PERSPECTIVES

Brexit: The Countdown Begins

March 29, 2018

With just a year to go until the United Kingdom officially leaves the European Union (EU), Dylan Ball, head of European Equity Strategies, Templeton Global Equity Group, and David Zahn, head of European Fixed Income, Franklin Templeton Fixed Income Group, weigh in on why "passporting" financial services into the EU is a crucial issue, and how EU countries might use the transition period to drive their own agendas.

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As the year-long countdown to the United Kingdom's departure from the European Union (EU) begins, we'd expect to see increasing urgency for answers on the transition deal.

Until people know what the rules are going to be, they are postponing investment, hiring and capital expenditure decisions.

The valuations of many UK-listed stocks currently reflect that uncertainty. In our view, some of the valuations in UK domestic stocks have been attractive for some time.

We think prices should revert to the mean, but we're realistic and recognise that it's not as simple as saying "when not if."

For example, in the absence of certainty on how the United Kingdom will trade with other countries, we can't be confident about its prospects as a standalone state, separate from the EU.

Still, in our experience, stocks typically anticipate recovery scenarios six to nine months before economic fundamentals improve. So given we have 12 months until the leave date, we'd assume we're nearer the end of the period of uncertainty than the beginning.

Passporting Will be Crucial

One of the most important issues for the United Kingdom and EU to iron out will be the future of so-called "passporting" of financial services into the EU.

Passporting allows a financial services company licensed and registered in one EU country to sell its products directly to customers in any other EU country with little or no additional regulator authorisation.

If the EU were to withdraw passporting rights from UK-based banks and insurers, it could have a dramatic effect, and not only on the country's huge financial services sector.

The trickle-down effect could impact many aspects of the UK economy including house prices, commercial real estate and construction across the country, but particularly in the southeast of England around London.

Looking for a resolution that keeps the status quo rather than allowing financial services companies to drift from London to European centres, such as Frankfurt or Luxembourg, should be high on the UK negotiators' priority list, we'd imagine.

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The United Kingdom may be closer to officially leaving the European Union (EU) on March 29, 2019. However, we think there's another side to the Brexit equation to consider.

Both parties have agreed that a 21-month transition period after the leave date allows more time for new trade relationships to be negotiated and agreed on between countries, and for businesses to prepare for new post-Brexit rules.

Gilts (UK government bonds) seem to have currently priced in a Brexit premium, the possibility the United Kingdom could leave without a deal, despite some evidence of progress.

But if the United Kingdom were to leave without a deal, we'd expect gilt yields to fall on the back of a flight to safety amid a backdrop of increased risk and an uncertain landscape.

Concerns over these "known unknowns"—whether the United Kingdom will make some trade deals in time or leave with a deal—has somewhat impacted UK sentiment. And, it has led to a revised UK growth rate[1] as people spend cautiously until further and more solid details are ironed out. However, we think this will change as new details of the transition period emerge over time.

Opportunity Knocks, for Some

In our view, individual EU countries will want to use Brexit negotiations to drive their own agendas during the transition period. The biggest sticking points currently lie with debates over keeping an open border between Ireland and Northern Ireland after Brexit, and likewise, Gibraltar and Spain.

So, while EU27[2] countries grasp these negotiation opportunities with both hands, it does show that the EU is not as homogenous as many people would lead us to believe.

Longer term, we think the United Kingdom's departure from the EU may start to reveal differences of attitude amongst different factions within the trading bloc. And, it may bring about a switch in the balance of power in the European Parliament towards eurozone[3] countries.

Countries, such as Germany and France, would want to have a more integrated EU. Other countries, for example in Central Europe, favour a looser grouping that offers them trading benefits while allowing greater control over their sovereignty.

Under European Parliament rules, a vote or veto needs 67% support to pass. Currently, eurozone countries represent 70% of the votes in the European Parliament, with non-eurozone countries, including the United Kingdom, representing the remaining 30%.

Once United Kingdom's 12% weighting in the European Parliament is removed, this could weaken the influence that non-euro countries currently have and provide opportunity for more European-centric countries to sway the vote even further.

The Euro Club

We think this could mean the EU becomes much more of a euro club. Countries that have not adopted the euro, such as Poland, may have to rethink their position if they want to have a say in the future of the bloc.

On a similar note, the United Kingdom has tended to take a more economically austere approach to the EU budget, often voting with Germany and other mainly northern European member states against spending increases.

Countries in favour of more EU spending may find themselves in the majority, with the potential to overcome possible German opposition.

This will play a big part in the negotiations between the United Kingdom and the EU this year as they decide how much funding the United Kingdom will need in order to maintain access to the EU.

As a result, the EU will need to somehow fill the budget gap. What we think will most likely happen is increased taxes for the top three EU countries: France, Germany and Italy.

It remains to be seen how these dynamics will work within the trading bloc, but we think European politicians are starting to plot their approach to this changing situation. We think this is something that should be on investors' watchlists.

Overall, the United Kingdom's departure from the EU will likely kick-start a "make-or-break" situation for the eurozone. While the EU attempts to bind together as one centralised system, it's important to remember that more than 50% of Italians voted for anti-EU parties in the Italian elections in March, casting doubt on whether all EU countries want to be part of the so-called "EU project."

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1. Office for National Statistics, February 2018.

2. The EU27 describes the 27 countries in the European Union (EU) that operate in a single market which allows free movement of goods, capital, services and people between member states.

3. The eurozone is a monetary union of 19 of the 28 European Union (EU) member states which have adopted the euro as their common currency.

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