



FIXED INCOME

Theresa May's Brexit Steeplechase Has Only Just Begun: an Investor's Perspective

November 14, 2018



David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group®

UK Prime Minister Theresa May seems to have cleared the first hurdle in her bid to secure a soft Brexit. Her Cabinet initially backed the withdrawal deal UK and European Union negotiators have agreed to. But subsequently, a number of Cabinet members resigned. David Zahn, Franklin Templeton's head of European Fixed Income, warns her most difficult challenge still lies ahead. And he believes there remain plenty of obstacles in her path, with profound implications for investors.

The UK government has largely come together behind a European Union (EU) withdrawal deal UK and EU negotiators have agreed to.

But UK Prime Minister Theresa May faces an uphill struggle to get the deal through parliament. As a result, we expect uncertainty and volatility in UK and European financial markets for some months.

Opposition among May's Supporters

Certain parts of May's Conservative Party will not support this deal, because of its provisions for remaining within the European Customs Union.

The planned status of the Northern Irish border with Ireland is also likely to be contentious for some members of parliament (MPs), including those from Northern Ireland's Democratic Unionist Party (DUP).

As May relies on the DUP for her working majority in the House of Commons, their dissent could pose a problem for her. The government may need to reach across the aisle and draw support from opposition MPs.

Both sides of the political divide in the United Kingdom have said they want to respect the referendum outcome and there could be a number of Labour MPs in particular willing to support this deal.

The Choice between Hard or Soft Brexit Hangs in the Balance

If May and her colleagues cannot garner parliamentary support for her agreement, the United Kingdom will essentially be heading for a no-deal Brexit, in our view. Gilts would likely rally, while the pound could decline significantly.

Parliamentary approval for the withdrawal deal, on the other hand, would bring some certainty. Under the terms of the withdrawal deal, if there wasn't sufficient progress on a trade deal between the United Kingdom and EU, the United Kingdom would remain part of the European Customs Union until it can achieve a trade deal.

We expect that scenario could bring some short-term relief for markets; gilt yield would likely rise while sterling would probably rally.

Difficult Questions Still Remain

However, parliamentary approval of the withdrawal deal wouldn't necessarily fix all of May's problems for good. It would merely kick the can further down the road.

Initially, we'd expect people to start to focus on what will happen at the end of the transition period, particularly on the progress of negotiations on trade. In addition, we know there will be a number of people, especially among the ranks of hardline Brexit-supporters, who will be very upset at the compromises in the withdrawal deal.

That discontent is likely to show in the next election, whenever that is. So in the longer term we'd expect more uncertainty, but in the shorter term we should have some relief and we think that should be positive for financial markets.

What Role for Active Management?

Our expectation would be that a trade deal eventually gets done; however, we recognize there's a not inconsequential chance of a hard Brexit. Against such a background, we reiterate our view that it makes sense to be active in the management of fixed income portfolios.

There are a number of scenarios in which gilt yields in particular could be much higher in six months' time, or conversely, much lower.

Investors will likely have to react to news flow coming out from Westminster and Brussels. It may be difficult to read through the noise, but we think for those investors who can, there may be a potential opportunity to add value to their portfolios.

The comments, opinions and analyses presented here are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the [Beyond Bulls & Bears](#) blog.

For timely investing tidbits, follow us on Twitter [@FTI_US](#) and on [LinkedIn](#).

What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments.