Perspectives

MAY 2019

BREXIT: Three Strikes and May Is Out

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On Friday, May 24th, Prime Minister Theresa May somberly announced her plans to resign as the Conservative Party leader and head minister of the U.K. Parliament on June 7th. When David Cameron turned over the reins in 2016, post the referendum vote results, May pledged to uphold the decision of the populous and lead the United Kingdom out of the bloc. Yet, May's best efforts to deliver a withdrawal agreement have come up short, and with growing pressure from her party and another no-confidence vote on the horizon, May bowed out in hopes that a new leader will break the Brexit deadlock.

Angst about the state of Brexit and May's performance had been coming to a boil throughout the month. On May 3rd, local elections across England yielded an upsetting blow to the country's two main political parties, the Conservatives and the Labours, which jointly lost 1,380 local seats in backlash from the political dysfunction surrounding the second Brexit extension. May's push to resolve the impasse prior to EU elections led to numerous resignation calls by both Conservative and Labour party MPs, with members of PM May's inner circle throwing in the towel.

In light of her resignation, how has the market responded? Who is competing to be Britain's next PM? Where does this leave the state of Brexit? The purpose of this newsletter is to address these questions and to provide our outlook on how Brexit will shape international investing conversations for the remainder of the year.

TEPID MARKET REACTION

One might have expected that the FTSE 100 index, a composite of the top 100 United Kingdom companies — or even Eurozone markets as a whole — to have sold-off on May's departure announcement. But to the contrary, we saw a half-hearted, somewhat dismissive reaction from the market, with the FTSE only down -0.1% and the EURO

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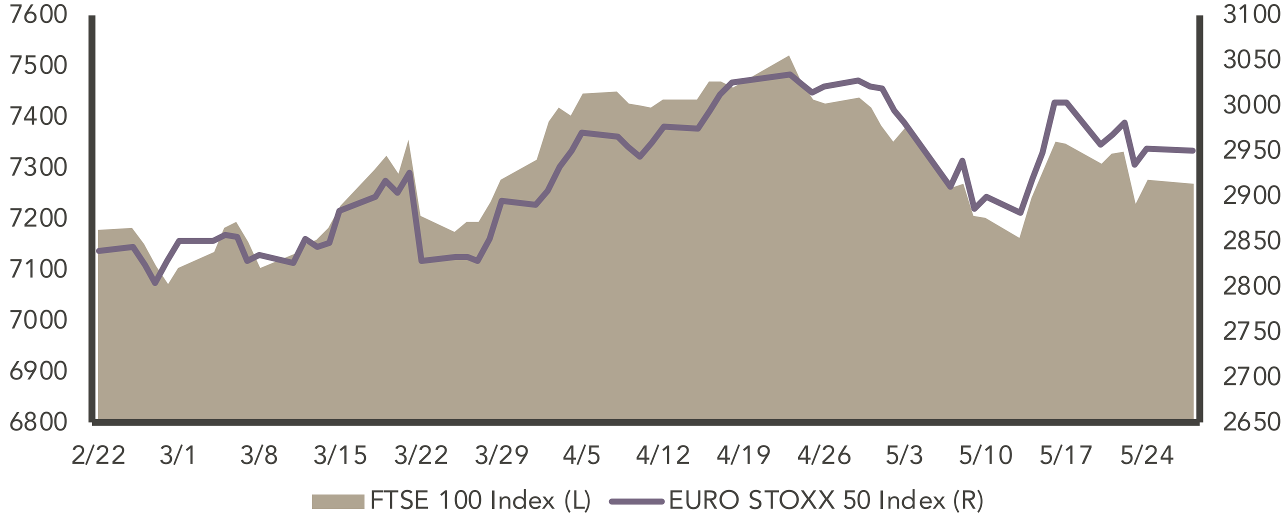
STOXX 50 up 0.5% on the following trading day post announcement. This is largely due to the composition of these broader indices, with 70% of the FTSE being composed of multi-national firms.

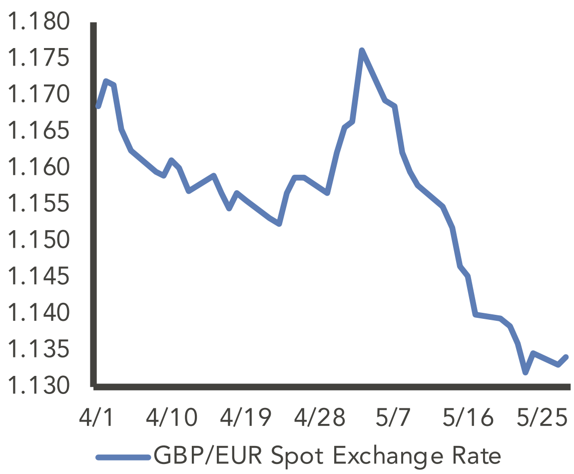
Exhibit 1: FTSE 100 and EURO STOXX 50 Closing Price

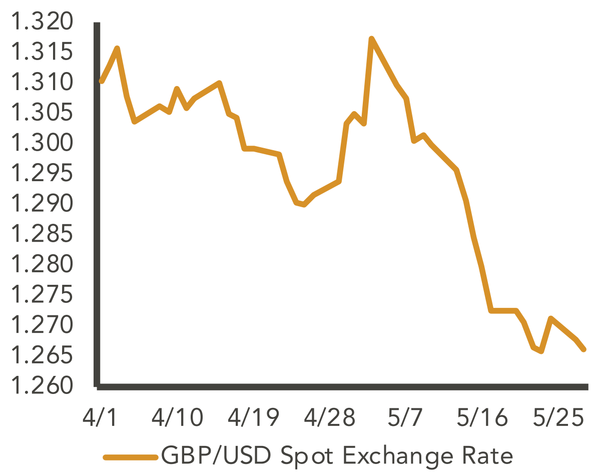


Source: Bloomberg

Referencing a phrase that has become synonymous with Brexit conversations, market participants may have mastered the art of "reading the tea leaves." It appears the market may have priced in her resignation a couple of weeks back, as the onslaught of resignation calls reached a feverish roar. Notably, after the Brexit deadline was pushed back to October 31st in late March, markets were cautiously optimistic that the U.K. parliament would take the necessary steps to avoid crashing out of the EU. That took an about-face in early May, when PM May made a last-ditch push at securing a deal prior to May 23rd to avoid participating in the European Parliament elections. Unfortunately, compromise conversations with the Labour party leader, Jeremy Corbyn, were unfruitful and it became clear that the U.K. would have to participate in the EU elections. This also sealed the fate that her days as PM were numbered.

Exhibit 2: British Pound Declines throughout May





Source: Bloomberg

As shown in Exhibit 2, the British Pound has been on the decline since early May, depreciating by 2.9% versus the U.S. dollar and by 3.0% versus the Euro from May 3rd through May 23rd. Yet, on May 24th, the pound appreciated slightly.

NEXT PRIME MINISTER AND IMPACT ON THE BREXIT DEAL

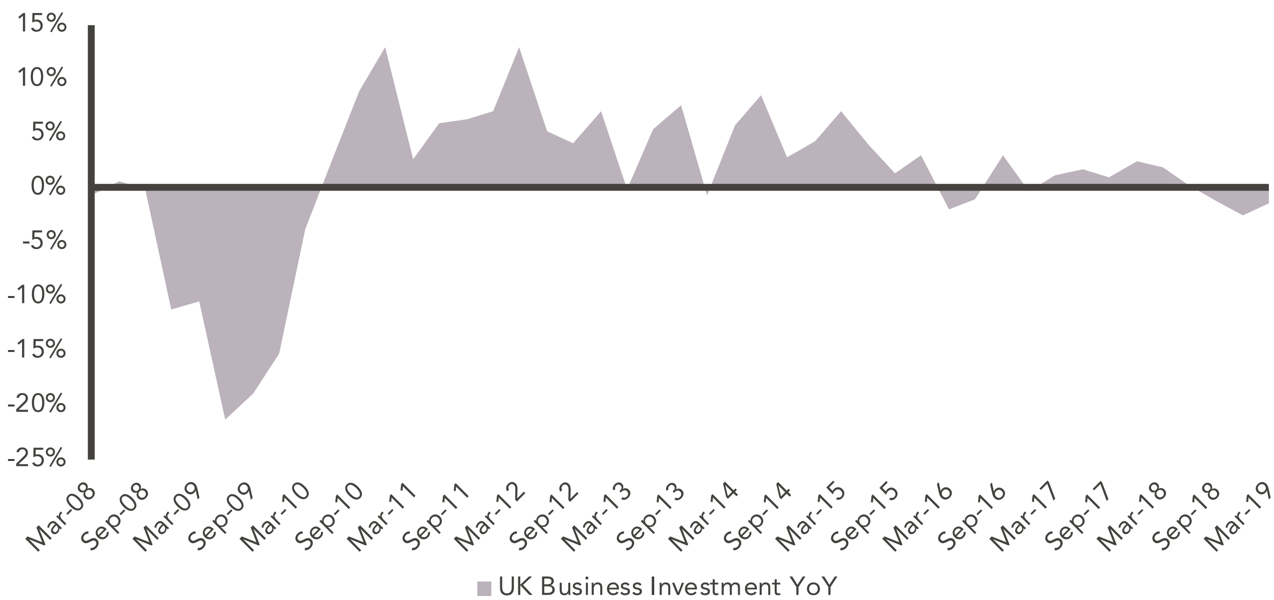
With Friday's announcement in the books, concerns have now turned to the likelihood that May's successor will be a strong Brexiteer, increasing the odds of a hard Brexit. So far, the contenders for May's spot have been hardline, pro-Brexit, most notably Boris Johnson and Jeremy Hunt. The nomination deadline is June 10th, with the intention of a new Prime Minister and Conservative Party leader being installed by the end of July.

Regardless of who is ultimately chosen as PM, there will be a continued uphill battle to gain any meaningful compromise on the divorce deal. The chances of a "no-deal" or "no-Brexit" outcome has become more likely. Post announcement, the opposition party leader, Corbyn, has commented that Labour leadership would back a referendum vote to avoid "a bad Tory deal" or "no deal at all." The European Union election results also lean towards a stronger likelihood that EU negotiators will be unwilling to budge on terms, as centrists throughout the Union lost seats to both nationalist and liberal parties.

CONCLUSION

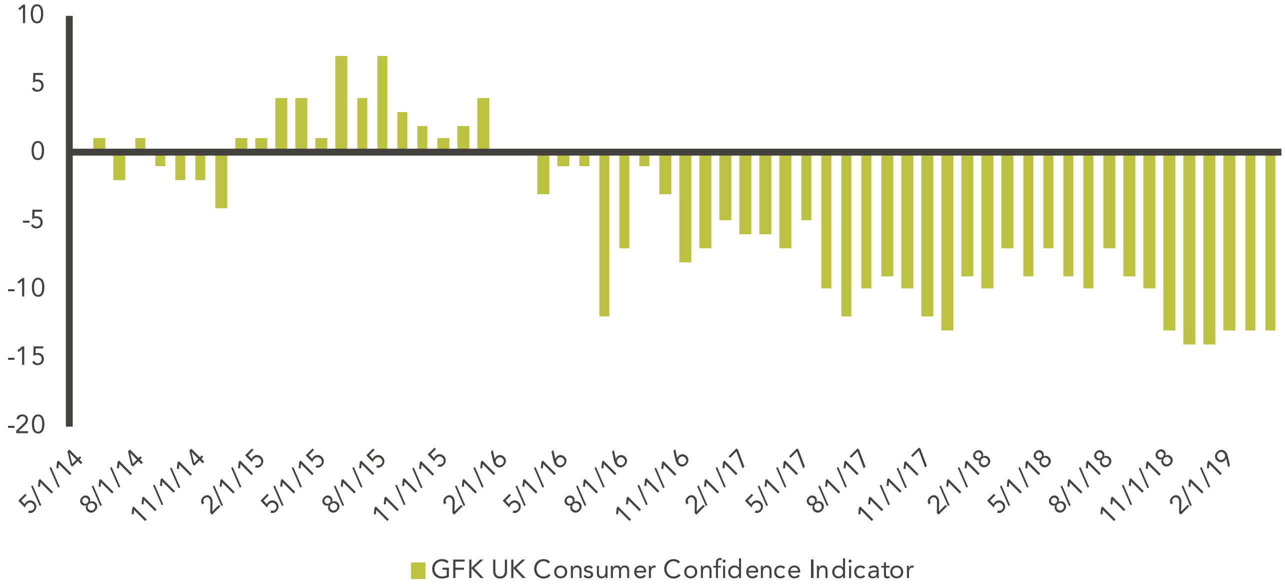
Uncertainty surrounding the ultimate Brexit conclusion will continue to be a major headwind throughout the remainder of 2019, and the fall-out from May's resignation is yet another twist to this now three plus years story. From an economic standpoint, U.K. businesses have postponed capital investments, as shown in the downward trend in year over year U.K. business spending in Exhibit 3. British consumers have remained fairly calm in the face of constant political indecision, as shown by the U.K. consumer confidence index remaining flat over the last five months, albeit squarely in negative territory.

Exhibit 3: U.K. Firms Have Cut Back Spending



Source: Bloomberg

Exhibit 4: U.K. Consumers "Keep Calm"



Source: Bloomberg

From an asset allocation standpoint, the dysfunction in Westminster has yet to materialize into any real, actionable next step that the market can digest. The extended Brexit timetable of October 31st has not been disrupted or changed, and there are no immediate signs that would point towards a near-term solution to the impasse, nor a button-up agreement deal. Given that these critical outcomes are still unknown, we recommend staying the course in your current asset allocation and international equity exposure. At this point, the market is looking for a resolution to clear up this uncertainty, and with May stepping away, we may be more likely to get to that final conclusion.

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