

Brexit primer: What, why and when?

March 2019

Brexit defined

Brexit is an abbreviation for “British exit” and refers to the UK’s decision to leave the European Union (EU) based on a referendum held in June 2016. Based on this result, the UK is scheduled to leave the EU in March 2019. Voters in favor of leaving the EU were motivated by economic, nationalistic and immigration concerns, and felt that the benefits of EU membership were outweighed by its costs. Many proponents of departing from the EU worked in industries that had, as a result of several decades of globalization, lost jobs to lower-wage countries (both in and out of the EU), while others objected to foregoing UK sovereignty over decisions related to fiscal and immigration policies, areas subject to EU rules and laws. Politicians in favor of leaving the EU launched what some believe to be misleading campaigns ahead of the vote, stressing the benefits of sovereignty without fully disclosing the potential costs (see *Exhibit 1*) which are varied and not easily measurable.

Withdrawal agreement

Following the referendum vote, the British government negotiated a withdrawal agreement with the EU to determine the

terms upon which the UK would leave the EU. In November 2018, UK Prime Minister Theresa May announced that a deal had been reached including, among other details, a £39 billion payment from the UK to the EU, rights for UK and EU citizens living in each other’s territories, and plans to avoid a physical border between Northern Ireland (part of the UK) and the Republic of Ireland (part of the EU). The agreement also allowed for a 21-month transition period during which trade would remain open between the UK and EU, giving both parties more time to negotiate a permanent trade agreement. Earlier this year, the agreement was rejected by Parliament by 230 votes, the largest defeat of a sitting government in UK history, but May retained control of the government and was given a mandate to negotiate a better deal. Concerns about the agreement included a lack of clarity about the final trade agreement and failure to regain control from the EU in a number of areas. One of the most significant sticking points was the Irish border, which both sides want to remain open; the deal allowed for a “backstop” under which Northern Ireland would remain subject to some EU rules, and some in Parliament objected to the UK’s inability to exit this without EU permission.



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Key highlights

- Brexit, or the British exit from the European Union (EU), is slated to occur in late March 2019.
- We think there are four main scenarios to consider relating to a potential UK departure from the EU.
- Our current positioning in Europe is neutral with a slight underweight of the UK, as we view Brexit as a negative for the country.

Exhibit 1: Potential impact due to leaving the EU

Market sector	Costs to the UK	Implications for the UK
Trade	Loss of free trade with EU and other countries.	Potential future tariffs and less efficient trade with EU and trade agreements with Asia and U.S. and others subject to renegotiation
Economy	Economic uncertainty	Loss of jobs as companies may not want to invest in the country, such as Nissan’s decision to scrap plans to make their new SUVs at a plant in Sunderland, England
Manufacturing, services industries and regulatory alignment	Loss of the benefits of an integrated global supply chain and higher costs for UK companies doing business in the EU	There is the need for UK companies to open offices, hire local staff and obtain licenses in individual EU countries. In the short term, there is the need for the UK to stockpile essential drugs it does not produce, such as insulin.
Labor market	Restricted ability for UK nationals and service sector firms to work throughout the EU	Companies relocating jobs and/or headquarters to the Continent as with Sony, Dyson and Panasonic

For illustrative purposes only.

Given the stronger bargaining position of the EU and our view that the agreement reached was reasonable, we think it is unlikely that the May government will be able to negotiate another withdrawal agreement that is acceptable to Parliament by the end of March. The question that remains is: what will happen next?

To Brexit or not to Brexit, that is the question

There are a variety of scenarios that could play out between now and the end of March, and a number of circumstances under which the UK may execute a Brexit or not. It is not logical to assign probabilities to these options since we would really only be guessing, but we would stress the following considerations: (1) EU country governments and bureaucrats would prefer the UK not to exit; (2) we believe that another referendum on the subject of Brexit would likely result in a vote to stay in the EU; and (3) Brexit will likely have negative implications for the UK's economy, the solidarity of its kingdom, and its global reach and power.

Scenario 1: Soft Brexit

- **How it might happen:** UK Parliament approves a withdrawal agreement (the existing one or something similar) before March 29, 2019, and moves forward with a negotiated withdrawal that allows for a 21-month stay on trade issues that are negotiated over that period. Also subject to negotiation would be the living/working status of the 1.3 million UK-born residents of the 27 other EU countries (EU27) and the 3.2 million EU27-born residents of the UK. This is called a "soft Brexit."
- **Expected impact:** While tariffs do not increase over the next 21 months, uncertainty over future tariffs and trade rules support the migration of businesses and jobs to the continent, hurting the UK economy. We would expect stocks of UK domestic-oriented businesses to suffer modestly as the British pound loses value and earnings forecasts are reduced to reflect lower expected economic growth. European equities will likely show mixed results as some European companies domiciled on the continent benefit from a shift in business and jobs to the mainland, but others are hurt by decreasing sales to the UK. Additionally, the risk premium placed on certain businesses related to the EU or eurozone breaking apart (or some countries splintering off) will rise modestly, negatively impacting some sectors, such as Italian banks, which would be unable to pay off euro-denominated debt should Italy ever leave the eurozone.

Scenario 2: Hard Brexit, aka, No-Deal Brexit

- **How it might happen:** UK Parliament does not approve a withdrawal agreement by March 29, 2019, but moves ahead with a "hard Brexit" anyway. Note

that Parliament is actively trying to avoid this scenario, as with its recent amendment to the Finance Bill that limited the Treasury's ability to make no-deal preparations unless authorized by Parliament. Other amendments have also been proposed and the net effect of them is to signal a Parliamentary majority against no-deal Brexit. That being said, a no-deal Brexit is the default option on March 29, 2019, unless Parliament can agree on an alternative with the EU.

- **Expected impact:** A hard Brexit is the most catastrophic possible outcome for both parties because chaos may ensue and trade could literally be stopped on a dime. Financial markets are currently not pricing in this outcome and will not like it. A hard Brexit will lead to increased risks pressuring financial markets in the near term. Immediately, we would expect turmoil at ports and other places of entry (e.g., airports), with the UK unable to process incoming goods and people, possible food shortages, shortages of manufacturing components and gridlock behind border checks. Over the short to medium term, trade would be subject to World Trade Organization (WTO) rules and most businesses would face new taxes on imports, exports and services. The EU has assured Britain that its citizens would still be allowed to travel within the EU without visas for up to 90 days, but Britons living abroad could find themselves in limbo. Other costs that could increase for Britons include healthcare when traveling abroad (since currently the UK and EU27 share reciprocal healthcare) and university education abroad (as only Germany and Norway offer free tuition to international students).

Scenario 3: UK Parliament decides to cancel Brexit

- **How it might happen:** Parliament could vote to revoke Article 50 of the Lisbon Treaty (the formal route of exit from the EU that is currently being pursued). The European Court of Justice has ruled that the UK can do this without approval of the other 27 EU countries. It is unlikely that Parliament would do this without another referendum or a change in government or some other factor indicating that the will of the people is against Brexit. A vote of no confidence and a change in government could be sufficient to set Parliament down this path.
- **Expected impact:** If the UK Parliament were to revoke Article 50, we would expect the pound to gain value, and British and EU equities to rise. While some economic loss would be permanent (e.g., most companies that have relocated or planned to relocate to the continent are unlikely to return), the UK's economic prospects would be considerably improved. Also, this would signal decreasing likelihood of an EU exit by any other countries. Stocks of companies, and especially financial companies in the eurozone, as well as the UK, particularly in countries such as Italy and the



Netherlands, would likely respond positively. UK, EU and global financial markets will like this outcome the most.

Scenario 4: The UK Parliament decides a soft Brexit or no Brexit is preferable to a hard Brexit, but dislikes the current withdrawal agreement proposal and postpones withdrawal from the EU.

• **How it might happen:** The wording of Brexit allows a minister to propose changing the definition of “exit day” through a legislative process, after which Parliament would have to approve it. This could occur much more quickly than a new act could be proposed and voted upon. Extending the Article 50 period is possible, as well, but would require the agreement of the remaining 27 EU countries and, hence, is less likely to occur before March 29, 2019.

• **Expected impact:**

- *Delay only:* While some in favor of not leaving the EU would likely applaud a delay over a hard Brexit, we believe this would only drag out the issue and slow the economy further while in the end not avoiding any of the costs outlined in Scenario 1.
- *Delay with announcement for a future referendum, in which the British people are offered another opportunity to vote on Brexit:* Parliament can approve legislation that would call for a new referendum, though its execution would take some time (and could not occur before March 29, 2019) since the Electoral Commission needs time to consider and advise on the referendum question. This path would open the door for a no-exit outcome and be a positive development in our view. Polls suggest that the most likely outcome of a referendum today would be a decision to stay in the EU, especially if the alternative were to accept the current deal with the EU. If this were to occur, we think it is likely that the UK Parliament would revoke Article 50 as described above in Scenario 3. Should a vote support Brexit, that would likely result in a change in UK government leadership and might increase the chances of a hard Brexit over a soft Brexit. See Scenarios 1 and 2 above for expected impacts.

- *Delay with announcement for a general election, in which the British people are offered an opportunity to vote on the government:* In this case, support of May would be interpreted as a political mandate for the current soft Brexit deal and a change in government would make another outcome more likely. A new general election requires support from two-thirds of all Members of Parliament and an election could be scheduled for 25 or more days after that, suggesting that the time for this option to occur before March 29 is technically possible without a delay, although it would have to happen soon to meet that deadline.

Positioning for an uncertain world

Investors are often faced with uncertain circumstances, but Brexit is a particularly fraught situation, with unpredictable results that, depending on the outcome, could send some stocks soaring or tumbling.

While we believe it would be rational for both parties to find a solution that minimizes trade, economic and financial disruptions, we recognize that forecasting the final outcome for Brexit with a reasonable level of confidence is close to impossible given the complex political nature of the process.

We believe the UK will be a big loser from Brexit. The EU would also be worse off losing one of its largest, most capitalistic and free market-oriented members. Regardless of the final outcome, the UK has already suffered negative and lasting impacts. Politically, the referendum and overall process of Brexit have divided the British population and its political parties. Economically, the extended period of uncertainty has driven away investment opportunities, as well as many high-paying jobs and corporate offices in London that have relocated elsewhere to the continent of Europe.

Reflecting the latest facts, our current positioning in Europe is neutral with a slight underweight of the UK. However, the situation is fluid and evolving. As the facts on the ground change, so likely will our positioning.

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