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Strategy*Insights*

Brexit Update

Tertius Bonnin and Kasim Zafar, CFA Oct 2018

Introduction

The aim of this paper is to set out the different withdrawal scenarios, detail their probabilities and assess how asset classes may react, either favourably or unfavourably. The paper is split into three main sections which include an overview of the current situation, our investment conclusion and further background details which contextualise our conclusion.

Background

Trying to guess the outcome of the EU referendum in 2016 was impossible. In the end the result was very close and contrary to expectations of most expert opinions. Positioning client portfolios for such an uncertain outcome was challenging but ultimately our research indicated the single greatest risk posed by the referendum in the short term was the possibility of a sharp fall in the value of our currency. Consequently, we made conscious investment decisions to diversify client portfolio exposure into non-sterling denominated assets. Over the weeks and months immediately before and after the referendum result, client portfolios were not only robust to hugely emotive moves in financial markets, but indeed because they were invested in foreign assets, their portfolios gained in value.

March 29, 2019 is the set date when the UK will formally exit the EU. There is a monumental amount of work to do in these divorce proceedings by the political establishment on both sides before this date. Ahead of this, the deadline for a vote on the Brexit package in UK parliament is set for 21 January 2019 at which point powers for MPs to influence ministers' next steps will kick in. Concurrently, given it seems this saga will keep us on the edge of our seats until the 11th hour, businesses have started making contingency plans for the risk that both sides fail to reach an agreement and no extension is granted to try and reach agreement.

The government has gone forth with its Chequers plan, losing significant ministerial posts in the process. The reception in the EU to the plan has been less than warm with the key point of contention being the Irish border. Given how intractable the question seems with the UK remaining part of the customs union on one side and a UK constitutional crisis on the other, it is easy to think the risks are high of getting to January/March with no deal leading the UK to World Trade Organisation (WTO) rules.

However, if we consider this scenario in more detail, it would be disastrous for all parties involved: the government would face massive criticism for allowing negotiations to reach that point, any rebellious groups within parliament (be that the DUP, Labour or the Conservatives) and even the EU would be blamed for quashing the Good Friday Agreement. The price to pay for reaching this point would no doubt lead to a huge leadership contest within the Conservative Party but the blame would land broadly across multiple parties.

Reaching an agreement with the EU is just the first in a series of hurdles that need to be jumped. The time frame to which the government is working is becoming increasingly tight. The hurdle through parliament is probably more likely than not, but it is far from a done deal. The chances of a second referendum are dwindling given the time it takes to organise one, but there is a chance it could still happen. If agreements are found along the way, their nature can lead to a variety of different kinds of Brexit.

On the following page we have created a decision tree on the various possible steps in the interminably tedious process of extracting the UK from the EU. There are no doubt additional nuanced branches that could be added, but the *basic* structure is decent and serves as a useful means by which to assess the likely outcomes on different asset classes.

Overview

Following the negotiations around the Withdrawal Agreement (WA), we can see four scenarios likely to unfold. These are defined as (and apologies for yet another series of silly labels to qualify different severities of a withdrawal):

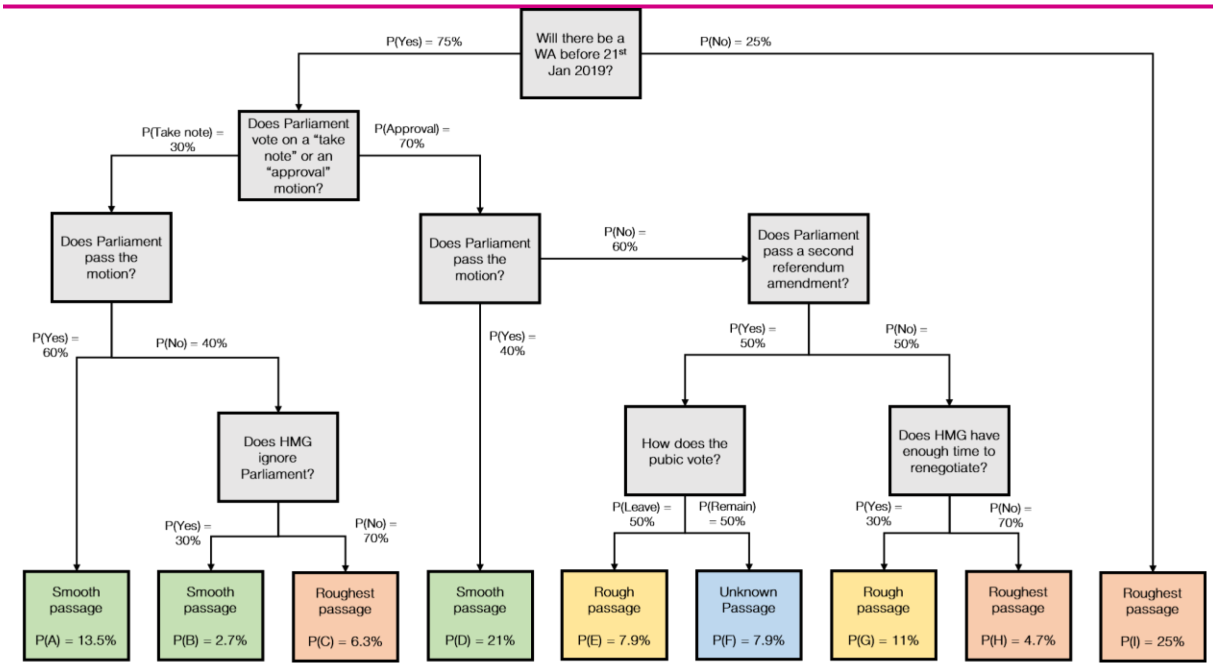
- **P(Smooth passage) ~ 40%**: Parliamentary approval and a timely exit which sees the start of a circa 2 year transition period and trade talks
- **P(Rough passage) ~ 10%**: A "down-to-the-wire" exit, significant last minute compromise from both sides giving rise to heightened short term market volatility
- **P(Roughest passage) ~ 40%**: Article 50 period expires without a WA, UK moves to WTO rules causing general risk-off attitude to domestically focused assets
- **P(Unknown passage) ~ 10%**: Parliamentary gridlock within UK given no overall Government majority, which has the potential to cause the deepest uncertainty over the future

Parliamentary rules provide two routes that can be taken by HMG which would give Parliament a say on the final WA before ratification.

- The first is a *take note* motion which is non-binding, meaning that HMG does not need to adhere to it.
- The second is an *approval* motion which is a binding vote but more crucially, it can be amended by Parliament whereas the *take note* motion cannot.

No matter the result of the negotiation, uncertainty is only truly set to dissipate once there has been substantive discussion around a UK-EU bilateral trade deal which will begin on 30 March 2019.

A number of crises may arise in the coming months



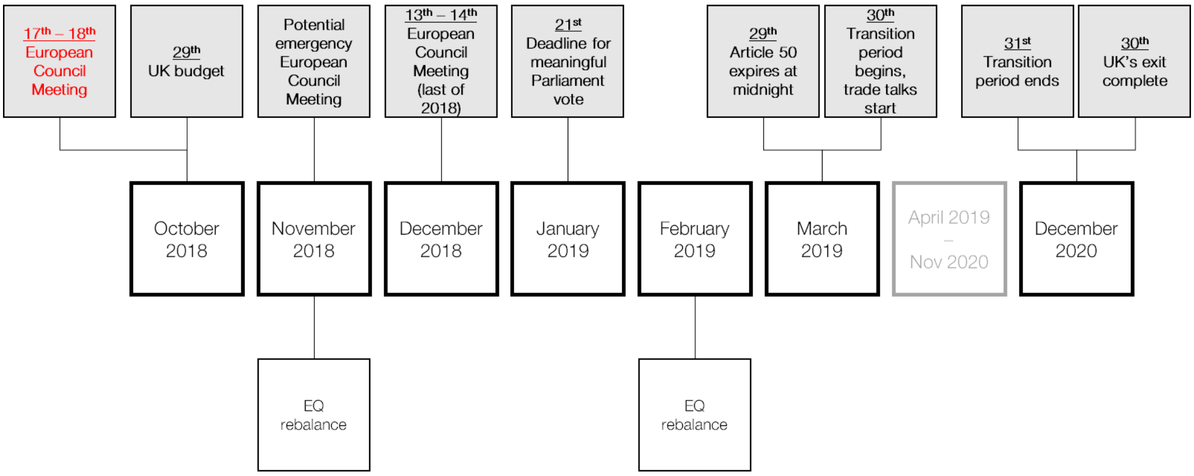
Source: EQ

Given these events are so binary, we can expect significant volatility should the probability of a sub-optimal outcome rise. Trades are likely to involve baskets of securities like we saw in the immediate aftermath of the referendum, e.g. "UK international earners" versus "UK domestic earners". Therefore, we are likely to see heightened sensitivity of UK assets at each split in the scenario analysis, though the correlations may be low.

A tight timetable increases the probability of being down-to-the-wire

The tight timings of this process will inevitably create political noise as we get closer to each deadline. This increase in noise is likely to be met with market volatility as fears of impassable tensions for withdrawal grow. We currently assign around a 50% chance to the UK Government (HMG) being able to secure either a smooth or a rough passage which would lead to an agreed transition period. This would then give HMG circa 20 months in which trade talks would begin and we would slowly gain clarity over what the future trading relationship between the UK and the EU-27 may look like.

The timeline of a UK withdrawal from the European Union



Source: EQ, European Commission

While a smooth passage would offer the path of least resistance (and as such market volatility), a rough passage (which ultimate ends in a transition but with a more steps along the way before ratification of the WA) could indeed create some interesting buying opportunities as the market demands a premium for uncertainty. Should the UK deviate from the timeline above then we may begin to see broad risk-off sentiment.

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Investment conclusion

Our outlook for individual asset classes is shown below:

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov (USTs)	Property	Non GBP
Smooth	- Positive as improved growth prospects will affect perceptions over future path of interest rates - Will also benefit from improved sentiment towards UK assets and asset flows in short term	- Benefits from stronger GBP and improved domestic growth outlook - Will also benefit from positive sentiment from international investors	- Suffers from stronger GBP though will benefit from improved domestic growth outlook - Positive sentiment from international investors may counteract FX headwind	- Stronger growth prospects and potential for future interest rate rises will lead to higher yields - Certainty will only really materialise with trade negotiations	- Real rates rise as inflation expectations fall - Gilts likely outperform linkers	- Unlikely to be significantly impacted	- Commercial property will benefit from prospect of a stronger consumer - Residential property to find support in London and South East	- Non-sterling assets will suffer from a stronger GBP
Rough	- Volatile in the short term as route to transition period may be unclear - Will eventually benefit from improved sentiment towards UK assets	- Volatile in short term as these stocks will be sensitive to political noise - Will eventually benefit from positive sentiment from international investors	- Suffers from stronger GBP though will benefit from improved domestic growth outlook - Positive sentiment from international investors may counteract FX headwind	- Stronger growth prospects and potential for future interest rate rises will lead to higher yields - Certainty will only really materialise with trade negotiations	- Gilts likely outperform linkers in longer term though uncertainty in shorter term clouds inflation path	- Unlikely to be significantly impacted	- Commercial property will benefit from prospect of a stronger consumer but path to transition leaves uncertainty	- Non-sterling assets will benefit from a weaker GBP
Roughest	- Lack of clarity over the future path of interest rates will be negative for sterling - Roughest exit will be damaging for sentiment towards UK assets so may see outflows of capital	- Suffers from any further falls in GBP and deterioration in domestic growth outlook - Roughest exit will be damaging for sentiment towards UK domestics	- Benefits from weaker GBP though will face headwinds from deteriorating UK domestic growth outlook and unknown future trade relationships - Limited upside	- Will benefit from risk-off trade and unclear path to policy normalisation - May be further influenced by BoE should it decide to stimulate economy to avoid recession - UK credit rating may be called into question	- Rising inflation expectations will mean linkers likely to outperform gilts	- International government bonds risk-off in short term - Hedged exposure may lead to high hedging costs	- Commercial property will suffer from fears of weakening consumer - Residential property will fail to find support in London and South East	- Non-sterling assets will benefit from a weaker GBP - Foreign equities may be volatile in short term as risk-off attitude sinks in but likely to outperform UK
Unknown	- Lack of clarity over the future path of interest rates will be negative for sterling - Threat of roughest exit will be damaging for sentiment towards UK assets so may see outflows of capital	- Potentially suffers from any further falls in GBP and deterioration in domestic growth outlook - Roughest exit will be damaging for sentiment towards UK domestics - Valuations are already "cheap" so negative moves may be limited	- Potential for weaker GBP tailwind but will face headwinds from deteriorating UK domestic growth outlook and unknown future trade relationships - Limited upside	- Will benefit from risk-off trade and unclear path to policy normalisation - May be further influenced by BoE should it decide to stimulate economy to avoid recession - UK credit rating may be called into question	- Potential for rising inflation expectations will mean linkers likely to outperform gilts	- International government bonds risk-off in short term - Hedged exposure may lead to high hedging costs	- Commercial property will suffer from fears of weakening consumer - Residential property will fail to find support in London and South East	- Non-sterling assets will benefit relative to sterling assets as uncertainty weighs over UK - Foreign equities may be volatile in short term as risk-off attitude sinks in but likely to outperform UK

By assigning each asset class a score from +2 to -2, highlighting the magnitude and direction of their sensitivity to each scenario (+2 very positive, -2 very negative) we can work out a probability-weighted score which is shown below.

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov	Property	Non GBP
Smooth	1.00	1.00	-1.00	0.00	-1.00	0.00	1.00	-1.00
Rough	-1.00	-1.00	0.00	0.00	0.00	0.00	0.00	1.00
Roughest	-2.00	-2.00	1.00	1.00	2.00	1.00	-1.00	2.00
Unknown	-1.00	-1.00	0.00	1.00	1.00	1.00	-1.00	1.00
Probability weighted	-0.62	-0.62	-0.01	0.44	0.43	0.44	-0.07	0.62

These probabilities will obviously be very sensitive to specific events, and as such arbitrary estimates of probabilities will have a large impact on the result. A sensitivity analysis of key events is shown considering the outlook for GBP below (a similar story to UK domestics).

Take note motion

P(Parliamenta ry approval)	P(Withdrawal agreement) 0%	25%	50%	75%	100%
0%	-2.00	-1.78	-1.55	-1.33	-1.10
25%	-2.00	-1.64	-1.29	-0.93	-0.58
50%	-2.00	-1.51	-1.03	-0.54	-0.05
75%	-2.00	-1.38	-0.76	-0.14	0.48
100%	-2.00	-1.25	-0.50	0.25	1.00

Approval motion

P(Parliamenta ry approval)	P(Withdrawal agreement) 0%	25%	50%	75%	100%
0%	-2.00	-1.79	-1.58	-1.36	-1.15
25%	-2.00	-1.65	-1.31	-0.96	-0.61
50%	-2.00	-1.52	-1.04	-0.56	-0.08
75%	-2.00	-1.38	-0.77	-0.15	0.46
100%	-2.00	-1.25	-0.50	0.25	1.00

This is a different picture from UK international equities (below) which will be relatively defensive.

Take note motion

P(Parliamenta ry approval)	P(Withdrawal agreement) 0%	25%	50%	75%	100%
0%	1.00	0.85	0.70	0.55	0.40
25%	1.00	0.76	0.53	0.29	0.05
50%	1.00	0.68	0.35	0.03	-0.30
75%	1.00	0.59	0.18	-0.24	-0.65
100%	1.00	0.50	0.00	-0.50	-1.00

Approval motion

P(Parliamenta ry approval)	P(Withdrawal agreement) 0%	25%	50%	75%	100%
0%	1.00	0.79	0.58	0.36	0.15
25%	1.00	0.72	0.43	0.15	-0.14
50%	1.00	0.64	0.29	-0.07	-0.43
75%	1.00	0.57	0.14	-0.28	-0.71
100%	1.00	0.50	0.00	-0.50	-1.00

Scenario 1: Smooth passage

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov	Property	Non GBP
Smooth	1.00	1.00	-1.00	0.00	-1.00	0.00	1.00	-1.00

A smooth passage would entail the path of least resistance; this would require a timely return of HMG to Parliament with a negotiated WA which would then pass with little issue. Our base case scenario analysis assigns a 37% probability to a smooth passage. It is sensitive to two events in particular: a timely WA agreed and Parliamentary approval. Implied probabilities of a smooth passage for each motion type are below.

Approval motion

P(Parliament approval)	P(WA Agreement) 0%	25%	50%	75%	100%
0%	0%	0%	0%	0%	0%
25%	0%	6%	13%	19%	25%
50%	0%	13%	25%	38%	50%
75%	0%	19%	38%	56%	75%
100%	0%	25%	50%	75%	100%

Take note motion

P(Parliament approval)	P(WA Agreement) 0%	25%	50%	75%	100%
0%	0%	8%	15%	23%	30%
25%	0%	12%	24%	36%	48%
50%	0%	16%	33%	49%	65%
75%	0%	21%	41%	62%	83%
100%	0%	25%	50%	75%	100%

Scenario 2: Rough passage

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov	Property	Non GBP
Rough	-1.00	-1.00	0.00	0.00	0.00	0.00	0.00	1.00

We have defined the rough passage as similar to a smooth passage, though we expect the negotiations to be "down-to-the-wire". In practice, this would likely be caused by:

- A second referendum with a vote to leave.
- Parliament rejecting the initial WA and HMG is forced to renegotiate with the EU-27 thereby making large concessions.

The latter would have obvious constraints on the amount of time available, given that it is not likely Article 50 would be extended for extra negotiating time. Our base case scenario analysis assigns a 13% probability to a rough passage. Its probability is sensitive to both Parliamentary approval and the prospect of a second referendum.

Approval motion

		P(2nd ref amendment)				
		0%	25%	50%	75%	100%
P(Parliament approval)	0%	70%	65%	60%	55%	50%
	25%	53%	49%	45%	41%	38%
	50%	35%	33%	30%	28%	25%
	75%	18%	16%	15%	14%	13%
	100%	0%	0%	0%	0%	0%

Scenario 3: Roughest passage

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov	Property	Non GBP
Roughest	-2.00	-2.00	1.00	1.00	2.00	1.00	-1.00	2.00

We have defined the roughest passage as the most disruptive exit for UK assets, as this effectively ends with the UK missing out on a transition period and moving to WTO rules at the end of March 2019. We see there as three ways by which this could occur:

- HMG tables a “take note” motion for the WA, giving Parliament the option of either the negotiated agreement or WTO terms which Parliament votes down.
- Parliament rejects the WA in the form of an “approval” motion and sends HMG back to the EU-27 to renegotiate. There is a relatively high probability that HMG will run out of time as Article 50 is not likely to be extended for negotiations.
- HMG and the EU-27 fail to come to a WA before, in effect running out of time.

Our base case scenario analysis assigns a 42% probability to the roughest passage to exit. Its probability is primarily sensitive to both Parliamentary approval and also the prospect of running out of time to renegotiate.

Take note motion

		P(Withdrawal agreement)				
		0%	25%	50%	75%	100%
P(Parliamentary approval)	0%	100%	93%	85%	78%	70%
	25%	100%	88%	76%	64%	53%
	50%	100%	84%	68%	51%	35%
	75%	100%	79%	59%	38%	18%
	100%	100%	75%	50%	25%	0%

Approval motion

		P(Withdrawal agreement)				
		0%	25%	50%	75%	100%
P(Parliamentary approval)	0%	100%	79%	58%	36%	15%
	25%	100%	78%	56%	33%	11%
	50%	100%	77%	54%	31%	8%
	75%	100%	76%	52%	28%	4%
	100%	100%	75%	50%	25%	0%

Scenario 4: Unknown passage

	GBP	UK eq (D)	UK eq (I)	Gilts	Linkers	Int gov	Property	Non GBP
Unknown	-1.00	-1.00	0.00	1.00	1.00	1.00	-1.00	1.00

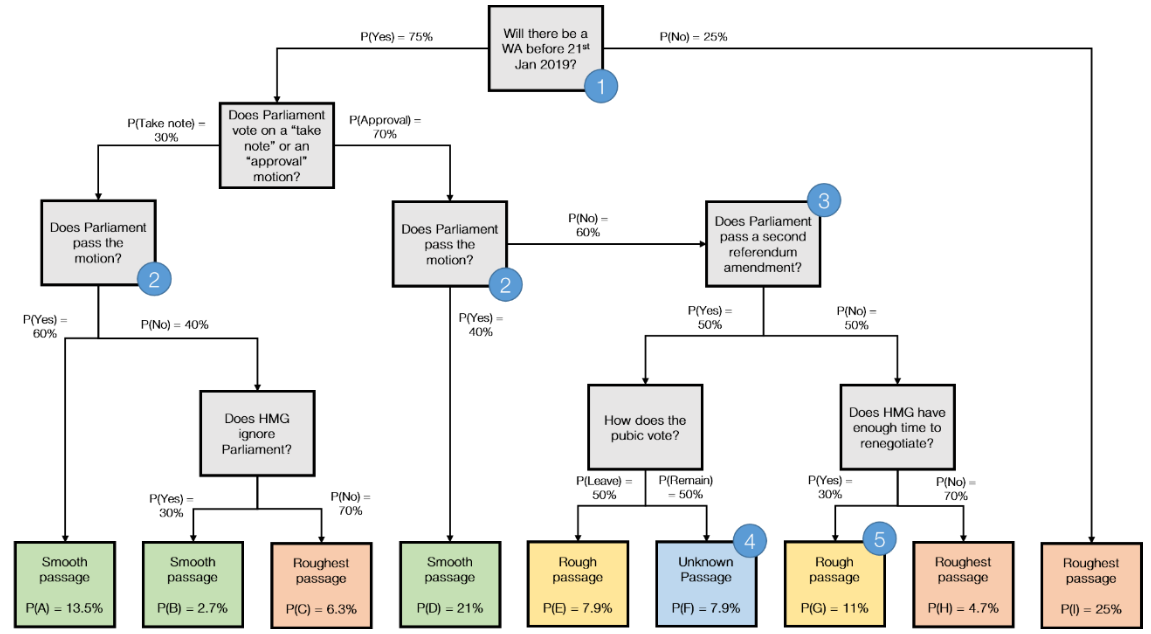
We have defined the unknown passage as an effective stalemate in which HMG cannot pass any version of the WA and will likely give rise to any one of a number of scenarios including a general election, a Conservative leadership challenge etc. Our base case scenario analysis assigns an 8% probability to the unknown scenario. Its probability is primarily sensitive to a second referendum amendment, followed by a vote for “remain”. Implied probabilities for an unknown scenario are below.

Approval motion

		P(Parliamentary approval)				
		0%	25%	50%	75%	100%
P(2nd ref amendment)	0%	0%	0%	0%	0%	0%
	25%	13%	9%	6%	3%	0%
	50%	25%	19%	13%	6%	0%
	75%	38%	28%	19%	9%	0%
	100%	50%	38%	25%	13%	0%

Addendum: Tertius' take…

A number of crises may arise in the coming months



Source: EQ

Reference #1: An Irish House of Cards

One area that will persist to be a problem, and could potentially be the downfall of HMG, is the Irish border issue. To keep the WA process on track in December 2017, PM May agreed that the border between Northern Ireland and the Republic of Ireland – the UK's only land border with the EU – should remain open in the spirit of upholding the 1998 Belfast Agreement (known as the Good Friday Agreement).

In practice, for there to be no Irish border, Northern Ireland will likely need to remain within both the Customs Union (the customs regime) and the Single Market (the regulatory regime). HMG is aiming to take control of its own trade policy once the transition period has ended. This means that, in the event talks fail to culminate in frictionless trade, there will need to be an economic border in the Irish Sea between Northern Ireland and the rest of the UK. As staunch unionists, Northern Ireland's Democratic Unionist Party (currently supporting HMG in a supply-and-confidence agreement) very firmly rejects any internal border that would separate it from the UK and as such have threatened to withhold Parliamentary support from HMG should this become a likelihood.

The difficulty for PM May is that the more hard-line MPs from her own party who favour a cleaner break from the rest of the EU-27 will not support a WA that makes provisions for a "backstop" that will maintain regulatory and customs alignment with the EU-27 indefinitely. As such, the current focus of the negotiations is to seek a "backstop" agreement that will prevent a hard Irish border or indefinite UK-EU alignment.

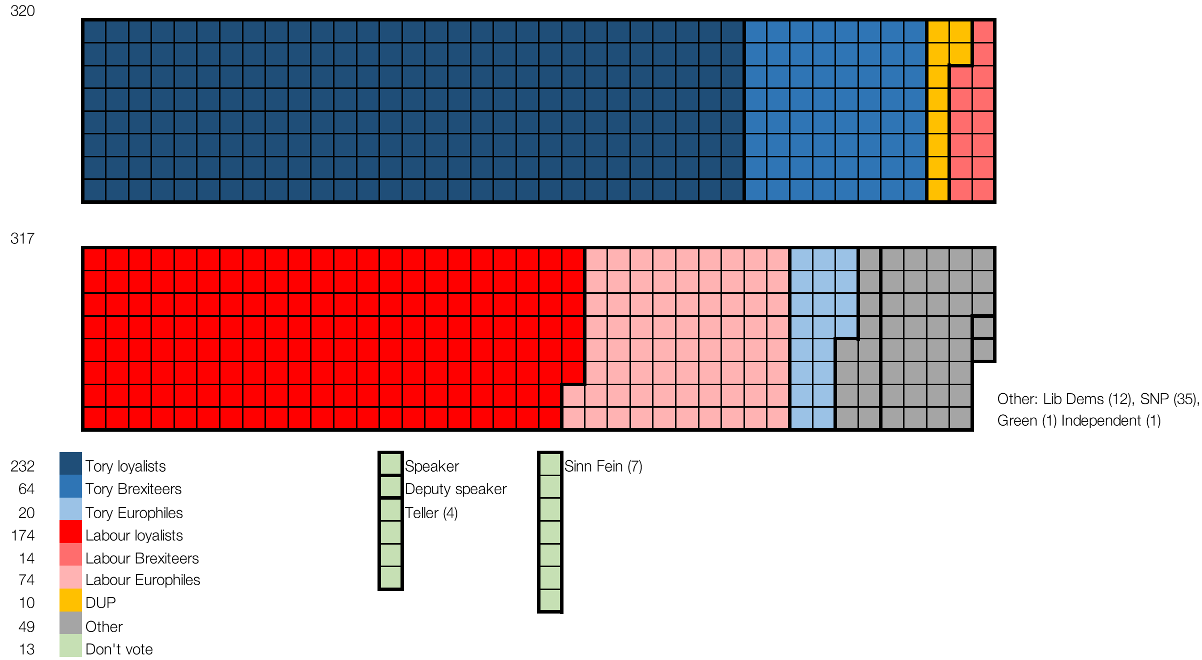
Reference #2: Parliamentary arithmetic gives PM May little space to manoeuvre

The largest hurdle HMG will need to overcome is Parliamentary approval for the WA. It is currently unclear as to whether HMG will be able to command a majority for a vote, but this may turn out to be less of an issue than feared. Parliamentary rules provide two routes that can be taken by HMG which would give Parliament a say on the final WA before ratification.

- The first is a *take note* motion which is non-binding meaning that HMG does not need to adhere to it.
- The second is an *approval* motion which is a binding vote but more crucially, it can be amended by Parliament whereas the *take note* motion cannot.

It is an important distinction to make because of the range of amendments that could be added to a Withdrawal Agreement Bill. These may include a second referendum or restrictions on remaining within the Customs Union and Single Market which would ensure "frictionless trade". While HMG is committed to giving Parliament a "meaningful" vote on the final WA, it is still unclear as to which type of motion it will choose to table.

Parliamentary arithmetic gives HMG little room to move



Source: EQ, Wikipedia, TS Lombard

With regard to Parliamentary arithmetic, the DUP have created a difficult situation for PM May. It is clear that if HMG is too soft in its negotiation stance with the EU-27, i.e. it chooses to align itself with the EU-27 so as to maintain the constitutional integrity of the UK, it risks losing the support of Tory Brexiteers who command over 60 seats. While dissent against any WA by Tory Europhiles is anything but uncertain, a worst case scenario in Parliament will create an extremely tight vote. HMG's thin majority can be quickly eroded by making too many concessions in negotiations.

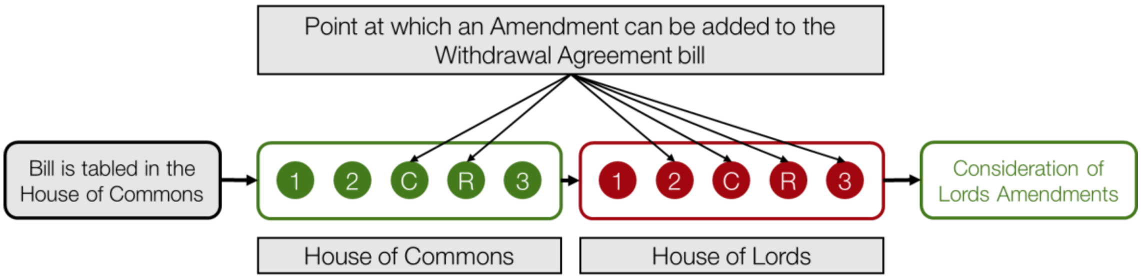
It is probable that should the WA contain something more contentious, it will be a take note motion as opposed to an approval. However, this would then give Parliament the choice of a WA or an exit onto WTO terms. In this case, we could be more confident that there would be enough abstentions or swinging votes that the Commons to avoid an exit to WTO terms.

On the other hand, if Parliament had a true say over the WA and knew it had the potential to block a withdrawal, this could potentially embolden certain characters in Parliament to defy party whips and block HMG's deal. This would be with a view to trying for a) a second referendum, b) blocking a withdrawal altogether (if you take the view that Parliamentary gridlock is better than a leave outcome), c) pushing HMG back to renegotiate, or d) forcing the UK to stay in the CU & SM (i.e. BINO – Brexit in Name Only).

Reference #3: Making amends

For reference, the path of a Bill tabled in the House of Commons is shown below. This is equivalent to the approval motion route.

Path of a Bill tabled in the House of Commons



Source: Parliament

As noted, there are several stages at which amendments can be made. There are two opportunities in the Commons and four in the Lords. In each House, there are five stages which go as follows: First Reading, Second Reading, Committee Stage, Report Stage, and Third Reading. Any amendments in the Lords will be sent back for approval in the Commons which is more commonly known as "ping-pong".

For the purposes of this paper, we will just focus on the Commons side of things. It is likely we will see HMG's Withdrawal Agreement Bill pass the First and Second readings in the Commons without significant issue.

The Committee stage is where proceedings may become more complex. The Committee has historically passed motions consistent with closer UK-EU alignment post–withdrawal, which would be at odds with the current WA. The Chair of this committee, Hilary Benn, has already dismissed the likelihood of a second referendum as low.

This would mean that the only stage in the Commons that a second referendum could be amended would be in the Report stage, which is open to the House. At present, we can clearly count 81 MPs who have publicly come out in support of this (35 SNP, 30 Labour, 12 Liberal Democrats and four Conservatives). It is impossible to second guess political manoeuvring in the meantime with regards to whether this will find a majority in the Commons.

Reference #4: Constitutional crises on the horizon

While some have suggested that HMG may look to find cross-party support for a WA, Jeremy Corbyn clearly outlined six tests that any WA proposed by HMG needs to pass at September's Labour Party Conference:

- Does the WA ensure strong and collaborative future relationship with the EU?
- Does it deliver the "exact same benefits" as we currently have as members of the Single Market and Customs Union?
- Does it ensure the fair management of migration in the interests of the economy and communities?
- Does it defend rights and protections and prevent a race to the bottom?
- Does it protect national security and out capacity to tackle cross-border crime?
- Does it deliver for all regions and nations of the UK?

Clearly any WA will not meet the six criteria mentioned above. Many commentators have suggested this is intentionally so, with the hopes for forcing the collapse of HMG and eventually triggering an early general election. However, this could be technically very difficult to achieve due to the Fixed Term Parliament Act. There are two ways in which a general election can be held before the end of the five year period which is currently due to expire in 2022:

- Parliament resolves a no confidence motion in HMG with a simple majority and HMG fails to pass a confidence motion in itself within fourteen days (with loss of support from DUP and no support from Labour Brexiteers, it is likely HMG will fail to pass a confidence motion in itself)

- Parliament resolves an early general election with a supermajority (support of two thirds of its total membership which includes vacant seats)

Should HMG table an “approval” motion and fail to resolve it, there would be a number of potential outcomes that could create volatility and cause further uncertainty. Should Parliament resolve that a second referendum should be held on the terms of the WA (the exact question would be laid out in legislation), it could create a situation where the general public vote against HMG’s WA. What would happen next would depend on the phrasing of the referendum question which we have no knowledge of at this point.

This would be the worst possible outcome for UK assets as it would leave the UK on an unknown passage and Parliament in a constitutional crisis which could likely only be resolved through a fresh general election – this would be difficult as it would require either a supermajority or effectively two motions of no confidence as mentioned above. This would introduce fresh risks, such as a Labour Government or another hung Parliament and further uncertainty. The consequences of a Labour Government will be the subject of future research.

Reference #5: Technicalities threaten to trip up Theresa

This raises the question as to the timings of Article 50 and the conditions under which it could be extended. The Article 50 period can only be extended by the unanimous agreement of the other 27 member states on the request of the withdrawing state – PM May has already said she is not prepared to do this. Further, it is generally accepted that the EU-27 would not agree to extend the Article 50 period for further negotiations on the WA, but could extend it if more time was required for constitutional matters (i.e. votes in Parliament, a second referendum, or a general election).

Whether Article 50 in itself is revocable is itself currently the subject of a legal dispute at the European Court of Justice, as the Article within the Lisbon Treaty was written with deliberate lack of clarity. The ECJ ruling should resolve:

- Is Article 50 revocable?
- Can it be done unilaterally or does it require the consent of the remaining 27 member states to agree to its revocation?

Either way, revoking Article 50 would require PM May to do so which she herself has said she does not intend to do.