PROPONOMICS

APRIL 2017

SOFT BREXIT ON THE HORIZON

After last year's hard Brexit rhetoric, evidence is emerging that the UK is heading for a compromise deal with the EU. The prospect of no significant change could draw property up the investment agenda.

Headlines

Talk of a transitional deal, with EU regulation remaining in place, suggests the UK is heading towards a soft Brexit

Growing awareness of the huge complications of untangling the UK and EU also raises the prospect that the final deal will itself be Brexit in name only

Property investors have already begun to disregard the political noise, and are re-entering the market, which has increased sales volumes

Further evidence that the status-quo is to be maintained will in our opinion draw more overseas and domestic investment into the market

JAMES ROBERTS
Chief Economist

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Financial markets early this week rallied on a strong poll for centrist candidate Emmanuel Macron in the first round of the French presidential election. Yet, as the co-editor for German newspaper Handelsblatt, Hans-Jürgen Jakobs, wisely commented: "the race for the Elysee won't be won on the trading floor".

Pursuing this logic, the way that some pundits have assumed the upcoming UK General Election will result in a larger majority for the May government, who will use it to pursue a soft Brexit, is a leap of faith. Across the developed world voters have been routinely tripping up the opinion pollsters, and we will only truly find out the election outcome in the early hours of June 9th.

In theory, one should be similarly wary of the assumption that a soft Brexit is rising up the agenda. However, we believe that this is the road Britain is moving down, based on the following recent developments:

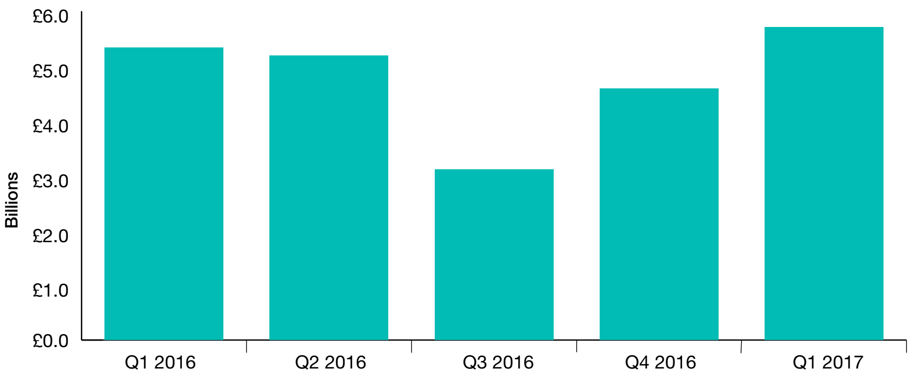
1. The Financial Times in late March reported that the government plans to incorporate large tracts of EU rules into UK law ahead of Brexit, and continue to accept oversight from the relevant European regulators. This effectively eliminates the potential economic advantage of being able to use Brexit to cut regulation.

   The reason given – there are not UK agencies ready to takeover – is certainly true, although it also means the UK has taken step one towards remaining EU compliant even once it is outside of the bloc. This will ease European concerns that the UK should not have the ability to undercut firms in the EU via lighter regulation, and thus opens a path to continued trade under existing terms.

2. The Prime Minister's letter invoking Article 50, suggests to the EU: "In order to avoid any cliff-edge as we move from our current relationship to our future partnership, people and businesses in both the UK and the EU would benefit from implementation periods to adjust in a smooth and orderly way to new arrangements".

   The EU's negotiating guidelines appear to welcome this offer, stating: "To the extent necessary and legally possible, the negotiations also seek to determine transitional arrangements which are in the interest of the Union and, as appropriate, to provide for bridges towards the foreseeable framework for the future relationship."

FIGURE 1
UK offices investment sales



Source: Property Data

In short, both sides are already thinking of an interim deal that looks much like being in the EU, which kicks in once Britain leaves. Considered alongside the UK's willingness to remain EU regulated, the continuation of the previous trade order after March 2019 could make Brexit a non-event.

3. There are many issues emerging as a result of the UK leaving the EU that will take years to settle, and in many cases the obvious settlement to reach is to preserve the status-quo. For instance, the majority of submarine telecom cables from Europe to North America run via the west of England; while 80% of European currency trading takes place in London. There are UK manufacturers who source most of their component parts from the EU. Both sides have compelling reasons not to rock the boat.

This beckons the question, once the UK's citizens have experienced a couple of years post-Brexit of having left the EU in name only, will they soften on the idea of the interim arrangement becoming permanent?

Diluting the Brexiteer influence in the House of Commons via a new intake of MPs could improve the government's chances of pushing a transitional deal through Parliament in late 2018. Moreover, it is hard to imagine that the momentum behind the populist-led voter rebellion, which resulted in Brexit, can be maintained all the way through to a 2022 General Election. If the final EU trade deal arrives to the backdrop of a normalised UK political scene, which generally hugs the middle ground, a 'no change' agreement might face little Parliamentary or public opposition.

What will this mean for commercial property?

According to Property Data, office investment sales in Q3 2016 slumped to £3.1 billion in the aftermath of the referendum. In Q4 2016, sales rebounded to £4.6 billion, then increased to £5.7 billion in Q1 2017. Even during the period when government ministers were making hard Brexit speeches, investors were returning to the market.

However, the rebound also owes much to a new atmosphere among investors, which is well illustrated by the 'Trump trade' in the US, where markets have decided to ignore the political noise and focus on economic fundamentals. Like the US, the UK economy has made huge strides towards normalisation.
Were it not for Brexit, the Bank of England would probably be matching the US Fed with rate rises.

For UK commercial property, particularly in markets favoured by foreign investors, we are already seeing an equivalent of the 'Trump trade'. Buyers are focussing on long-term prospects, not the short-term politics. Evidence we are moving down the road of soft Brexit will spur this trade.

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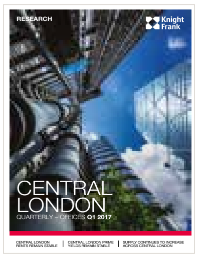

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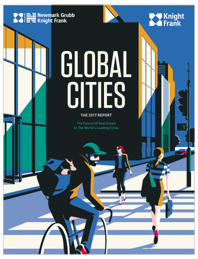

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