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Are We Nearly There Yet?: Revisiting the Politics and Processes of Brexit

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In the summer, Sandy Nairn, Chairman of Templeton Global Equity Group and CEO of Edinburgh Partners, authored a paper entitled *The Politics and Processes of Brexit.* His analysis drew on insights from former diplomat Lord Kerr, an advisor to Edinburgh Partners and one of the authors of Article 50 of the Treaty of Lisbon, which outlines steps a country must take to leave the European Union. The paper explored a number of scenarios the United Kingdom faces on its path to Brexit. One of the questions Nairn posed was “Are markets underestimating the chances of the United Kingdom not leaving?” In this update, he examines the current situation and revisits that question.

After a tumultuous few days for UK Prime Minister Theresa May and UK financial markets, there remains very little we can say with absolute certainty about Brexit.

A withdrawal deal agreed upon by UK and European negotiators is set to go to Parliament in the second week of December. However, it has drawn derision from all sides, and the key question for most observers is whether the UK government can secure enough votes for it to pass.

The agreement, as it stands, sets out the details of the financial settlement governing the United Kingdom’s departure from the European Union (EU). It also includes a section on citizens’ rights after Brexit, for EU citizens in the UK and British citizens elsewhere in the EU.

Several of the deal’s provisions are likely to prove sticking points for some crucial players.

The treatment of Northern Ireland in particular looks to be an obstacle. The withdrawal deal proposes a backstop that would maintain an open border between Northern Ireland and the Republic of Ireland, in the event that there is no trade deal agreed by March 29, 2019.

However, that arrangement has been rejected by Northern Ireland’s Democratic Unionist Party (DUP) because it treats Northern Ireland differently from the rest of the United Kingdom. Crucially, May relies on the support of the DUP for her parliamentary majority. Losing DUP support could threaten the Conservative Party’s ability to remain in power.

Ardent Brexiteers within the Conservative Party are also unhappy with the deal. They feel the continued influence of Europe over key UK policies, as set out in the withdrawal agreement, remains too large.

For the Scottish Tories, uncertainty regarding the proposed fisheries policy might suggest that the Scottish fishing industry is again being sacrificed. A number of Scottish Tory members of Parliament rely on the fishing community for votes.

On the opposition benches, MPs from both the Labour Party and The Scottish National Party (SNP) will likely be ordered by their leaders to vote against the deal.

This means that the only plausible route to get the deal approved is for the vote to be framed as a binary outcome. In other words: "It's either this deal or it's no deal."

Parliament Will Decide: Deal or No Deal

We expect any bluff would likely be called. If that does occur, the deal would almost certainly be rejected in Parliament.

In turn, we'd expect the Labour Party would then demand a general election in a bid to oust the government from power. The question then is whether the Tories would be willing to propose a second referendum on Brexit to head this off.

Again, it comes down to the arithmetic of votes, but the debate over a second referendum would likely intensify, and we think Labour would find it increasingly difficult to avoid staking out a clear position. If we got to that situation, it is highly likely, in our view, that one of the major parties would propose "going to the country" for a general election, while offering a second referendum thereafter. Whichever party does this first would leave its opponent in a very difficult position.

In the meantime, it is hard to see how anything can be achieved without an extension to the negotiating period.

How Could Investors Respond?

As the situation unfolds, we need to see whether there are further resignations and identify the likely direction of the political consensus regarding Brexit next steps. Then we can better frame the risk-reward calculations on investments.

The probability of both a general election and a second referendum have just gone up, which means that among the range of potential outcomes, a so-called "tail event" has become more likely. One tail includes a Labour government (with or without Brexit), and the other tail includes "No Brexit" (with or without the Tories still in power).

As we pointed out in our paper, *The Politics and Processes of Brexit*, markets are likely to take the threat of a change in government much more seriously than they have in the past. That has implications for both the Gilt and UK equity markets.

The current Labour leadership has been very clear that nationalization or highly prescriptive regulation of certain critical sectors, the return of collective wage bargaining and a significant increase in government expenditure are all key policies.

From the investment perspective, our approach to a potential Labour government would begin by avoiding the industries where regulation and nationalization are mooted. We are simply not being paid to take this risk.

More international businesses should continue to trade as before, but a risk premium for corporate tax changes and other possible burdens might need to be added.

In the meantime, we need to pay very close attention to the electoral arithmetic to see whether "Remain" and a continued Conservative government could be a likely outcome.

We believe it is likely over the coming months risk premiums will rise and potentially spur investment in stocks which have already been largely discounted for a worst-possible Brexit outcome, including the financial services and construction sectors. Periods such as this often provide meaningful opportunities, and a prerequisite for taking advantage of them is understanding the boundaries of risk and reward.

To hear Sandy Nairn and Lord Kerr discuss Brexit, listen to our archived episode of Talking Markets.

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