FEG INSIGHT

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BREXIT:
A Certainty of Uncertainty

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On a rainy Thursday in June of 2016, the British took to the polls to decide if they should remain in, or leave the European Union (EU). To the surprise of pundits and pollsters, and markets worldwide, the referendum result was to leave. More than two years later, the exit is looming, and the full breadth and scope of Brexit's consequences are still unclear.

Given the uncertainty, we feel it is important to provide insight on the possibilities of Brexit, as important dates are approaching. What follows is not intended to be an in-depth analysis of multiple scenarios, but rather an opportunity to help investors understand the current state of affairs and possible outcomes. One of the unfortunate consequences of investing is the associated uncertainty; however, that uncertainty is ultimately the very risk that can provide rewards. Given the stakes, FEG continues to pursue an understanding of the complexities surrounding Brexit to mitigate the risks and capitalize on the associated rewards.

HOW DID BREXIT HAPPEN?

The vote was brought about by several social and economic issues, largely centered around sovereignty, patriotism, trade, and immigration. The referendum came at a time when populist revolts in Europe were gaining momentum—a trend that the "leave" camp used to paint the officials in Brussels governing the EU as "political elites" who were not democratically elected by British citizens and thus may not be qualified to make political, social, and economic decisions on Britain's behalf.

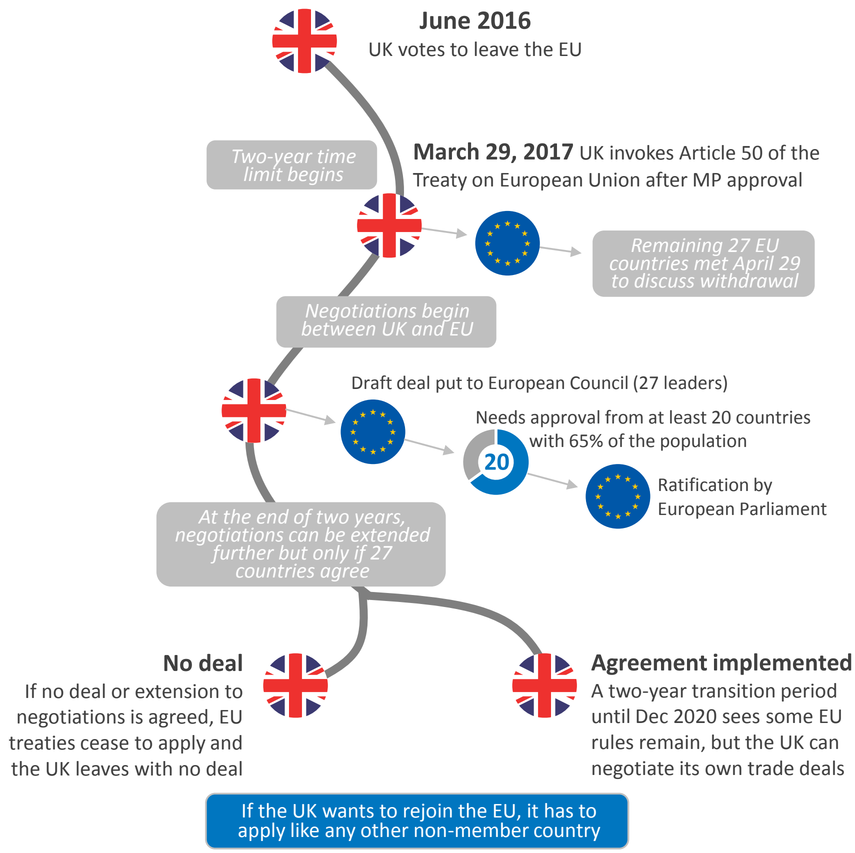
SIDES OF THE BREXIT VOTE

LEAVE CAMP	REMAIN CAMP
This group pushed for the people of Britain to take a stand to control immigration into the UK and leave the single market, which they believed was holding Britain back from higher growth potential opportunities in emerging markets.	This group stressed the advantages to trade by staying in the single market, pointing out that 44% of Britain's exports went to other countries in the EU. Furthermore, they warned that leaving the EU would cause banks to flee the UK and capital to drain from London – the EU financial center.

While it was expected that the June 23 vote would be close, many believed Britain would remain in the EU. As the last few votes were counted, however, the government announced that with a final vote of 51.9%-48.1%, Britain would be leaving the EU. Afterward, some pundits claimed they had seen the writing on the wall, suggesting that the UK's failure to fully embrace the euro and adherence to consequentialist interest rate policies indicated an ongoing resistance to unification simmering just beneath the surface.

David Cameron, the Prime Minister of the UK at the time of the referendum, announced his resignation immediately after the results of the vote were announced. He was replaced by the newly appointed head of the Conservative Party, Theresa May. Initially part of the "Remain" camp, May vowed to move forward in the direction the people of Britain had voted to proceed.

STEPS TO UK LEAVING THE EUROPEAN UNION



Source: https://www.bbc.com/news/uk-politics-32810887

Almost a year later, May triggered Article 50—or the right to quit unilaterally from the EU—on March 29, 2017, giving the UK two years to form new trade agreements with the EU and all its other trading partners. Additionally, the UK has been allowed a transition period from March 29, 2019 to December 31, 2020 to allow businesses and others to prepare for the new, post-Brexit rules to take effect.

Since the referendum, there has been ongoing uncertainty. Immediately after the vote, investors with exposure to global equities and credit-sensitive investments witnessed negative performance from those areas, as the markets were rocked with volatility. Although the pound slumped the day after the vote, the UK economy continued to grow at an annual rate of 1.8% through 2016 and 2017, slowing slightly in 2018. Inflation has since stabilized at 2.7% and unemployment continues to fall.[1]

With all eyes on the UK market it is important for investors to keep in mind the scale of the UK economy and thus, the expected global impact of negotiations. As of 2017, the GDP of the UK was $2.6 trillion, in U.S. dollars, which represents just 4.2% of the world's GDP. In comparison, the GDP of the U.S. was $19.3 trillion, 31.3% of the world's GDP.[2]

In July 2018, May rolled out the Chequers Plan, which was the UK's initial view of a proposed Brexit deal. As the plan has made its way through May's cabinet and EU approval, it has gone through numerous amendments and name changes—from Chequers to May's Plan, and now, the Withdrawal Agreement. The potentially final approval lies with the UK Parliament in a vote.

KEY ISSUES

Parliamentary approval of the "compromise deal" could allow both sides to move forward in transitioning to the new regulations governing the UK and the EU—the proposal has divided parties within the UK government and failed to please either side of the aisle—but at this point approval looks unlikely. Otherwise, the UK and EU could end up back at square one. While there are several details that still need to be ironed out over the following months and years—such as how much money the UK should pay to leave the EU— three complex issues remain at the forefront: trade, immigration, and the Northern Ireland border.

TRADE

The EU currently operates as a single market, which essentially merges members' economies together. The single market allows for the free movement of goods, services, people, and money, circumventing the need for border control, customs, immigration, etc. While the single market is designed to boost trade, create jobs, and lower prices among member countries, the single market also requires a common set of laws and regulations and prohibits members from striking their own external trade deals.

Critics of the single market argue that it imposes excessively punitive regulations and strips members of control over their internal affairs. Theresa May has all but ruled out staying in the single market, going as far as to say, "No deal is better than a bad deal."

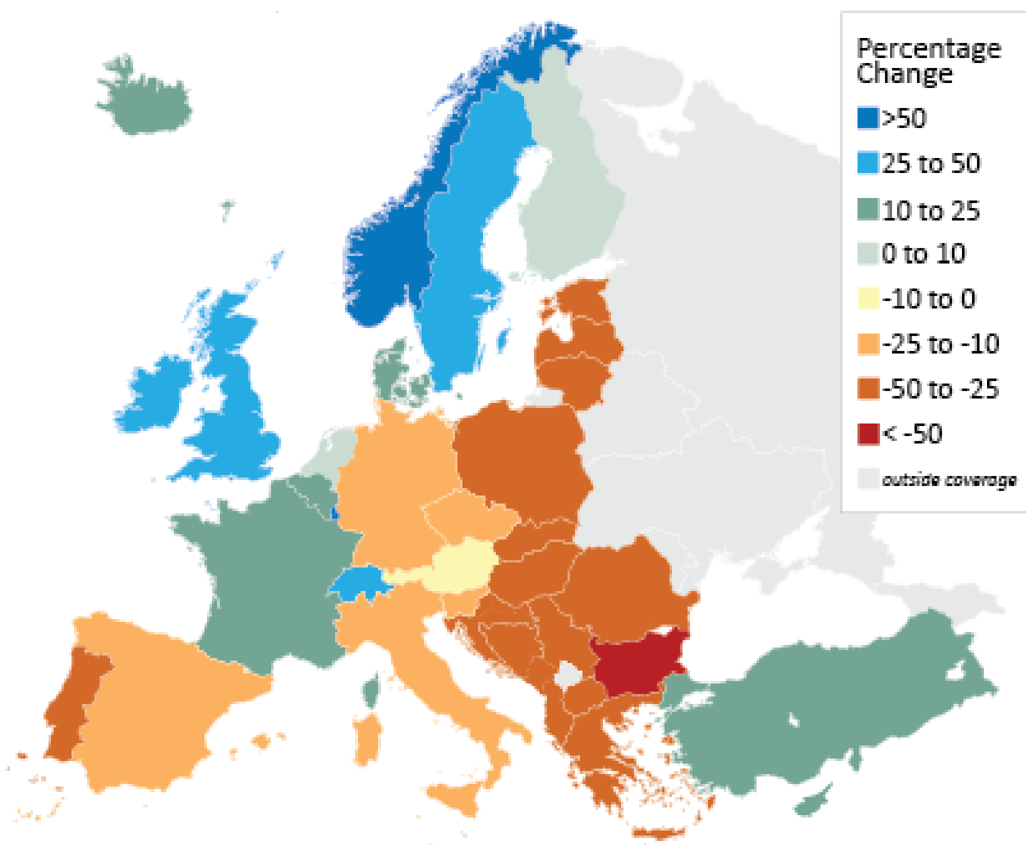
The latitude afforded to the UK to negotiate its own trade deals outside of the EU remains an important dividing factor in current negotiations between the UK and the EU. The UK would generally prefer something closer to what is being deemed a "Canada-style" arrangement. This type of deal would most closely resemble a free trade area, which facilitates the free movement of goods and services within the area but allows members to make their own external trade deals. The EU opposes this arrangement, arguing such a scheme would give the UK a competitive advantage by allowing the country to avoid a common set of regulations on items, such as pricing and technical standards.

The preference of the EU27—the 27 remaining countries that comprise the EU—seems to be a "Norway-style" deal, in which the UK essentially remains part of the single market, adhering to a common set of regulations and allowing the free flow of goods, services, people, and money across borders. However, this type of deal would clearly not satisfy the UK's desire for autonomy in negotiating outside the borders of the EU.

IMMIGRATION

Population growth has long been a central issue across certain EU member countries, a problem that has been exacerbated by the free flow of people across the union. Predictably, immigrants tend to flow from poorer countries into more prosperous ones, seeking a better standard of living and greater opportunity. The UK is one of the EU members most affected by immigration and is projected to overtake Germany as the most populous EU country by approximately 2050, with one of the highest annualized population growth rates across the region.[3]

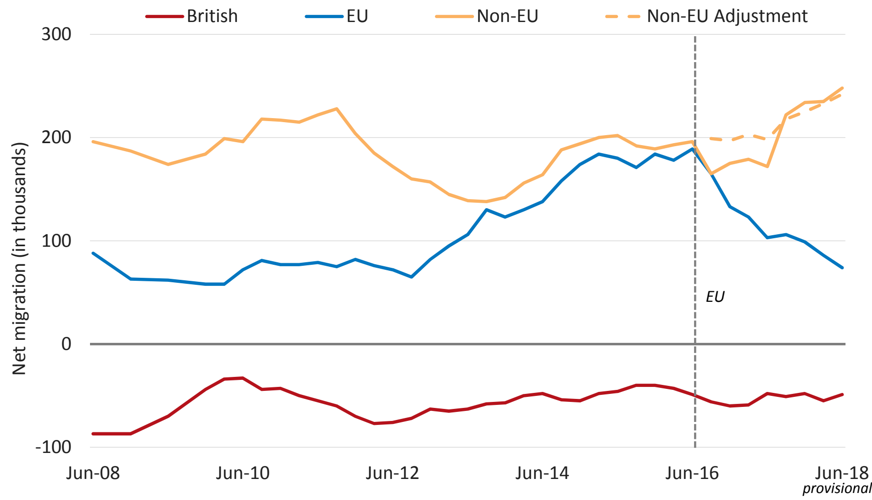
PROJECTED POPULATION CHANGE IN EUROPEAN COUNTRIES
2015–2100



Data source: World Population Prospects, the 2015 revision provided by United Nations Department of Economic and Social Affairs.

May has been vocal throughout the Brexit negotiations about ending the free flow of immigrants into the UK and allowing the UK to control who enters the country.[4] At its prior pace, immigration posed several threats to the UK economy that the government would like to get under control, such as pressures on public services and unemployment/underemployment. Following Brexit, net migration into the UK has declined—predominately from EU countries—but remains elevated against measures of migration throughout the past decade.[5]

MIGRATION TO AND FROM THE UK



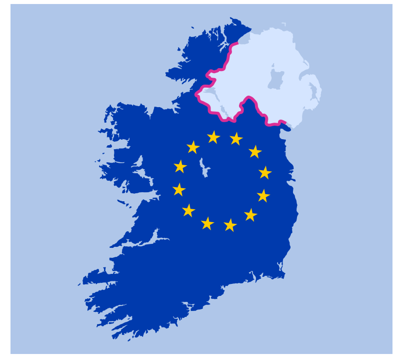
Data source: Long-term International Migration, Office for National Statistics; data as of June 2018.

Immigration and the free flow of people are important factors for many businesses in the UK. Specific to the UK's participation in the EU are the questions surrounding the status of EU27 citizens currently living and working in the UK and UK citizens currently living and working EU27 countries.

One facet of the immigration issue involves the UK's workforce and whether individuals from outside the UK will be able to easily live and work inside the UK once negotiations are complete. While there is a large population of workers from outside the UK employed in various industries within the country, one of the largest industries employing immigrants is the financial services and banking sector. Should tighter immigration policies take hold, the population of financial workers who are not native to the UK may be put in a difficult spot, which would likely have ripple effects for businesses throughout Europe—with the most negative implications for UK businesses.

A bright spot is that this is one of the few aspects of the ongoing negotiations that the two sides have seemingly been able to resolve, as the President of the European Commission, Jean-Claude Juncker, called allowing people to stay and retain rights within their current locale a "cheap and simple administrative procedure."[6]

NORTHERN IRELAND



The more severe the post-Brexit immigration divide between the UK and the EU, the greater the need for borders. However, the only place a physical land border exists is the 310-miles between Northern Ireland, a part of the UK, and the Republic of Ireland, a member of the EU. This component of the Brexit negotiations has been, and continues to be, one of the most contentious debates between the UK and the EU.

Neither the UK nor the EU want to reignite the Troubles – the more than 30 years of deadly conflict in Northern Ireland over their constitutional status, which ended with the Good Friday Agreement of 1998 that had a tenet which removed security checkpoints between the two countries. Additionally, both Northern Ireland and the Republic of Ireland have closely tied economies that would be complicated with border checks.

The EU's suggested solution was a "common regulatory area," essentially keeping Northern Ireland as part of the EU single market. This proposal has been met with strong opposition from the UK, who believes this would effectively split Northern Ireland from the rest of the UK.

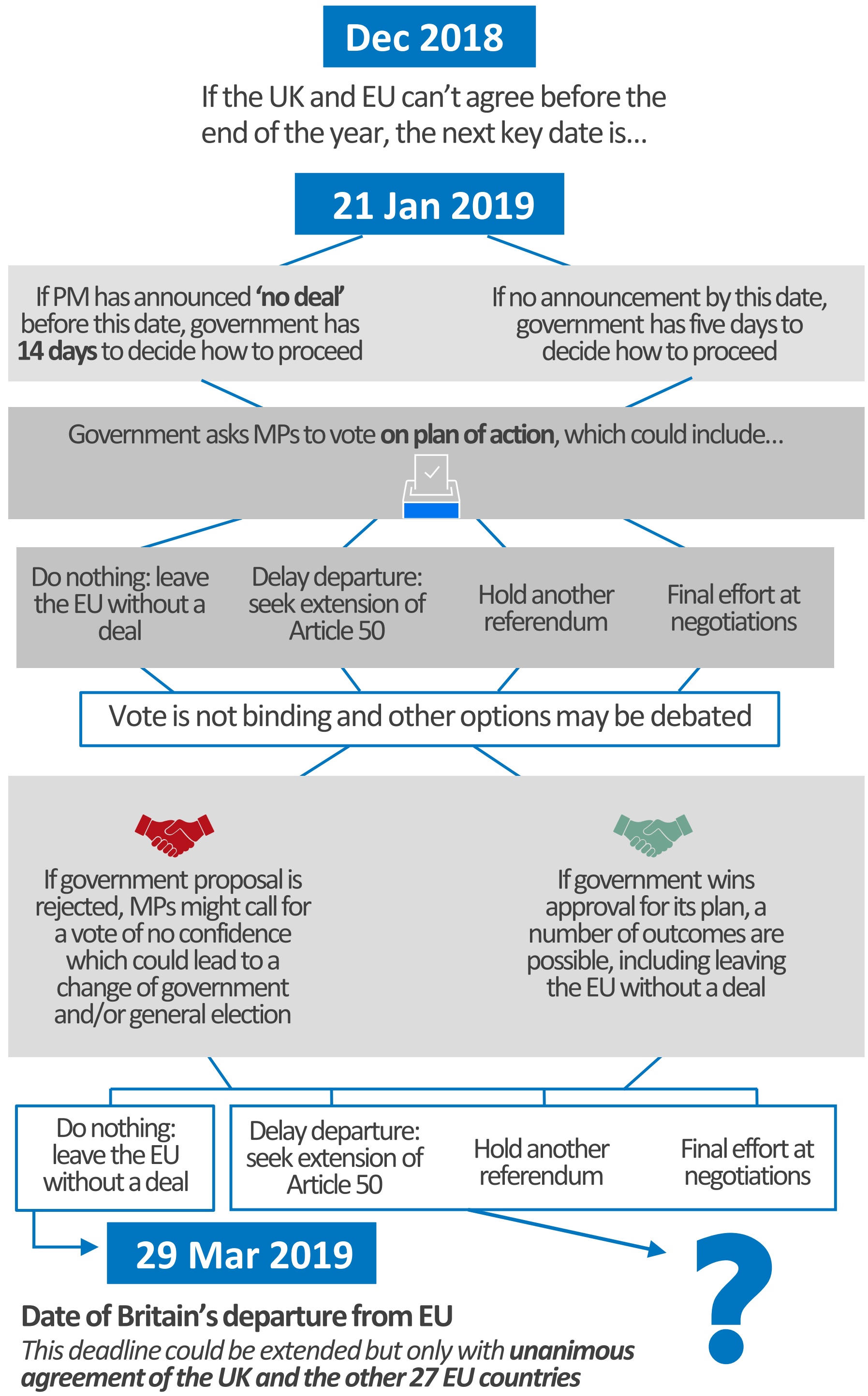
Alternatively, May had proposed a common rule book that would apply to food and manufactured goods crossing UK and EU borders. This plan has generated criticism from the opposition in fear that this arrangement could facilitate cheating in the designation of what constitutes a "food or manufactured good."

So far, the UK and the EU have agreed to put a "backstop" in place, which would serve as a safety net to ensure that no hard border is created regardless of the outcome of the Brexit negotiations. This would mean Northern Ireland would stay aligned to some EU rules (related to food products and goods standards), prevent the need for checks on goods at the Irish border, and keep the entirety of the UK out of the EU customs union. May has expressed her distaste in regards to the backstop and said she does not want to use it the way it is currently set up.

Along the 310-mile land border between Northern Ireland and the Republic of Ireland there are up to 275 crossings. Often the only notification a person is changing countries is traffic signs like the one to the left.[7]

Photo source: Remizov / shutterstock.com

WHAT HAPPENS IF NO DEAL IS AGREED ON BREXIT BY THE END OF 2018?



Source: https://www.bbc.com/news/uk-politics-45601502

WHERE DO WE GO FROM HERE?

The coming months before the March 29, 2019 UK departure deadline could be critical to the fate of the UK and the EU. May's plan—originally up for vote in the UK Parliament on December 11, but pushed back to a later date by May after receiving warning of a devastating defeat—provides hope for an orderly resolution to Britain's exit from the EU. May has spent considerable effort to sell her plan and rigorous debate on the issues continues leading up to the Parliamentary vote.

If approved, the 21-month 'transition period' will begin on the departure date and last through December 2020. The transition period is designed to give governments, businesses, and citizens time to prepare for the new rules agreed upon in the Brexit negotiations. If the plan is voted down, which is the consensus expectation—notably, the consensus also expected Brexit to be voted down—Britain's exit from the EU could very well be back at square one.

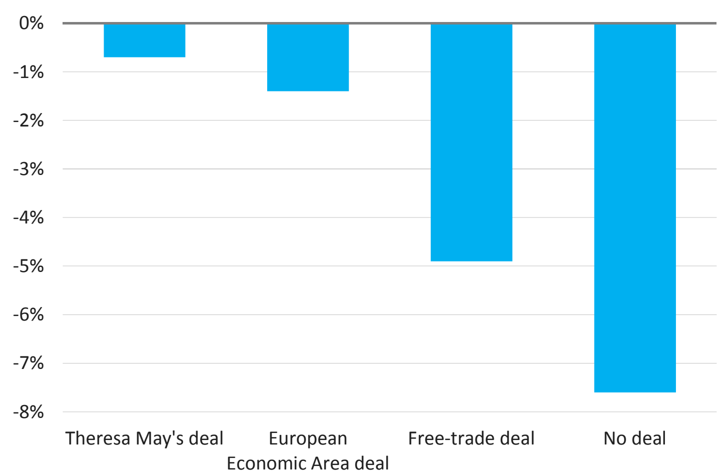
The implications of the latter scenario are unknowable as negotiations could crumble and result in a disorderly divorce, an extended delay, or even a last-minute agreement.

IMPLICATIONS

The consequences and impact from Brexit are ultimately dependent on the closeness of the relationship between the UK and EU following the split. Without knowing the specificities of the agreement, it can be difficult to assess potential implications; however, utilizing UK government analysis and conversations with investment managers which closely follow Brexit, it is possible to analyze potential outcomes.

The UK government recently released a report that provides economic analysis of different Brexit scenarios based on how hard-lined the final Brexit deal is on the issues detailed in these pages (e.g., trade and immigration). Regardless of the Brexit scenario, negative impacts to gross domestic product (GDP) are forecasted.

EXPECTED GDP IMPACT UNDER DIFFERENT SCENARIOS ANALYZED BY UK GOVERNMENT



Data source: U.K. Government (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/759762/28_November_EU_Exit_-_Long-term_economic_analysis.pdf

The report indicates varying degrees of negative impact, with May's plan having the least negative impact of the scenarios assessed—something she undoubtedly will use as a rallying cry for her plan to be approved in the December vote. The clear loser is the "no deal" between the UK and Europe scenario where free trade and immigration between the EU and the UK is effectively terminated. It may be that the government's own analysis is enough to rally UK politicians around May's plan, but that remains to be seen.

If the proposed plan is voted down, a possible scenario is another referendum on whether the UK remains in the EU. If the population is sufficiently frustrated by the lack of progress made by the government to negotiate a good deal with the EU and the economic and other impacts are perceived as overwhelmingly negative, the government and citizens may opt to put the issue to vote a second time, thus returning to square one, once again.

In conversations with investment managers who invest in, and follow European markets, FEG analysts have asked, and continue to monitor, how they perceive this ongoing issue, what expectations they have for Brexit, and how these feelings influence their investment behavior. To be frank, many of these investors—several of whom are based in London—feel just as uncertain as those of us across the pond in their expectations about Brexit. Although some of this uncertainty may be fallout from the errant assumption that UK citizens would not support Brexit, these views predominately reflect the complexities and the divisiveness surrounding the topic. They can see both the positive implications of independence and sovereignty, as well as the negative implications of reduced free trade.

With this backdrop, many managers are taking a very cautious and neutral approach to the Brexit negotiations. Where managers can hedge, they often do, in an effort to minimize potential negative impacts. As an example, after the Brexit vote, the British pound sold off. Some managers have instituted hedges on the pound for protection in the event a deal is not approved, as this could spell additional losses for the pound in the future.

Other managers are seeking investments as insulated as possible from the consequences of Brexit negotiations to the extent possible (e.g., investing in companies with little dependence on the UK/EU relationship) for the well-being of company finances or operations. Some managers, who have the option to invest across various regions, have reduced their exposure to the UK and even the EU to help minimize risk.

Other managers, however, see the uncertainty surrounding Brexit as an opportunity to invest in the UK. Their expectation is that the downside to the UK is so great without a deal that something will surely be approved before the deadline, ultimately supporting UK investments. These managers often regard this type of investment as a calculated risk in which the market expectations are excessively dire but the upside is significant enough that probabilistically, the trade is a good one.

With perspectives on every side of the issue—much like the Brexit event itself—investors have a multitude of options and little surety about how the event, and markets, will unfold.

CONCLUSION

At present, no one knows what to expect from Brexit other than uncertainty, but uncertainty brings risk, and with risk there can be opportunity. We will continue to monitor the developments surrounding Brexit negotiations and the potential impact to our clients, both in the near term and well into the long term. The topic of Brexit has surfaced intermittently following the UK's vote as new developments occur, and as important dates in the Brexit timeline near, this event is likely to be among the most important issues driving markets in Europe and beyond. Given the complexities of the issue, long-term asset-allocating investors can be best served by not trying to time the markets, but instead, recognizing the degree of UK and European risk in their portfolios and understanding the approach their managers use to manage risk and seize opportunities in the region.

FOOTNOTES

[1]https://www.bbc.com/news/uk-politics-32810887
[2]https://tradingeconomics.com/
[3]https://www.eea.europa.eu/data-and-maps/indicators/total-population-outlook-from-unstat-3/assessment-1
[4]https://www.politico.eu/article/theresa-may-unveils-new-uk-immigration-system/
[5]https://www.eea.europa.eu/data-and-maps/indicators/total-population-outlook-from-unstat-3/assessment-1
[6]https://laresidence.co.uk/latest-news/78-a-decisive-step-clarification-of-citizens-rights-after-brexit
[7]https://www.bbc.com/news/uk-politics-42180074

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