EQUITY

Does a Brexit Resolution Require a New Referendum or a General Election?

December 14, 2018

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Political infighting abounds in the United Kingdom as the clock ticks relentlessly towards the March 29 Brexit date. Amid entrenched positions on all sides, Sandy Nairn, Chairman of Templeton Global Equity Group and CEO of Edinburgh Partners, argues that only a fresh referendum or a general election can break the Brexit deadlock and examines some of the implications for investors.

After another week of political upheaval in the United Kingdom, the probability that the House of Commons will support Prime Minister Theresa May's proposed Brexit deal has diminished further. That being the case, we now feel that there can be no end to the Brexit deadlock without either a fresh referendum or a general election.

A soft Brexit, along the lines of the withdrawal agreement proposed by May, now seems the least likely outcome, given the opposition to the proposals on all sides of the House of Commons. We also see little chance of the so-called "Norway Option", which requires free movement of people, gaining any traction.

Therefore, the only options left on the table at this stage of negotiations are "no deal" (Hard Brexit) or another referendum, possibly leading to a general election.

Other than with a small core of ideologues, there is little enthusiasm for a Hard Brexit, either in the UK Parliament or among the public at large. We believe, along with most observers, that exiting the European Union (EU) without a deal would be a mistake. In our opinion, no deal would be an outcome which flowed from circumstances rather than a deliberate choice.

The Path to a New Referendum

May has set her face against a fresh referendum and her Conservative Party colleagues are wary of a General Election given their shaky standing in opinion polls.

But May's political standing has been fatally damaged after last week's leadership challenge in which two-thirds of her backbench members of parliament (MPs) voted against her.

We think she is likely to continue as Conservative leader only as long as Brexit is unsettled and while her party attempts to find "the right" successor.

Meanwhile, the Brexit countdown clock ticks on. Therefore, logically, the most likely course of events is that May and her government request a delay in the Brexit process.

Any extension of the Brexit negotiations requires agreement from all of the 27 other EU member states.

While it is likely to be granted, we have little confidence the EU would be prepared to make substantial concessions. Thus, we envisage a scenario in which May comes back to Parliament with roughly the same deal as before, but a few more platitudes attached.

In our view, lacking significant change, this would also likely fail to secure parliamentary support. The logical step would then be for May “reluctantly” to call a second referendum, framing it to her backbenchers as the “least bad option” (i.e. not a general election).

Given the EU’s firm line on no renegotiation and the tight timeline, it is hard to see a soft Brexit option fitting as a referendum question. This leaves only “Remain” or “Hard Brexit” as possible options to offer. This will be vociferously resisted by the hardcore Brexiters and the airwaves will be filled with the claims of treachery, but by then we think the tide of opinion may have turned.

In the event that “Remain” won a second referendum, we would expect May to stand down and be replaced as prime minister by a remain-supporting Conservative MP. The new prime minister would then be in a position to revoke Article 50 and the United Kingdom would stay in the EU, under its current membership arrangement.

If the answer were to be “Hard Brexit”, the Conservative Party would likely split in two and there would almost certainly be a general election.

General Election Fallout–An Investor’s Analysis

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 nationalisation 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 nationalisation 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 continue to believe risk premiums will likely maintain their upward trajectory as the Brexit situation comes to a head.

That could potentially spur investment in stocks which have already been largely discounted for a worst-possible Brexit outcome, including in 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. At the current time, we seem to be eroding the middle part of the spectrum and it is the more extreme ends (both positive and negative) that remain.

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

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