

## Anarchy in the UK

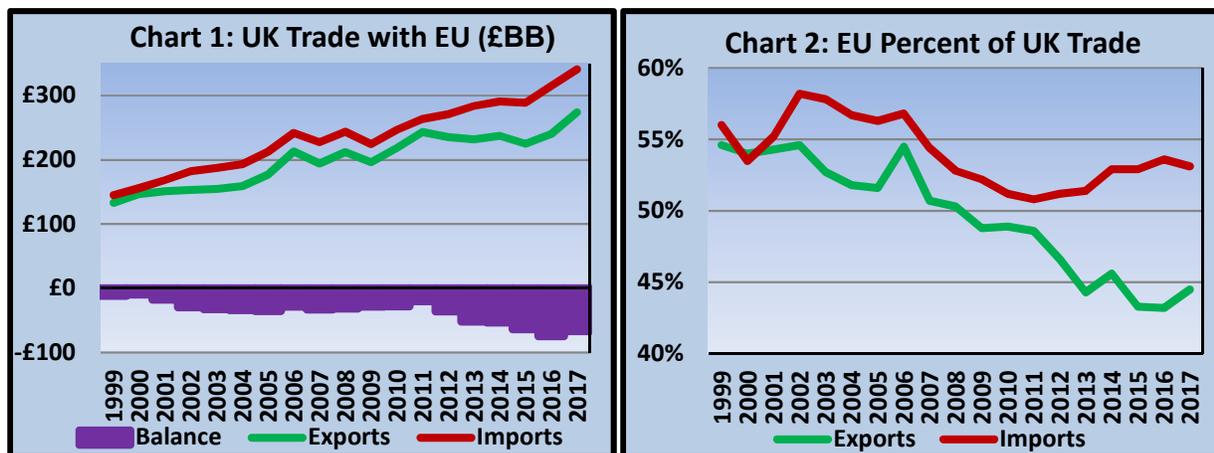
*Michael A. Tyler, CFA®, Chief Investment Officer  
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Almost three years ago, the British people voted to leave the European Union, setting in motion a process that has had all the makings of a PBS drama like *The Crown* or *A Very English Scandal* – political intrigue, colorful personalities, existential questions about Britain’s national character, and more. About all that has been missing are the sex and the pistols. But unlike the television series that have captivated millions of viewers, Brexit is very real, very important to investors, and very difficult to handicap.

Britain’s impending exit from the European Union is most relevant to British residents and investors, of course, and its impact will also be felt substantially in the EU itself. But Americans, too, need to be concerned about how the process plays out, because it could adversely affect U.S. economic growth, inflation, and asset values.

As things stand today, Britain is scheduled to exit the EU in a scant five weeks, on March 29. Unless some other deal is arranged, the country’s terms of trade with EU countries will revert to the same default rules that govern all other World Trade Organization nations; that (plus some financial-sector agreements already in place to protect the integrity of transactions) will ensure that commerce can continue uninterrupted, albeit under different terms. Without this backstop, the United Kingdom could have been completely paralyzed by confusion and chaos.

But the WTO rules are hardly appealing; they are the “rack rate” of global trade, metaphorically equivalent to the posted prices on the back of a hotel room door; tourists would have to be clueless to pay the rack rate when all sorts of discounts are always available. UK politicians would likewise have to be “pretty vacant” (to quote the political theorist John Lydon) to stumble into a “hard Brexit” in which Britain would be forced into WTO rack rate tariffs and trade terms.

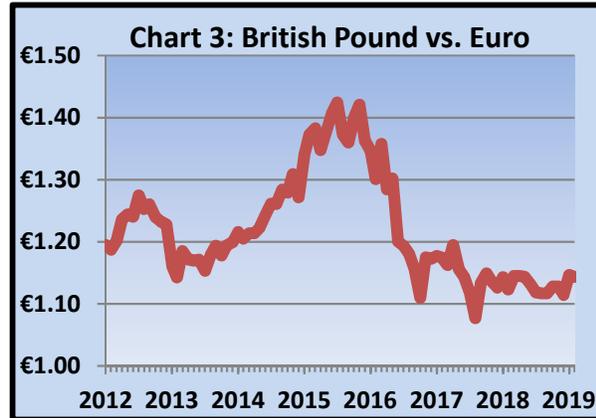


Source (both charts): UK Office of National Statistics

The UK has enormous incentive to try to work a better deal from its European trading partners, but Prime Minister Theresa May was dealt a rotten hand to play. Dissension within both her own Conservative Party and across the aisle has sapped her political capital. Her coalition partners in the Democratic Unionist Party have further limited her options because of their focus on the UK's only land border, between Ireland and Northern Ireland. Parliament has resoundingly defeated her first negotiated agreement and then her attempt to modify the Brexit timetable. Mrs. May is now scheduled to present her final proposal to Parliament on March 12.

The Europeans, in contrast, have very little incentive to ease the process; they want to deter other nations from considering defection, and their economies won't suffer as much without Britain in the Union. The vicious reality is that Britain needs the EU much more than Europe needs Britain. About 44% of all UK exports go to the 27 other EU countries, but less than 8% of EU exports go to Britain.<sup>1</sup> Charts 1 and 2 (prior page) show that Britain's trade deficit with the EU has worsened in recent years; if a hard (or "no-deal") Brexit occurs, the £67 billion trade deficit would incur much higher net tariffs, driving up inflation and impinging on economic growth.

In the wake of the Brexit vote, Britain's currency has been walloped, as shown in Chart 3. This has helped the UK's export sector, especially with respect to non-EU countries; the sector has also benefited from inventory stockpiling among EU importers worried about Brexit's implementation.<sup>2</sup> Even so, the deterioration of British export growth has been worrisome. Surprisingly, however, the drop in the currency has not led to a rise in consumer prices, nor to any reduction in British imports from the EU.



Source: FactSet

As the March 29 deadline nears, Mrs. May is caught in Corryvreckan's maelstrom with few good options. The possible outcomes include a hard no-deal exit, a "kick-the-can" delay, a negotiated soft exit, a second referendum, and a termination of the Article 50 declaration. None of these are universally good, but some would be worse than others.

- **Hard no-deal Brexit**, with its abrupt shift to WTO rules, would cause supply shocks across the entire global economy. Some analysts see British GDP falling 8%, inflation jumping to 6%, unemployment spiking to 7%, and sterling plunging to parity with the dollar as the Bank of England injects emergency liquidity. While this is widely acknowledged as the worst potential outcome, powerful incentives motivating both the Europeans and the splintering British polity may still lead inexorably to a hard Brexit.

<sup>1</sup> Sources: House of Commons Briefing Paper CBP-7851, "Statistics on UK-EU Trade," by Matthew Ward; <http://www.worldstopexports.com/top-european-export-countries/>.

<sup>2</sup> Note the sudden uptick in British exports to the EU in 2017, the most recent year for which figures are available (Chart 2).

- **Kicking the can** (also known in Britain as “fudge-and-delay”) would merely prolong the uncertainty without actually resolving anything. American investors seem to favor this solution, perhaps because it is the frequent outcome of fiscal policy debates in this country. Prime Minister May’s first negotiated agreement with the EU (which Parliament rejected) was, in its essence, nothing more than a kick-the-can strategy that papered over substantive disagreements and required future negotiation over the most difficult issues. In a kick-the-can scenario, most analysts believe that extended uncertainty would lead to economic stagnation but not to recession – GDP might grow about 1%, an unhappy but not catastrophic outcome.<sup>3</sup>
- **Soft Brexit** is every Briton’s pipe-dream solution, a negotiated agreement that preserves all of the economic benefits of EU membership with none of the political concessions to Brussels. Such an outcome could lead to an acceleration in GDP growth due to the release of pent-up demand; the economy could easily grow 2.5% in such a scenario, with little inflation. Sterling could rebound to pre-Brexit levels as the “no-deal” option would be eliminated. The problem is that the various templates for such an agreement (existing EU trade deals with Norway, Switzerland, and Canada, for example) wouldn’t be viable in the UK. The biggest challenge, now as ever before, is the border between Ireland and Northern Ireland: How can an agreement preserve an open frontier while still enforcing the EU customs and trade restrictions? Soft Brexit is the Lorelei solution, seductively appealing but mythically dangerous to navigate successfully.
- **A second referendum** would give the British people a chance to kill the entire process at a stroke, thereby retaining full membership in the European Union. This would be the wisest economic choice, but it would come at a huge political cost to Mrs. May’s government – especially now that the opposition Labour Party has explicitly endorsed a second referendum. Nor is it clear which side would win a second referendum; the electorate remains closely divided. A second Leave outcome would likely lead to Mrs. May’s ouster and an abrupt plunge into a hard no-deal outcome.
- **Unilateral termination of the Article 50 declaration** is possible but politically suicidal to Mrs. May. She has the right to revoke the UK’s declaration of withdrawal from the Union even without a second referendum. But with half of her country and now the opposition party deeply committed to exit, doing so would invite mutiny within her own party and calls for new national elections. It might be the best outcome for Britain to return to its prior full membership in the EU, but doing so without another referendum would also be the end of Mrs. May’s political career and the beginning of a new round of political anarchy in the UK.

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<sup>3</sup> The UK can ask the EU for an extension to the March 29 deadline, but it would require unanimous consent from the other 27 nations. Such consent might be forthcoming if the member nations see substantial progress being made toward a negotiated solution, but it might also be withheld if it’s perceived as merely playing for time. A new European Parliament will be seated in July, and it’s doubtful that the member nations will want to include British representation if the UK is truly exiting the EU; hence any agreed extension would likely be extremely short.

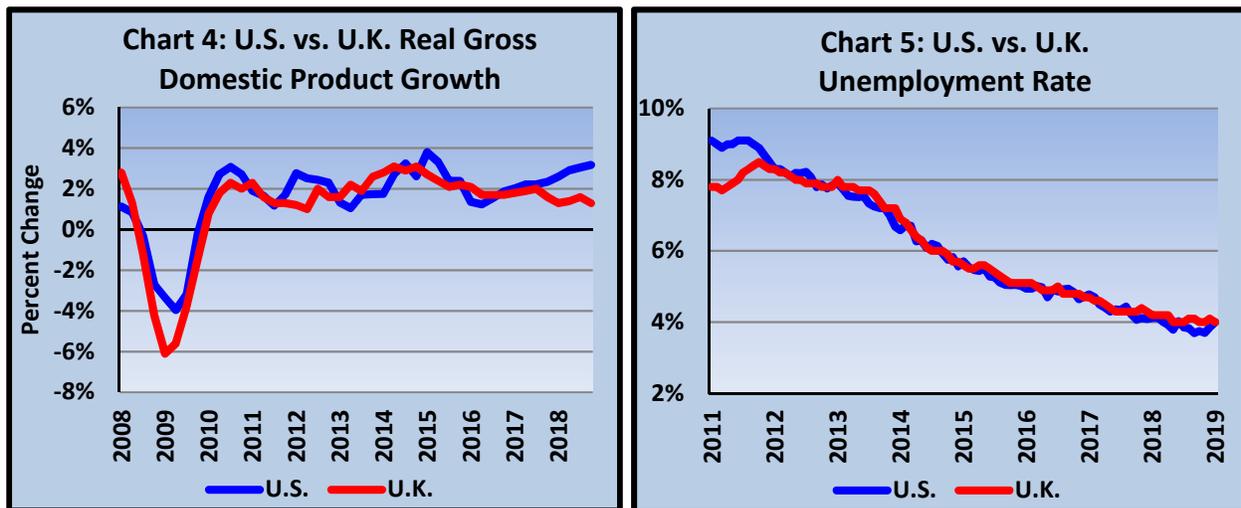
The shock waves from any of these outcomes would ramify well beyond the United Kingdom. A no-deal Brexit would undoubtedly cause major disruptions to supply chains worldwide, potentially causing disruption in the U.S., China, and other major nations; in addition, a sudden sterling devaluation (whether or not accompanied by Bank of England monetary easing) would make imported goods much more expensive, hurting shipments and profits for American and European suppliers.

In time, the hard-Brexit scenario might lead to bilateral trade deals with the U.S., Japan, China, and other nations that might be better for Britain than it has been getting under current EU pacts, but that may just be wishful thinking; after all, Britain has more economic clout as part of the EU than it would independently, though a truly independent UK wouldn't have to consider factors that affect the Continent in negotiating its own trade deals. In short, the impact on global economies – including on the United States – would be consequential, varying over time, and largely unpredictable. Financial markets wouldn't like that outcome.

Similarly, the kick-the-can and second referendum outcomes merely delay a serious reckoning, leaving investors guessing for longer. Even the best outcomes – a negotiated soft Brexit or a withdrawal of the Article 50 declaration – have potentially adverse outcomes, as investors and businesses rethink their strategies in a world in which Britain's position will have clearly changed for the worse: even in these scenarios, Britain could no longer claim the stability that made it the financial linchpin of Europe, and the likelihood of a new Labour government would force investors to rethink their assumptions about British economic prospects.

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The real shame of the entire morass is that the UK economy had actually been doing reasonably well before the 2016 Brexit vote, and it's still in better shape than the Brexiteers are willing to admit. A comparison with the United States, as shown in Charts 4 and 5, is instructive. From the 2008 financial crisis through 2016, Britain's GDP growth and unemployment rates had closely mirrored those of the United States. The same was true for inflation and other key indicators.



Sources (both charts): U.K. Office of National Statistics; U.S. Commerce Department

Since the Brexit vote, however, Britain's GDP growth has slowed, while the U.S. economy has powered ahead. Part of the U.S. gain may be attributed to the late 2017 tax reform, but Britain's stagnation is almost entirely due to Brexit-driven paralysis. Even so, the UK's 1.4% job growth, 4% unemployment, and 2.8% wage gains indicate a resilient economy. Inflation remains only 1.8% despite the weaker currency. Retail sales were up about 4% in January, the best pace in two years; perhaps the spurt was due to pre-Brexit inventory stocking. The most notable weakness in the British economy has been in durable goods, as business investment has fallen 3.7%; this could reflect a lack of confidence in the post-Brexit prospect for Britain's economy.

This caution is also evident in the country's financial markets. The breadth of possible outcomes has caused enormous uncertainty for investors: Would supply chains adapt quickly? What would happen to consumer spending if the currency sinks and inflation returns? Would changes to supply or demand be temporary or long-lasting? And while God may save the Queen, the Prime Minister has no such protection; the political and market implications of her possible ouster are difficult to assess but wouldn't be pretty.

No one knows whether the Bank of England will hike interest rates to protect the currency, or cut rates to inject liquidity and stimulate demand. No one knows whether Parliament will increase spending to deter financial collapse, or stick to its current fiscal policy restraint. British stocks have lagged the worldwide recovery this year, as investors debate these issues. Valuations aren't especially cheap and the UK market still has enormous risk, in our view. We'd rather wait for Mrs. May's report to Parliament in two weeks and for a better sense of where Britain is heading before committing capital.

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