
WHAT ARTICLE 50 TRIGGERS: DOMESTIC DEMAND UNCERTAINTY NEW RISKS FOR STERLING ASSETS, BETTER OPPORTUNITIES FOR DIVIDEND STOCKS

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This blog is part of a series of blogs covering this year's European geopolitical risks. [Click here](#) to view our 2017 European geopolitical risks infographic, highlighting this years' key events to watch out for.

Theresa May will soon begin Brexit negotiations with a long list of demands in her hands. Her priorities include the creation of a new trade deal, retaking control over immigration and restoring British law-making sovereignty. But while the government remains hopeful for a favourable deal, UK domestic assets remain most at risk from the macroeconomic uncertainty lurking ahead. More insulated from these risks are ironically, broad UK equity exposures—dividends in particular.

Paving the way for a hard Brexit

With the Dutch elections having just passed, and with France, Germany and Italy all facing elections over the coming eighteen months, the EU may adopt an increasingly hard-line stance so as to avoid appearing weak. By implication, EU officials will not allow the UK to cherry pick proposals for fear of emboldening populist rhetoric elsewhere in Europe. This means that securing favourable terms on most, if not all, of the government's current Brexit objectives will be near impossible. Unless it recalibrates demands accordingly, the UK faces the prospect of being offered a bad deal—or even no deal.

In this regard, pressure for May to reconsider the UK's Brexit objectives will come solely from home, but it is unlikely to come from pro-EU or conservative Brexiters from within May's own party. The recent dismissal of Lord Heseltine—a Tory peer dissenter and government adviser—underscores May's commitment to keeping party discipline in line, and any hint of Tory rebellion is set to be firmly crushed.

At this point, pressure from the opposition represents the only realistic challenge to May's Brexit ideology. As things stand, the Scottish Nationals pose a greater threat than the Labour party, with the prospect of a second referendum on Scottish independence offering yet more unwelcome uncertainty for the government to ponder. A simultaneous break-up of the Union on multiple fronts, or at least the potential of it, could spell the final death knell for the government's push for a clean break with the EU.

Austerity set to continue amidst Brexit uncertainty

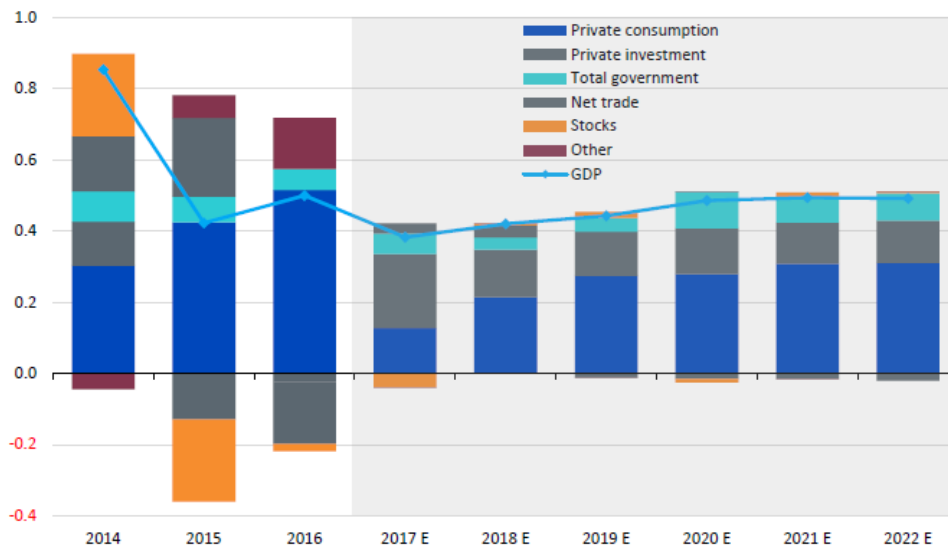
In light of the upcoming political risk, the economic risks facing the UK economy in

coming years are also skewed to the downside. The Office for Budget Responsibility (OBR) forecasts UK GDP to slow in 2017, primarily as a result of falling domestic demand (comprised of household consumption, private investment and government spending) with total quarterly contributions to GDP expected to drop by 0.1% in 2017 (represented by grey shaded section in Chart 1), equivalent to over 0.4% a year on an annualised basis.

Facing a slowing economy, the UK Chancellor Philip Hammond has given little away with respect to upcoming economic strategy, with the Spring budget offering no hints of a pre-Brexit boost in spending. By contrast, the government reaffirmed its commitment to austerity, pledging to maintain deficit reduction targets well over the course of current parliament. I think this suggests that no adjustment to fiscal policy is planned, and austerity is set to continue amidst Brexit uncertainty.

However, the OBR's base scenario implies a soft Brexit scenario where trade deteriorates gradually over 10 years and with no consideration for a final Brexit bill. This therefore represents a more upbeat scenario for the UK with milder economic consequences. Since the potential for a hard Brexit cannot be ruled out, the risk of significant disruptions to the UK economy remain. Against such a backdrop, the possibility for austerity to be relaxed could increase.

Figure 1: Diminishing domestic demand amidst Brexit uncertainty
Contributions to average quarterly GDP growth (in percentage points)



Source: WisdomTree, Bloomberg and Office for Budget Responsibility.
Data as of 31/12/2016.

Such a move would undoubtedly push the deadline for eliminating the deficit well into the next parliament, as well as undermine UK Chancellor Philip Hammond's fiscal stance. But in the absence of any obvious drivers of growth, less austerity for longer could be necessary to counteract weaker domestic demand. Signs of weakness in household consumption are already emerging with January YoY retail sales growth at its lowest since 2013. Private investment also looks vulnerable, with UK mid/small caps set to face a triple squeeze from higher import costs, higher wages and higher business rates. Alongside a broader and deeper economic slowdown, supported by softer PMI numbers coming into 2017, the Chancellor could be called upon to loosen purse strings rather than tighten.

Asset allocation: Bullish UK exporters, bearish domestic UK equities and gilts

The pursuit of May's Brexit ideology will intensify macroeconomic pressures for the UK

over the near-term. Further Sterling weakness arising from trade uncertainty will weigh on the safe haven status of UK gilts. A strong push for Scottish independence could also present an additional source of concern for UK gilt investors.

Against this vulnerable macro backdrop, investors may consider diversifying their UK equity allocations. In particular, baskets of UK dividend payers with high exposures to UK multinationals could provide better opportunities, with the fall in the pound boosting overseas earnings.

Investors in UK gilts and UK domestic equities may also consider hedging their exposures with short ETPs.

All data is sourced from WisdomTree and Bloomberg, unless otherwise stated.

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+ [European macro outlook political risk at the gates: If 2017 is no threat to equities, it is for the Euro and peripheral bonds](#)

Investors sharing this sentiment may consider the following UCITS ETFs and ETPs:

+ [WisdomTree UK Equity Income UCITS ETF \(WUKD\)](#)

+ [Boost 3X Short UK 10Y Gilts ETP \(3GIS\)](#)

+ [Boost 3X Leveraged UK 10Y Gilts ETP \(3GIL\)](#)

+ [Boost 1X Short FTSE 250 ETP \(1MCS\)](#)

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