ClearBridge Investments

Implications of Ongoing Brexit Negotiations

March 25, 2019

Key Takeaways

- Continuing a trend of drawn out planning and implementation, we believe the most likely outcome of the current Brexit negotiations will be another extension.
- Pressure from the European Union, led by France, could lead to a "soft Brexit" outcome that leaves much of the current framework between the United Kingdom and the EU in force.
- Brexit uncertainty has caused UK equities to severely underperform global markets, creating valuation opportunities that will likely be supported by aggressive stimulus measures.

Over the past three years, when citizens were given the opportunity to express their displeasure with the incumbent government, they jumped at the chance. Centrist and establishment parties were removed from power in Brazil, Mexico, France, Italy, Germany and the United States. The British ejected their Prime Minister back in 2016 with a referendum to leave the European Union known as Brexit. But as with many decisions driven by emotion and political opportunism the years since the June 2016 vote have been filled with regret, realization and unintended consequences. Brexit became the thing that everyone claimed was a "mandate of the people" with no one exactly sure how to do it. Brexit didn't even look good on paper let alone when people contemplated the reality of abandoning a 46-year-old relationship. It appears to us a reasonable path forward would be calling a "time out" with an extension, or a "do over" with either a new vote or soft Brexit that keeps the United Kingdom (UK) in the common market - the Norway option.

The UK petitions website crashed on March 21 with 1500 signatures per minute in support of revoking Brexit. By week's end, the total number of citizens asking to stay reached 3 million. So much for the "mandate of the people" invoked by pro-Brexit MPs.

The European Union (EU) is giving British Parliament two more weeks to try and get a deal ratified. Prime Minister Theresa May now has until April 12 to decide if the UK leaves without an agreement, or more likely, requests a much longer extension. Ultimately, Speaker of the House of Commons John Bercow will determine if a new proposal will be brought to a third vote sometime this week. It is not at all clear that May will be around for the second phase of Brexit in which the details of future trading rules are negotiated. Her leadership is also at some risk if the third vote goes poorly.

French President Macron is taking the hardest line at the current summit, but this is probably more of an attempt to help May get her deal approved by Parliament. He claims that France is prepared for a no-deal Brexit and is not interested in a long and unproductive extension. Ms. May can use this tone to convince the "hard Brexit" members of her party that Brexit will be "softer" or not happen at all if they don't support her proposal next week. Under a "hard Brexit," trade would be governed by WTO rules. Basically, the UK and EU would be bound by a "most favored nation" rule and required to award each other equivalent treatment.

Regulatory Oversight Could Suffer Under Brexit

The Financial Times this past week highlighted the real downside of leaving the EU that businesses and consumers are now just realizing. UK regulators have been discussing the need to add to inspection staff as multiple national standards replace a single, harmonized set of rules. Researchers at Harvard found that small and medium-sized UK businesses view the EU regulations as beneficial and retain a well-founded fear of the British bureaucrat. Farmers are now contemplating the loss of EU subsidies and protective tariffs while also likely facing greater competition from non-EU producers. President Trump has expressed his excitement at selling Wisconsin cheese and Iowa wheat to the UK once Brexit is in place. Even the anti-immigration and border control issues that fueled much of the support for Brexit is backfiring. There has been a loss of skilled and high earning EU workers which has been offset by a 15-year-high flood of immigrant/non-EU lower paid workers. As a result, the net tax base has shrunk.

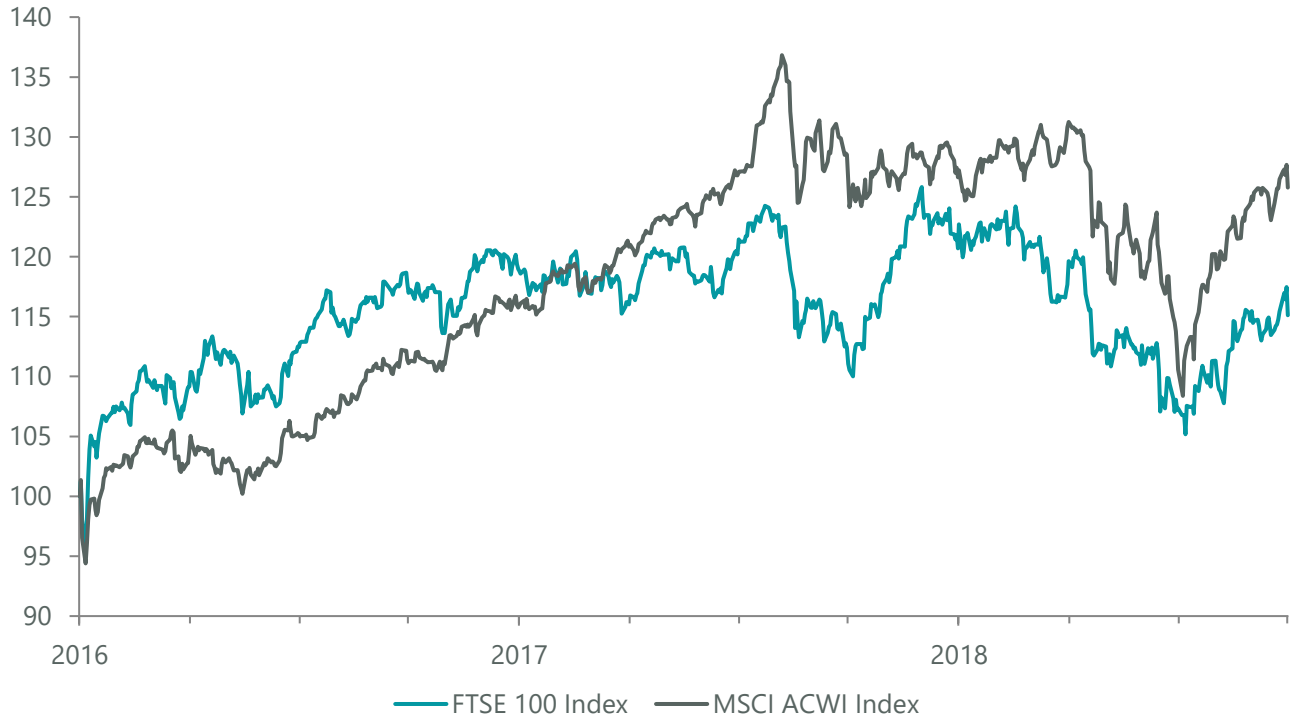
The time frame of any Brexit vote extension is complicated by the upcoming European Parliament elections beginning on May 23. On April 18, the current Parliament is dissolved and can't ratify any Brexit deal before July 2. The longer extension May is likely to request if her deal loses on a third vote next week would ensnare the UK in legal issues surrounding continued £1 billion a month in support payments and political issues related to participating in European MP elections. Interestingly, if the UK participates in the upcoming voting this would serve to increase the anti-EU and populist coalition and potentially influence the choice of European Commission President. That would be a parting gift that the establishment parties in the EU would like to avoid receiving.

Brexit Risks Continue to Mount in UK

The UK has already taken significant actions to limit disruption in trade if there is a no-deal Brexit, especially in relation to the Irish border. They have enacted a temporary import regime that removes tariffs on 87% of goods for the next 12 months. Also, the UK will remain a member of the Common Transit Convention which moves checks away from the borders to the final destinations. This is helpful but would not eliminate all costs of leaving the Common Market such as biosecurity checks, dangerous chemical declarations and VAT duty reporting requirements.

While the UK is enjoying record high employment and improving wage growth, Brexit uncertainty has caused consumer confidence to plunge to recession levels. As with much of the world, uncertainty surrounding trade, political and monetary policy has led to an "air pocket" in economic activity. Corporate investment has been particularly weak in the UK, contracting year-over-year at the sharpest rates since the 2008-09 financial crisis.

Exhibit 1: UK Stocks Have Lagged Since Brexit Vote



Returns are from June 22, 2016 through March 22, 2019. Both indexes rebased to 100 on June 22, 2016, the day before the Brexit vote. Source: Bloomberg.

Since the Brexit vote on June 23, 2016, UK shares have badly lagged global equity markets and risen less than half as much as the MSCI ACWI Index. On a sector-adjusted basis, this has put the relative valuations of UK companies back down to levels last seen during the downturns of 2001 and 2008. While British exporters have benefited from the weak currency, more domestically dependent shares have contributed the most to the underperformance.

The benefit of a longer extension is the greater likelihood of a more workable "soft" Brexit that limits the harm to UK companies and consumers while keeping Ireland border-free. Either an extension or deal approval would support a sharp economic rebound. A no-deal/hard Brexit, or the formation of a new government, would keep the UK economy under a cloud of uncertainty. Worst case would be an essentially powerless non-majority Labor government led by Jeremy Corbin. This would likely weaken the economy, currency and stocks. The UK government is planning significant stimulus over the next five years with the reduction in personal taxes and subsidies that encourage capital investment. If Brexit related uncertainty is removed, this fiscal support will add to the strength of an economic rebound.

An extension should not be a surprise given it took four years, from 1969 to 1973, for Britain to work out terms for originally joining the EU. Hopefully the divorce is less painful and faster than the courtship, but that is not always the case.

About the Author

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- 35 years of investment industry experience
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Past performance is no guarantee of future results.

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