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What investors need to know as Brexit nears

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Summary

As the date of the UK's planned exit from the EU approaches, there's an increased probability the Prime Minister will win support for her Brexit deal. But a "no-deal" scenario cannot be ruled out – and it could have a heavy impact on the UK economy. Here's what investors need to know to navigate markets.

Key takeaways

- There's a strong probability that Prime Minister May will get some version of her Brexit deal through Parliament at the next vote, though she will need to make the "backstop" more palatable to her party
- A "no-deal" scenario is still possible, but headlines about the economic disruption from a Brexit crash-out may have further hardened minds against this outcome
- If Mrs May gains a parliamentary majority for her withdrawal agreement, we think sterling would would be positioned to appreciate, gilts would likely sell off and equities would rally after a brief initial drop
- Given that any new agreement would merely set the scene for long negotiations about the future UK-EU relationship, uncertainty will persist; investors must prepare for a wide range of scenarios

The complex Brexit saga arrives at another milestone this month, when British Prime Minister Theresa May faces the latest parliamentary vote on her Brexit withdrawal deal.

This follows the resounding rejection of Mrs May's Brexit proposal by MPs in a mid-January vote. However, just two weeks later, she secured a majority for an amendment seeking assurances from the European Union on a key sticking point: the so-called Northern Irish "backstop". This signalled that a deeply divided Parliament may be inching towards compromise.

In the midst of the steady flow of Brexit-related headlines, the date of the UK's planned exit from the EU – 29 March 2019 – is focusing people's minds. While multiple Brexit outcomes are still theoretically in play – ranging from a second referendum to an extension of Article 50 – the nearer we get to the March deadline, the fewer options there may be.

The backstop is the most immediate issue

The backstop causing Mrs May so much trouble refers to the withdrawal deal's mechanism designed to prevent a "hard border" in Ireland. If a trade deal isn't agreed before the Brexit transition period ends in December 2020, border controls may otherwise need to be put in place between Ireland (as a member of the European Union) and Northern Ireland (which, as a part of the United Kingdom, would have left the EU).

Mrs May seems committed to avoiding a hard border in Ireland, insisting in a recent speech in Belfast on the importance of having arrangements in place to prevent it – and reiterating her "unshakeable" commitment to keeping the border open.

The probability is high that the prime minister will likely succeed in getting some version of her deal through Parliament, whether with a renegotiated backstop or alternative arrangements in place. The vote at the end of January showed there was a parliamentary majority for Mrs May's deal in a less controversial form, assuming MPs' concerns about the backstop can be addressed. In a letter to Mrs May in early February, the opposition leader Jeremy Corbyn set out five conditions for supporting her Brexit deal, while apparently leaving the withdrawal agreement untouched – potentially increasing the chance of the deal making it through Parliament.

The challenge will be finding a way of making the backstop – whether through a time limit or other means – palatable to her party, particularly hard-line Brexiteers. This is particularly important now, after her speech in Belfast seemed to reiterate the importance of having a backstop in place.

"No deal" can't be ruled out

Despite Mrs May's success in gaining a parliamentary mandate to revisit the withdrawal agreement, the prospect of a cliff-edge "no-deal" Brexit cannot be ruled out. Simply put, it's the default outcome should the UK reach 29 March without a negotiated withdrawal agreement in place. This date represents the end of the two-year negotiation period allowed by Article 50 of the Lisbon Treaty, which establishes the legal process for leaving the EU.

Even though MPs voted against a no-deal outcome, the vote was non-binding, and there was no majority for any one course of evasive action – for example, by extending the Article 50 deadline.

While there are some MPs who favour a no-deal scenario – whether they are vocal on the topic or not – the news flow in recent days points to the economic disruption of a Brexit crash-out for a UK economy that is already plagued with uncertainty. This may have further hardened minds against a no-deal result, but an agreement is far from assured and there has been tough talk from EU negotiators.

There has been some discussion of extending Article 50, although the prime minister has played down any ministerial talk of an extension. Whether or not that's an option, Mrs May's goal at the moment seems to be to "run down the clock" and focus people's minds on that impending deadline.

Three of the potential outcomes and their implications

The 14 February parliamentary vote on Prime Minister May's withdrawal deal is an important one, although it is by no means the only milestone on the Brexit path. Looking ahead to the coming weeks, the potential outcomes include:

1. Mrs May gains a parliamentary majority for some form of her withdrawal deal
As previously stated, we believe this is the most likely scenario – though by no means guaranteed. Approval of Mrs May's deal with the EU may relieve some immediate uncertainty for business and industry – but it simply sets out a framework for the process of negotiating the UK's future relationship with the EU.

The UK and EU would have until the end of the transition period (31 December 2020) to negotiate the immensely more complex and comprehensive trade deals with both the EU and the bloc's trading partners. This may or may not go well, and therefore uncertainty would still be elevated.

Still, this scenario would be a massive improvement from the existing situation. We would expect news of a deal to trigger a sustained boost for UK assets, since the UK is a massive underweight for many investors:

- **Currencies:** A deal would likely result in significant appreciation of the British pound sterling.
- **Fixed income:** We'd expect a large selloff of gilts, particularly at the front end – and we'd expect sterling to appreciate – as the market moves to price in UK rate hikes.
- **Equities:** There may be a short-lived initial selloff, driven in part by sterling appreciation – but we think the stock market would rally thanks to new money coming into the UK from abroad. We'd expect UK equities to outperform global and European benchmarks; domestic stocks and mid-caps could also look attractive.

2. Mrs May fails, and the UK crashes towards a no-deal Brexit
If Parliament doesn't approve an agreement soon, this is the default option – so even though we think a no-deal scenario is less likely, it cannot be ruled out. To some extent, "no deal" is a misnomer: there are some temporary side deals being agreed across different industries.

Still, our view is that it could have a heavy impact on the UK economy and investors:

- **Currencies:** Sterling has historically fallen whenever odds rise of a no-deal scenario; if the 29 March deadline hits without an agreement, we would not be surprised to see a collapse in the UK currency.

- **Fixed income:** We expect a selloff in gilts if a no-deal Brexit comes to pass. We don't even find gilts attractive now, both because we expect the Bank of England to be less dovish than the market does, and because government bonds haven't yet reacted to the rally in risk assets and the stabilisation in global economic data.

- **Interest rates:** If sterling falls precipitously, there is a slight risk the BoE will hike rates aggressively to push the currency back up again. This is because the UK might follow the well-trodden emerging market path of hiking rates in a crisis to support its currency, even if its economy faces serious difficulties.

- **Equities:** The impact of a no-deal Brexit on the UK stockmarket could be mitigated – at least to some extent – by the high international exposure of UK-listed companies. While mid-caps may sell off, as they did following the referendum result in June 2016, large-cap stocks could rise. This underscores the importance of being active and selective as an investor, in an effort to find attractive opportunities.

3. Mrs May looks for an extension of Article 50
It appears that a majority in Parliament is against no-deal, and they may well vote for Mrs May to go back to the EU and request an extension of Article 50 to give the UK time to sort out some of the bigger sticking points. (Bear in mind that a request for an extension could even happen in the event of a withdrawal agreement because the schedule is so tight.)

The EU has a strong incentive to stick to its tough negotiation stance and only compromise, if at all, at the last minute, but we think the prospect of an extension of the 29 March deadline has risen. For investors, the implications of this scenario are fairly positive:

- **Currencies:** We'd expect to see the pound rally somewhat.

- **Fixed income:**We anticipate a small selloff in gilts – though far smaller than what we'd expect in a no-deal scenario.

- **Equities:** An extension could mean better earnings prospects for the UK's domestic sectors, though the late-cycle British economy may keep earnings growth more grounded.

What it means for investors

Much of the longer-term guidance we provided in January remains unchanged:

- *Uncertainty is here to stay.* Even if a "cliff-edge" no-deal scenario is avoided, uncertainty will persist given that the "package deal" will merely set the scene for the trade relationship, and therefore leave plenty of room for ambiguity. Investors and companies need to prepare for a wide range of scenarios.

- *Brexit will hurt disproportionately.* Whatever the ultimate Brexit end state will look like, more frictions in trade with Europe seem unavoidable. This will affect the EU member states, the UK and its sectors in different ways. For the UK, time and active trade policies are may be necessary to mitigate some losses from higher restrictions to EU trade – but these losses might not be offset completely.

- *Brexit entails a bumpy ride for UK assets, but the UK stock market is not the UK economy.* Seventy percent of FTSE 100 revenues are generated overseas. The dichotomy between internationally and domestically oriented UK stocks might well continue.

Even after the latest parliamentary votes, perhaps we believe the most important thing investors can do is be active and selective as events unfold. Taking beta risk – passively holding portfolios with broad market exposure – is unlikely to be rewarded in such an uncertain, headline-driven environment.

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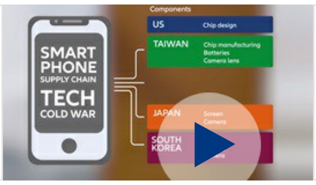

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