisions, rather than widespread downgrades, more likely to occur if the downside economic and market scenarios occur.

Economics: No-Deal Brexit--Downside Scenario Revisited

(Primary contacts: Sylvain Broyer and Boris Glass)

We have updated our economic scenario of a no-deal exit, first outlined in "Countdown to Brexit:

No Deal Moving Into Sight," published Oct. 30, 2018, in view of the new U.K. government's commitment to leave the EU by Oct. 31, notwithstanding the likelihood of a further extension of Article 50, as required by the No. 2 Act.

The main change from our earlier scenario versions stems from the Oct. 31 exit date. In our updated scenario, the economy now takes most of the damage in 2020, with GDP contracting 2.8%, rather than the impact being spread over two years. We also reassessed the household sector slightly more favorably, as well as assuming slightly more government spending. The latter is limited to mitigating the fallout from a no-deal Brexit, rather than a full-blown fiscal stimulus package, but this still raises GDP slightly. Another key revision affects the value of sterling on foreign exchange markets. In particular, we revised downward the pound (GBP)-euro exchange rate. Furthermore, we are also less optimistic about the euro's appreciation against the U.S. dollar, which therefore compounds GBP-dollar weakness. CPI inflation is higher as a result.

Combining these adjustments in our scenario analysis, the overall impact is now somewhat less severe than previously, when measured by the cumulative loss in GDP.

Table 1

U.K. Economic Indicators in the No-Deal Scenario Versus S&P Global Ratings Base-Case

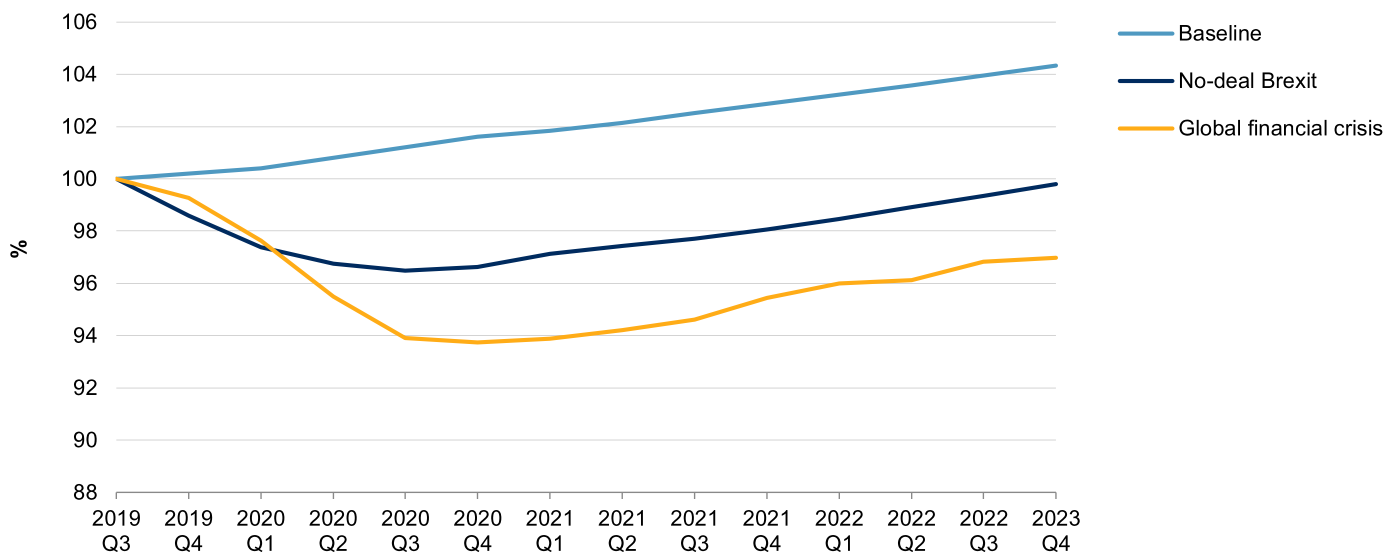
	Scenario				Baseline				
	2019	**2020**	**2021**	**2022**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP (% year)	0.8	(2.8)	0.8	1.6	1.4	1.2	1.1	1.3	1.4
Unemployment Rate	3.9	5.5	6.8	6.7	4.1	3.9	4.2	4.5	4.6
CPI (% year)	2.3	4.4	2.1	1.9	2.5	1.9	2.0	2.4	2.0
USD per GBP	1.2	1.1	1.2	1.2	1.3	1.3	1.3	1.3	1.4
BoE Policy Rate	0.6	0.0	0.0	0.0	0.6	0.8	0.9	1.1	1.4
House Prices (% year) *	(1.7)	(10.2)	(6.1)	5.9	2.4	0.0	1.5	3.5	4.0
Share Prices (% year)§	(5.9)	(8.9)	11.3	6.8	0.3				
Expenditure Components (% year)									
Private Consumption	1.5	(3.1)	0.7	2.2	1.8	1.8	1.4	1.5	1.8
Gvt Consumption	2.8	3.9	1.2	1.2	0.4	2.2	1.8	2.0	1.6
Fixed Investment	0.2	(5.9)	(0.7)	3.5	0.2	0.2	0.9	3.7	2.6
Exports	(0.6)	(5.4)	3.5	2.2	0.1	1.2	1.6	1.3	2.4
Imports	2.4	(5.4)	2.3	4.0	0.7	3.1	1.1	3.0	4.0

*House price inflation is reported year-on-year for the fourth quarter in each year. §No baseline forecast available. Source: Oxford Economics, ONS, BoE, S&P Global Ratings Research.

In our updated scenario, after the initial hit, and following a small and gradual rebound, GDP is still 4.7% below our baseline (Brexit with a deal) in 2021, compared with 5.5% below the baseline in our October 2018 report, with limited prospects of a faster recovery thereafter (see chart 1). This is because the economy, and notably potential growth, remains encumbered by regulatory and infrastructure challenges, previous lack of investment, less favorable external trade arrangements, lower prices of financial assets, and lower immigration, among others.

Chart 1

The Impact Of A No-Deal Brexit
U.K. GDP (volumes)



Source: Office for National Statistics, S&P Global Ratings.

Our updated scenario does not assume any major fiscal stimulus package that could be part of a broad policy response to a no-deal Brexit. Nor does it assume any swift, large-scale negotiation of favorable trade deals with the EU post Brexit. Should any of these factors materialize, notwithstanding increased fiscal pressure, economic outcomes would be more favorable. On the other hand, while our scenario incorporates significant disruptions in the first two quarters after a no-deal exit, they are not nearly as severe as the worst case, such as that outlined in the government's recently published Yellowhammer papers. Should disruptions be more severe than we assume, or last longer, economic outcomes could be considerably worse.

Sovereigns: Government Finances And Real Incomes Will Deteriorate In A No-Deal Scenario

(Primary contact: Aarti Sakhuja)

In a no-deal scenario as set out by S&P Global economists, the U.K. economy is likely to undergo a structural shift, worsening key metrics considered in arriving at our economic, fiscal, debt, and external assessments to varying degrees. Sterling would depreciate further and households' purchasing power would decline through a combination of a weaker exchange rate and higher inflation relative to trading partners. Such a scenario could result in downward pressure on our sovereign ratings on the U.K. Our 'AA/A-1+' sovereign credit ratings on the U.K. already take into account a less predictable policy framework following the 2016 referendum. The outlook on the ratings is negative, reflecting the risk of sustained economic weakness and deterioration in government finances in a no-deal Brexit (see "Research Update: Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative," published April 2019).

Economic impact: Considerably lower GDP per capita than in our base case

In the event of a no-deal Brexit, we anticipate that the U.K.'s GDP per capita (measured in U.S. dollars) would fall by 20%, from its 2018 level--which we estimate at about $42,500--reflecting a combination of sterling depreciation and economic contraction. We anticipate that this metric would start to recover from 2021 as sterling regains some of its lost value, and as the economy recovers, albeit from a lower level. Even so, by 2022, the U.K.'s GDP per capita could still be considerably lower than in our base-case assessment. Nevertheless, the strength of household balance sheets, with household net financial assets among the highest in Europe, would provide a significant buffer against lower purchasing power. One major uncertainty would be the fallout of a no-deal Brexit on property prices, as well as other asset markets. Under our scenario, we project that the decline in house prices would accumulate to nearly 10% between 2019 and 2020. Sharper falls would almost certainly weigh more on private consumption, the broader economy, and government finances.

Fiscal and debt impact: Higher deficits, rising inflation

We anticipate that the consequences of a no-deal outcome will also be reflected in wider general government deficits through 2022 relative to 2018 and our base-case scenario. Government spending would increase, in part due to the costs of customs excise administration and other checks as a result of the U.K. leaving the customs union. Public sector employment and procurement expenses are also likely to rise through 2022. Consistent with rising unemployment, benefit payouts would increase. Central government interest costs would rise given that about one-quarter of U.K. government debt is inflation-linked and that we project inflation will rise well above our base-case scenario. Any savings related to EU budgetary contributions are likely to be channeled into expenditures, particularly to those areas that are currently net recipients of EU funds. At the same time, tax revenues are likely to be lower, reflecting higher unemployment, lower corporate profitability, and a fall in intake from consumption-related taxes (such as value-added taxes and excise duties). The financial services sector, one of the sectors most likely to be heavily exposed to a no-deal Brexit, contributes about 10% of government revenues through direct taxes, taxes on employee incomes, and value-added taxes.

We believe the government would find it difficult to fully offset the impact of higher spending and a lower tax intake. It might choose to defer investment in some areas, raise certain taxes, while putting on hold planned cuts to tax rates or raising certain taxes. Cuts in other areas, such as welfare benefits after a decade of fiscal consolidation led primarily by expenditure-side measures, would be politically less palatable, in our view. As a result, in a no-deal Brexit, we project general government debt will rise toward 100% of GDP by 2022, compared with our base-case scenario where we project it will stay relatively flat at about 86% of GDP through 2022.

External impact: Weaker sterling is likely to yield limited competitive gains in the face of supply chain disruptions

In the aftermath of a no-deal Brexit, we project sterling would depreciate toward parity against the dollar during 2020 before staging a recovery. Recent history suggests that a more competitive exchange rate has had a limited effect on the U.K.'s volume of goods and services exports, although it has helped profitability in outward-facing sectors, including tourism and manufacturing. Given the likely disruption to manufacturing supply chains in the event of a no-deal Brexit, it is difficult therefore to be very optimistic about the initial benefits of a weaker exchange rate to growth. Nevertheless, a cheapening of U.K. assets should ensure ready financing of the country's external deficits. We also continue to take the view that sterling's reserve currency status will protect the economy from any risk of heightened balance of payments pressures.

Corporates/Infrastructure: Some Ratings At Risk In A No-Deal Scenario

(Primary contacts: Alex Herbert and Paul Watters)

Potential no-deal Brexit-related risks continue to be a factor in our ratings and outlooks on EMEA-based corporate and infrastructure companies. In recent months, these risks have been reflected in our negative outlooks on U.K.-based companies such as the aero-engine manufacturer Rolls-Royce PLC; premium car manufacturer Jaguar Land Rover Automotive PLC; and luxury sports car manufacturer Aston Martin Holdings (UK) Ltd. These companies face risks from the disruption to supply chains in the aerospace and automotive sectors, which are highly integrated, and the disruption to distribution channels when exporting to the EU from the U.K. In these and other cases, such as U.K.-based building materials distributor Travis Perkins PLC, there were sector-related trends, and company specific factors, which were also important elements behind our rating and outlook changes. We have also highlighted Brexit downside risks for other companies such as GKN Holdings Ltd and McLaren Group Ltd.

In a no-deal scenario we envisage a small number of issuers could face a downgrade, negative outlook, or CreditWatch. The most exposed sectors continue to be automotive, leisure, retail, real estate, aerospace and defense, and transport infrastructure.

Contingency planning is ongoing, the net effect of which will serve to reduce--but not eliminate--the more extreme cliff effects that could otherwise threaten the short-term viability of businesses heavily reliant on U.K-EU cross-border activity.

Over the medium to longer term, Brexit, particularly in the event of leaving without a deal, would lead to a fundamental re-evaluation of U.K. business strategy and priorities. Not least, business supply chains will gradually have to adapt to maintain competitiveness, depending on the level of tariffs and degree of friction at the border.

Ahead of a potential near-term general election, we see the possibility of a Labour government, which pledged in its 2017 manifesto to bring key utilities back into public ownership. This could impact certain sectors, and could include:

- Bringing private rail companies back into public ownership as franchises expire;
- Regaining control of energy supply networks by altering the National and Regional Network Operator license conditions and transitioning to a publicly owned system;
- Replacing the water system with a network of regional publicly owned water companies; and
- Reversing the privatization of Royal Mail.

Labour's recent conference also pledged to nationalize the largest energy providers.

Financial Institutions: Braced For The Worst

(Primary contacts: Osman Sattar and Giles Edwards)

Recent half-year results from the major U.K. banks show continuing robust asset quality metrics, stable capital, and healthy liquidity and funding. Together, these strengths provide a firm foundation from which to weather Brexit-related uncertainties or other factors such as trade tensions threatening a global economic slowdown. They also underpin our current stable trends for the banking sector's economic and industry risk in our U.K. Banking Industry Country Risk Assessment (BICRA, our analysis of the strengths and weaknesses of the banking industry in a given country).

That said, a no-deal Brexit could result in severe macroeconomic weakness, which would lead to rising personal and corporate U.K. delinquencies and weaker collateral values. In time, this would likely play through to banks' asset quality and activity, weakening earnings and, possibly, capitalization. Any associated disruption in the wholesale funding market would also be unhelpful for the sector as a whole. Spread widening or funding disruption for the banks and other U.K. corporates could be more acute if the market perceived a weakening of the U.K. sovereign.

At the same time, major U.K. banks currently have adequate funding profiles and healthy liquidity. To date, we have not seen widespread evidence of reduced access to funding or spikes in the cost of funding relative to European peers. In our view, the Bank of England (BoE) would likely step in to provide additional funding facilities to banks if it saw an increased likelihood of the banking system coming under stress from a no-deal Brexit.

We also note that results from the BoE's late-2018 stress test exercise showed the relative resilience of major U.K. banks, albeit with a material hit to their regulatory capital ratios. This exercise was based on a severe macroeconomic stress that modeled more severe domestic conditions than the BoE's no-deal Brexit scenario, combined with a severe global recession. This is materially worse than our economic prognosis in the event of a no-deal Brexit.

For U.K. bank ratings, the above factors mean that in the event of a no-deal Brexit becoming our base-case, we currently see outlook revisions as more likely than downgrades in the near term. Specifically, we envisage that any U.K. bank outlook revisions would follow a downward revision in the trend for economic and/or industry risk in our U.K. BICRA to negative, from stable. This reflects our view that the impact of a no-deal Brexit could spread across the domestic banking sector. That is not to say that a move to a negative trend for economic risk and/or industry risk in the U.K. BICRA automatically translates into outlook revisions or rating downgrades for all rated U.K. banks. We would consider bank-specific factors, including, for example, the extent of each banking group's focus on the U.K. in the context of its overall business.

Finally, were we to assess a substantially more severe macroeconomic impact from a no-deal Brexit than that set out in our current downturn scenario, we could directly revise down our U.K. BICRA economic risk score. All else being equal, a downward revision in the BICRA economic risk score to '5' would result in a downward revision of the anchor for domestically focused U.K. banks to 'bbb' from 'bbb+', and, in turn, could lower U.K. bank ratings by one notch.

Limited ratings impact for non-U.K. banks in a no-deal scenario

International financial institutions operating European business from the U.K. are well advanced in implementing their Brexit contingency plans, mainly through the establishment of additional licensed entities in the EU-27, which is helping to mitigate the effects of a no-deal Brexit. That said, corporate customers' reluctance to switch from a U.K. bank entity to an EU-27 bank entity in the same banking group remains a key issue. This likely stems from uncertainties about the implications of dealing with a different counterparty as well as perceptions that a no-deal Brexit is a less likely scenario.

We expect banks in other largely open European economies--like Ireland, Belgium, or The Netherlands--to be able to withstand a no-deal Brexit and we do not expect widespread rating changes.

U.K. Public Sector: No-Deal Could Affect Social Housing Ratings Most

(Primary contact: Felix Ejgel and Abril Canizares)

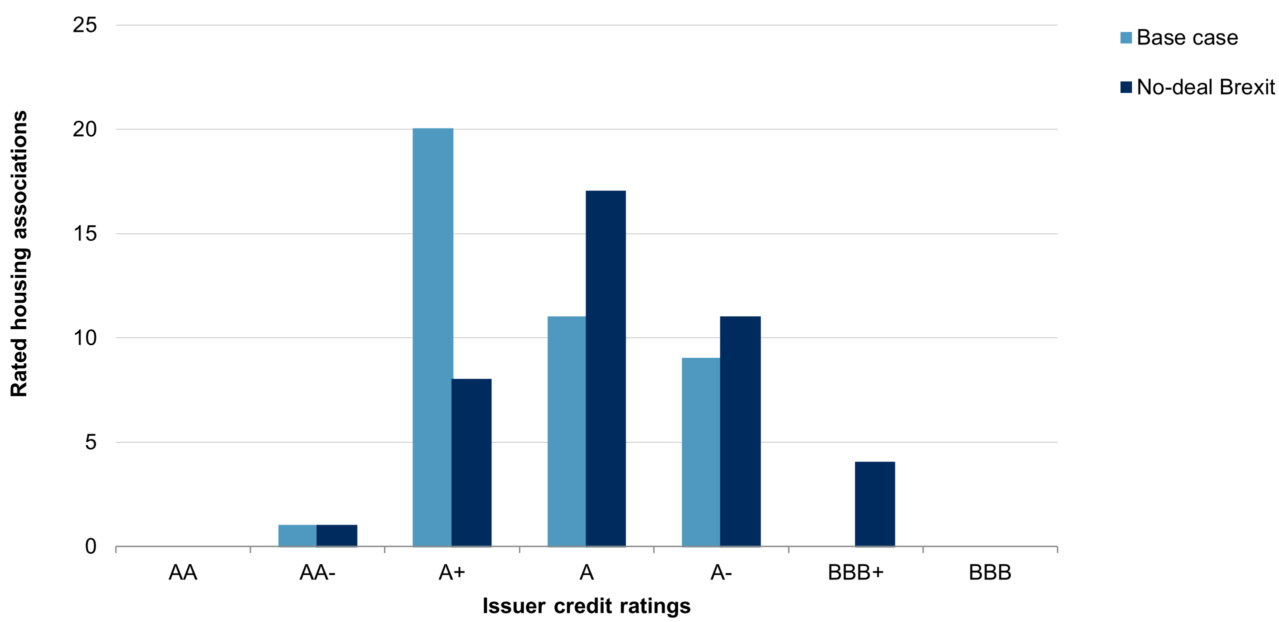
Housing associations could face downgrades

Our sensitivity analysis of a no-deal Brexit scenario shows that we could downgrade half of the 41 publicly rated U.K. social housing association (HAs) in our portfolio (see chart 2). In particular, we view the ratings on those providers which increasingly depend on proceeds from market sales, or which receive extraordinary support from their related government, as particularly vulnerable. A downgrade of the U.K. sovereign rating, for example, could result in downgrades of 10 HAs.

Some HAs have recently reduced their expected proceeds from asset sales because of weaker-than-planned demand in the real estate market. We believe that Brexit uncertainty has already started to trickle into HAs' financial performance, therefore influencing our expectations going forward. Over the past 12 months, we have lowered the ratings on six HAs and revised the outlook to negative on five others.

Chart 2

Issuer Credit Ratings Transition



Source: S&P Global Ratings.

Management responses to these challenges will be key to containing the overall impact of a no-deal scenario. While our scenario does not take into account proactive measures, we acknowledge that many HAs have mitigation strategies in place that they can swiftly implement. In most cases, they can delay maintenance and capital spending, and from 2020 would be able to raise rent fees.

Universities may lose foreign students

Our ratings on three of the four U.K. universities that we rate carry negative outlooks, reflecting a potential rise in spending on salaries and pensions, as well as weaker demand and lower fees. We observe a gradual weakening of financial performance across all rated universities. Whatever the exit scenario, Brexit may further reduce the U.K.'s attractiveness to international students and academics, primarily from the EU, especially if combined with stricter immigration measures. It could also herald uncertainty about fee structures for domestic students, as well as the availability of EU research and capital funding. Nevertheless, a weaker sterling in a no-deal scenario could attract overseas students to U.K. universities and somewhat boost their competitiveness.

Local governments would face pressures from sovereign links

The ratings on Greater London Authority (GLA; AA/Negative) and Transport for London (TfL;

AA-/Negative) might come under pressure, mainly because of the link with the sovereign rating and dependence on central government funding. The rating on GLA is currently at the sovereign level, and we believe that U.K. local and regional governments should not be rated above the sovereign. The rating on TfL reflects our expectation that GLA and the Department of Transport will continue to cover cost overruns generated by TfL's flagship investment projects.

Insurance: Preparing For No-Deal Continues

(Primary contacts: Dennis Sugrue and David Masters)

We believe that U.K. insurers are well-positioned to weather short-term Brexit-related uncertainties during the remainder of 2019 and 2020. We don't expect material changes in the operating environment and believe that capital should remain a strength for the industry. In addition, management is taking additional actions to address emerging risks.

That said, a no-deal Brexit outcome would have important long- and short-term implications for the U.K. economy, through its impact on income levels and growth prospects, government finances, external financing prospects, and financial markets.

A no-deal Brexit would also weigh on our view of the U.K. insurance industry and country risk, which could affect our view of U.K. insurers' business risk profiles. It could also constrain our view of U.K. insurers' financial risk profiles due to potential volatility in their balance sheets (e.g. fixed income, equity, foreign exchange volatility, etc.). Other effects could include more increased collateral requirements, or reduced liquidity.

We anticipate that outlook revisions, rather than widespread downgrades, would be more likely to occur within the U.K. insurance sector in the event of a no-deal Brexit. Specifically, we see a no-deal Brexit potentially affecting ratings on insurers in three key ways:

- First, if we lowered the long-term U.K. sovereign rating, we would review whether the ratings on Aviva PLC, Legal & General Group PLC, and Prudential PLC were resilient to our sovereign stress scenario.
- Second, we estimate that the adverse macroeconomic and financial market impact of a no-deal Brexit could put downward pressure on insurers' capital positions. However, we note that management teams have taken some mitigating actions to address this.
- Third, the financial implications of operational challenges could have negative implications for ratings on U.K. and EU insurers. These would include additional costs for U.K. insurers establishing operating subsidiaries in the EU, or vice versa for EU insurers operating in the U.K.

Economics: Brexit Uncertainty Has Already Affected Growth

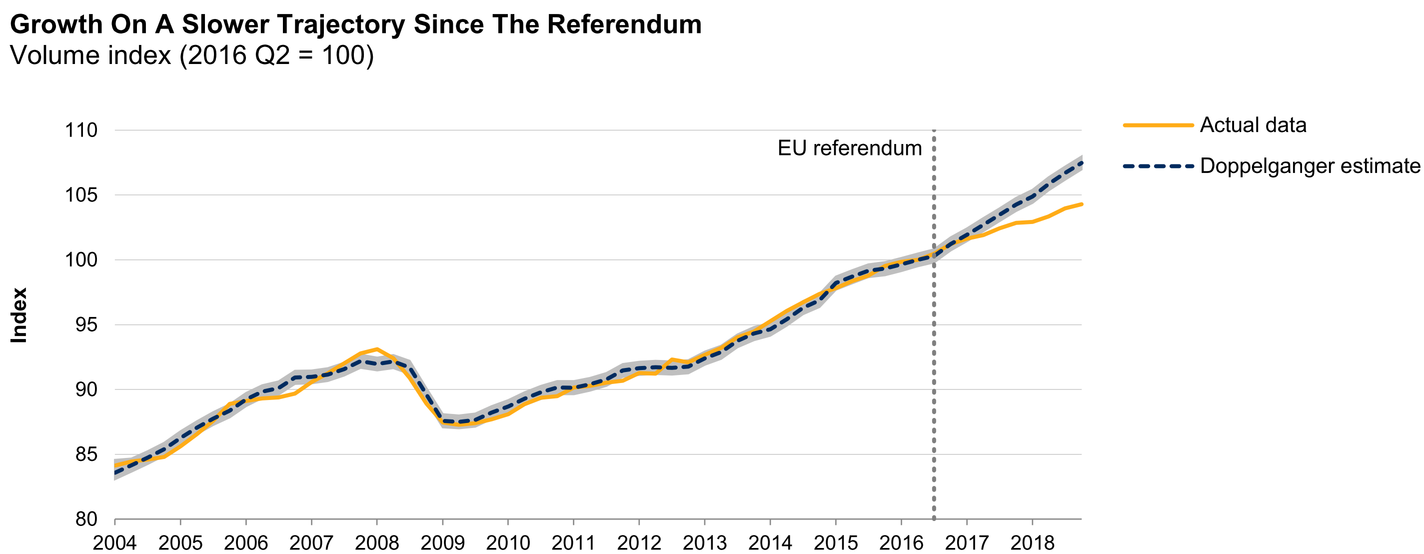
(Primary contacts: Sylvain Broyer and Boris Glass)

Whether the U.K. leaves the EU with or without a deal, its business model is set to change--more gradually in a deal scenario, and abruptly and potentially disruptively in the event of no deal. Our research shows that the mere anticipation of Brexit following the leave vote in June 2016 has caused the economy to suffer. And our updated scenario analysis suggests a no-deal Brexit would cause further economic harm.

A lower growth trajectory since the referendum

The economic collapse predicted by many observers for the aftermath of the EU referendum in case of a leave vote did not materialize. However, the referendum did still have a negative impact. As we wrote earlier this year ("Countdown To Brexit: What Might Have Been For The U.K. Economy," published on RatingsDirect on April 4, 2019) the economy moved to a lower growth trajectory almost immediately after the referendum (see chart 3).

Chart 3



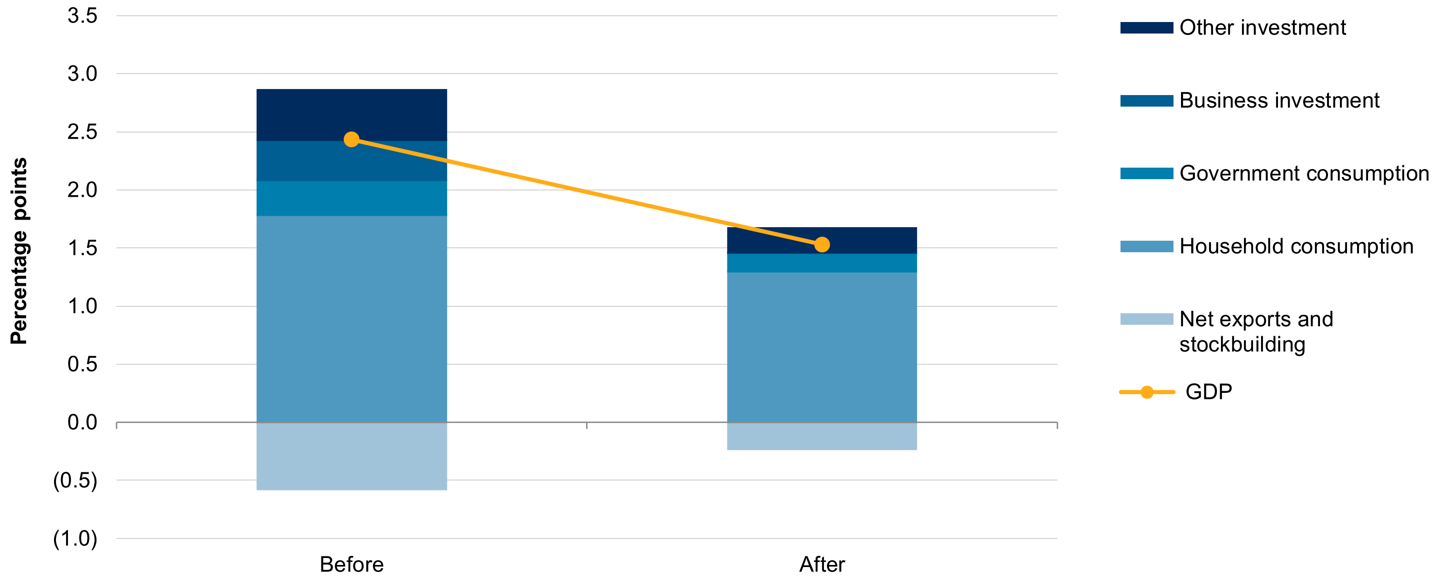
Note: Grey area shows one standard deviation on each side of the estimate. Data is quarterly.
Sources: Office for National Statistics, S&P Global Ratings.

We estimate that, by the end of 2018, the size of the U.K. economy was already between 2.4% and 3.4% smaller than it could have been otherwise. Under this estimate, that translates into average forgone economic activity of £6.6 billion (in 2016 prices) in each of the 10 quarters since the referendum.

Among the spending components of GDP, household consumption explains the biggest portion of the slowdown, contributing an annualized 0.5 percentage points less since third-quarter 2016. This has more to do with the large share consumption has in U.K. GDP (at about 62% of the total) than with weaker consumption spending. In fact, although household spending growth slowed following the referendum, it did so less than proportionately--its share in GDP actually increased and continued to underpin GDP growth (see chart 4). Investment and government consumption both dragged on growth, while exports lifted growth by an annualized 0.35%, compared to the 12 quarters prior to the referendum.

Chart 4

GDP Growth Shrank In The 12 Quarters After The Referendum



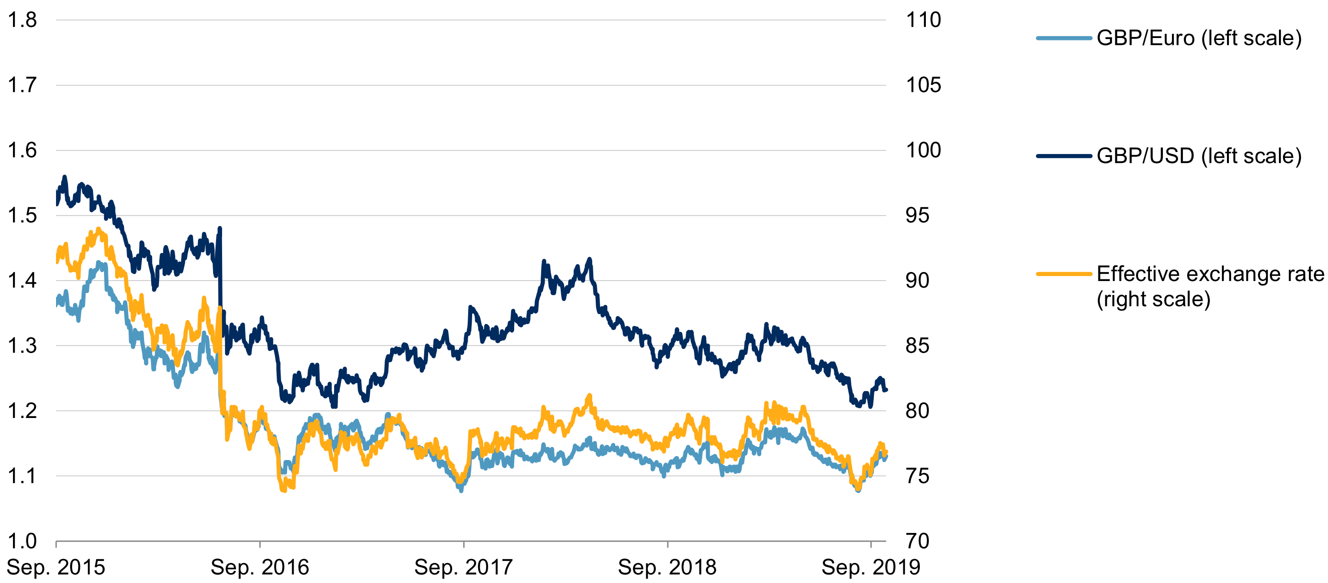
Source: Office for National Statistics, S&P Global Ratings.

Consumers saved the day

The most visible impact of the leave outcome was the depreciation of sterling by about 16% against major currencies after the referendum--a sign that markets expected weaker U.K economic performance in the future (see chart 5).

Chart 5

Sterling Fell In The Aftermath Of The Referendum

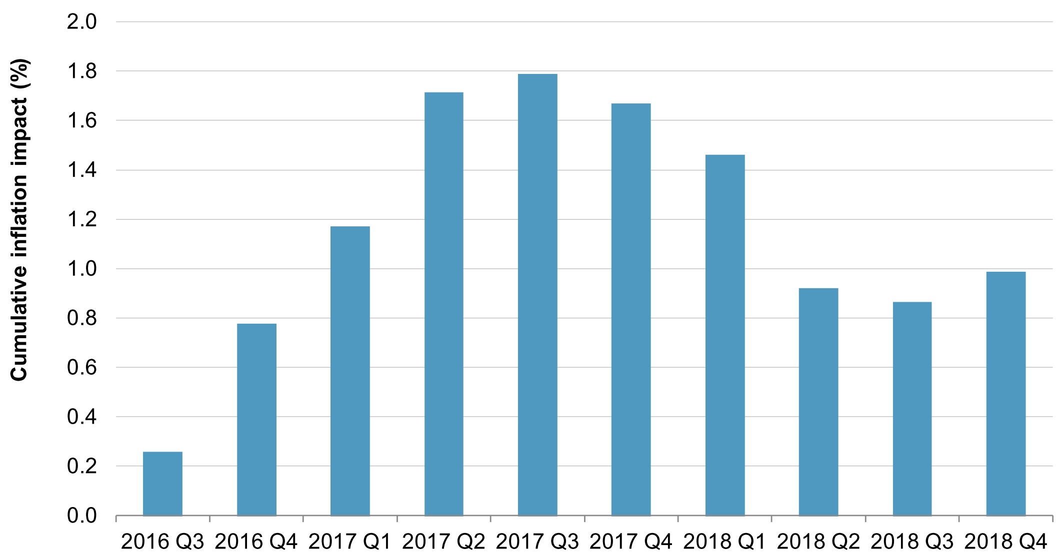


Source: Refinitiv.

As the sterling cost of imports rose, this quickly put pressure on consumer prices, with inflation rising from 0.5% in June 2016 to 2.6% 12 months later, peaking at 3.1% in November 2017. We estimate that this increase was indeed predominantly due to the depreciation of the currency (see chart 6).

Chart 6

Inflation Accelerated Following The Referendum
Difference in CPI inflation



Source: S&P Global Ratings.

Despite the increase in consumer price inflation, which outpaced pay growth and, as a result, squeezed households' spending power, households continued to spend almost as before, using savings to make up for the shortfall. One explanation for this is that they considered inflation would remain only temporarily high, and rightfully so. It has since returned to the BoE's 2% target, and wage growth has now picked up to a pace well above inflation, supporting ongoing, albeit weak, spending growth against the background of Brexit uncertainty.

Exporters' predicament fails to boost the economy

Many observers had noted in 2016 that, boosted by cost competitiveness thanks to a weaker sterling, external trade would provide an offset to weaker domestic demand. However, little of this materialized. We believe it doubtful that any such boost could be sizable for the U.K. because of the structure of its economy. Services, in particular, which make up the bulk of exports (and incidentally the economy as a whole), are more specialized and differentiated than manufactured goods, and demand for them is therefore less price-sensitive. In manufacturing, U.K. goods' production requires a high proportion of imports, which had become more expensive. As a result of higher input costs, there was not much leeway to lower prices. Moreover, from late 2016, the situation for exporters was probably one of the least favorable for boosting exports. The U.K's future external trading framework had become more uncertain. Would the U.K. be able to negotiate a relatively frictionless trade agreement with the EU, or would trade fall back to WTO rules, the most basic of any trade framework? This uncertainty made it difficult to refine supply-chain relationships with EU partners or increase market share. It also discouraged investment in production capacity. Exporters made the best of the situation and, rather than selling higher volumes, maintained euro and dollar prices and cashed in. This resulted in higher sterling profits because of the weaker exchange rate, but not much higher net trade contribution to growth.

Downside risks paralyze long-term business decisions

Uncertainty, if evenly distributed around a central outcome, usually creates both opportunities and adversities. In the case of Brexit, however, downside risks dominate, in our view, whichever form Brexit will ultimately take--a view shared among most economists. It is true that even a no-deal Brexit will create some opportunities, for example for businesses able to develop software to help with customs declarations or companies that are specialized in port infrastructure. But for the economy as a whole, material downside risks reduce incentives to invest while uncertainty lasts. Indeed, spending on business investment did not perform well following the referendum, and since second-quarter 2018, with the Brexit deadline approaching, it has been contracting year on year. The BoE, in a recent working paper (https://www.bankofengland.co.uk/working-paper/2019/the-impact-of-brexit-on-uk-firms), estimated that in the absence of Brexit uncertainty, investment could have been 11% higher by the second quarter of 2019 than it actually was. It is difficult to see a recovery of investment spending setting in before current uncertainty is resolved. Underinvestment does not just translate into weaker growth right now, it also results in softer productivity and wage growth, often with a long delay, setting up the U.K economy for weaker growth in years to come.

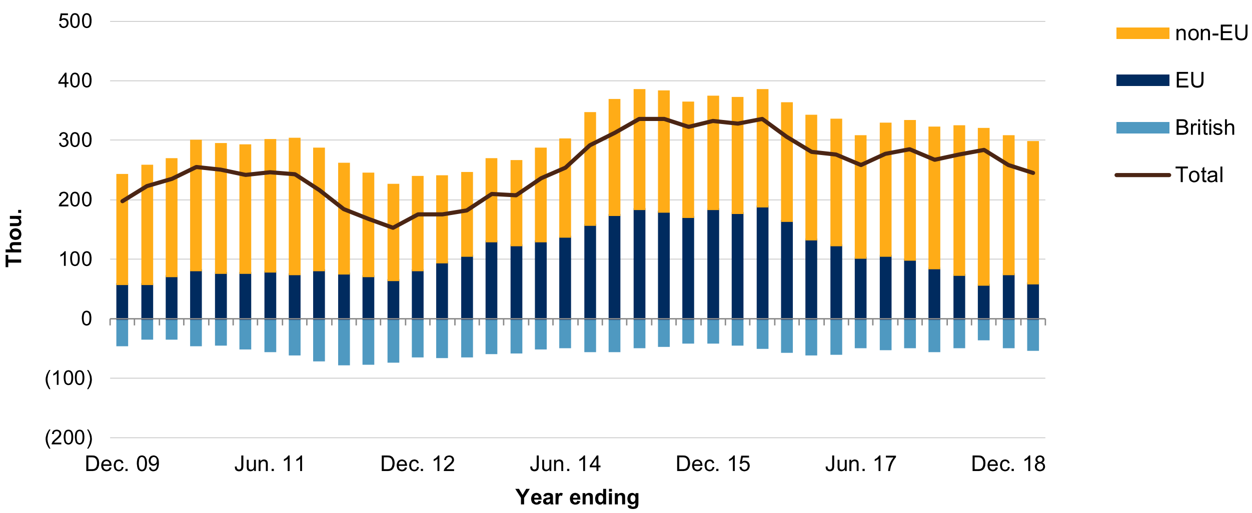
In addition, many businesses, especially in the financial and related sectors have ventured well beyond the point of no return in view of the risk of EU trading restrictions, and have set up new headquarters in the EU27, or expanded operations there rather than in the U.K. These decisions are not easily reversed and have already lowered the base from which the U.K. economy will be able to grow in the future, irrespective of which form Brexit will take.

Far fewer EU workers arriving, but the labor market is still the bright spot for now

The post-referendum slowdown in economic activity has not visibly affected the labor market. On the contrary, the unemployment rate stands at a record low (3.8% in July) and wage growth has recently picked up to post-crisis highs (4% year on year in July). Two factors go at least some way to explaining this. The first is related to investment: while businesses are holding back committing long-term to spending on machinery, they can temporarily increase capacity by hiring more workers, an action that is relatively easy to reverse. The second factor is related to immigration: net immigration from the EU, although remaining positive and hence contributing to an increase in the U.K. workforce, has started to slow following the referendum (see chart 7). In the year to March this year, it had fallen to 60,000, to less than one-third of its peak of 190,000 in the year to June 2016, just before the referendum. While some of this slowdown is likely caused by strong economic recovery in origin countries, there is no doubt that the referendum outcome has been an important contributor.

Chart 7

Immigration From The EU Declined Following The EU Referendum
UK net immigration by origin



Note: From March 2019 data are provisional. Source: Office for National Statistics, S&P Global Ratings.

More specifically, Office for National Statistics data show that, of those still arriving, fewer are coming to work. The high labor market participation of EU immigrants and the declining share of new immigrants that come to work helped reduce the U.K. participation rate following the referendum, among other factors. People who do not work, or are not looking for work, are not counted in the unemployment rate. We estimate that this shift in the composition of the U.K.'s working-age population lowered the unemployment rate by about 1 percentage point, or 320,000 unemployed.

Notwithstanding, employment remains strong and, coupled with recently strong wage growth, should keep consumers spending, albeit at a slower pace. It should keep the economy afloat, unless consumers start worrying much more about their future, either after Brexit or a forthcoming general election.

Brexit-Related Rating Actions Since October 2018

Table 2

Brexit-Related Rating Action and Research Updates/Bulletins Since Oct. 30 2018

Non-financial Corporate	Publication Date
Research Update: U.K.-Based Travis Perkins Outlook To Negative On Potential Reduction In Size And Scope; Ratings Affirmed	11 Sep 2019
Research Update: Rolls-Royce PLC Downgraded To 'BBB'; Outlook Negative	22 Aug 2019

Table 2

Brexit-Related Rating Action and Research Updates/Bulletins Since Oct. 30 2018 (cont.)

Bulletin: Tui Reiterates Full-Year Guidance But Earnings Could Bow Under A Weakening Pound Amid Brexit Woes	22 Aug 2019
Research Update: Jaguar Land Rover Automotive Affirmed At 'B+', Off CreditWatch, Outlook Negative On High Cash Burn And Geopolitical Risk	09 Aug 2019
Research Update: Aston Martin Holdings (UK) Downgraded To 'B-' On Weaker Volumes And Profitability; Outlook Negative	31 Jul 2019
Research Update: Thomas Cook Group PLC Downgraded To 'B-' On Trading Uncertainty And Liquidity Pressures; On CreditWatch Negative	02 May 2019
Research Update: German Travel Group Tui Outlook Revised To Negative On Expected Weaker Earnings And Cash Flows; 'BB' Ratings Affirmed	11 Apr 2019
Research Update: Aston Martin Holdings (UK) Ltd. Outlook To Negative On Geopolitical Risk; 'B' Rating Affirmed	29 Mar 2019
Research Update: Jaguar Land Rover Automotive PLC Downgraded To 'B+' On Weak Profitability; Ratings Kept On CreditWatch Negative	27 Mar 2019
Research Update: U.K.-Based Parkdean Resorts Outlook To Negative On Declining Caravan Sales, Margin Pressure; 'B-' Rating Affirmed	20 Mar 2019
Research Update: Lifetime Brands Inc. Downgraded To 'B' On Weaker-Than-Expected Operating Performance, High Leverage; Outlook Stable	18 Mar 2019
Bulletin: Brexit Still Weighs On Getlink Despite Strong 2018 Earnings	27 Feb 2019
Research Update: French Auto Supplier Valeo S.A. Outlook Revised To Negative; 'BBB/A-2' Ratings Affirmed	26 Feb 2019
Bulletin: Brexit Still Weighs On Heathrow Rating, Despite Strong Earnings In 2018	25 Feb 2019
Research Update: Thomas Cook Group Downgraded To 'B' From 'B+' On Weakened Trading And Reduced Liquidity; Outlook Remains Negative	19 Feb 2019
Rating Action News: Rated Debt Related To Three U.K. Transportation Infrastructure Assets On Negative Outlook On Rising Brexit Risks	19 Dec 2018
Research Update: U.K.-Based Jaguar Land Rover Downgraded To 'BB-' On Weaker-Than-Expected Profitability; Ratings Kept On Watch Negative	04 Dec 2018
Research Update: Thomas Cook Outlook Revised To Negative On Weak 2018 Performance And Challenging Outlook For 2019; Ratings Affirmed	29 Nov 2018
Research Update: U.K.-Based Jaguar Land Rover 'BB' Ratings Placed On Watch Negative On Weak First-Half Results	02 Nov 2018
Sovereign (including International Public Finance)	
Research Update: Northern Ireland-Based Apex Housing Association Downgraded To 'A-' On Increased Leverage; Outlook Stable	23 Nov 2019
Research Update: King's College London Outlook Revised To Negative On Cost Pressures; 'AA-' Ratings Affirmed	21 Nov 2019
Research Update: U.K.-Based Sanctuary Housing Assn. Outlook Revised To Negative On Increasing Market Exposure; 'A+' Rating Affirmed	15 Nov 2019
Research Update: U.K.-Based Social Housing Provider Chelmer Housing Partnership Downgraded To 'A'; Outlook Stable	14 Nov 2019
Research Update: U.K. Social Housing Provider bpha 'A+' Rating Affirmed; Outlook Revised To Negative On Increasing Market Exposure	04 Oct 2019
Research Update: U.K.-Based The Guinness Partnership Outlook Revised To Negative On Weaker Financial Performance; 'A' Rating Affirmed	13 Aug 2019

Table 2

Brexit-Related Rating Action and Research Updates/Bulletins Since Oct. 30 2018 (cont.)

Research Update: U.K. Housing Association Stonewater Outlook Revised To Negative In Line With Sovereign Rating; 'A+' Affirmed	24 Jul 2019
Research Update: U.K.-Based Housing 21 Downgraded To 'A' Due To Weaker Financial Performance; Outlook Stable	24 Jul 2019
Research Update: Octavia Housing Outlook Revised To Negative; 'A+' Rating Affirmed	23 Jul 2019
Research Update: Clarion Housing Group Ltd. Outlook Revised To Negative; 'A' Ratings Affirmed	23 Jul 2019
Research Update: U.K.-Based London & Quadrant Housing Trust Rating Lowered To 'A-' On Weaker Earnings; Outlook Stable	18 Jul 2019
Research Update: Outlook On U.K.-Based University of Nottingham Revised To Stable From Positive; 'A+' Rating Affirmed	28 Jun 2019
Research Update: U.K.-Based Notting Hill Genesis Downgraded To 'A-'; Outlook Stable	05 Jun 2019
Research Update: Richmond Housing Partnership Downgraded To 'A+'; Outlook Stable	15 May 2019
Research Update: U.K.-Based Thrive Homes Outlook Revised To Negative; Rating Affirmed At 'A'	29 Mar 2019
Research Update: Local Space Outlook Revised To Negative On Uncertainty In Liquidity Management; 'AA-' Rating Affirmed	22 Feb 2019
Research Update: U.K. Social Housing Provider Home Group Downgraded To 'A-' On Heightened Risk Linked To Sales Activities; Outlook Stable	14 Dec 2018
Research Update: Scotland-Based Registered Social Housing Landlord Link Group Outlook Revised To Negative; Rating Affirmed At 'A+'	13 Dec 2018
Research Update: Swan Housing Association Outlook To Negative On Increased Market-Related Activities; 'A-' Rating Affirmed	12 Dec 2018
Research Update: Lancaster University Outlook Revised To Negative On Sector-Wide Cost Pressures; 'AA-' Ratings Affirmed	05 Dec 2018
Research Update: U.K.-Based Sovereign Housing Association Outlook To Negative On Increasing Market Exposure; Rating Affirmed	24 Oct 2018
Financial Institutions (including Insurance)	
No rating actions	

Source: S&P Global Ratings.

Related Research

- Credit Conditions EMEA: Lingering In The Lowzone, Sept. 30, 2019
- Countdown To Brexit: Research By S&P Global Ratings, Aug. 30, 2019
- Research Update: United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019
- Countdown To Brexit: What Might Have Been For The U.K. Economy, April 4, 2019
- Countdown To Brexit: Rating Implications Of A No-Deal Brexit, Feb. 6, 2019
- Countdown To Brexit: No Deal Moving Into Sight, Oct. 30, 2018

This report does not constitute a rating action.

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