EQUITY

Brexit: Are Markets Underestimating the Chances of the UK Not Leaving?

July 27, 2018

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With nine months to go until the date on which the United Kingdom officially is due to leave the European Union (EU), much remains unclear both about the process and the outcome. The recent resignations of two prominent Brexiteers from the UK government has added further uncertainty to the outlook. In this article, Templeton Global Equity Group Chairman Sandy Nairn attempts to cut through the noise and present some of the likely scenarios facing the United Kingdom and the EU as negotiations enter the end game. In doing so suggests there may be a higher probability of the United Kingdom remaining in the EU than many observers have thought.

Although markets generally still seem to assume that the United Kingdom and the European Union (EU) will agree to some form of "soft Brexit," neither the definition nor the time horizon is clear.

For most observers, soft Brexit carries with it the connotation that trading arrangements in both goods and services will be largely unchanged. But does that mean such an agreement within the prescribed timescale is something the EU member states will accept, or is it a holding pattern while the terms are negotiated post-exit?

Two Versions of Soft Brexit: Decide Now…

The first version of soft Brexit involves the United Kingdom accepting continued European jurisdiction over a range of areas to preserve the principal elements of free trade in goods and services.

This seems to be the object of the compromise proposal—known as the Chequers Agreement—eked out by Theresa May and her Cabinet in early July. Their proposal, which is similar to the so-called Norway model, would include a free trade area for goods, while limiting access for services, capital and people.

But it has already provoked fresh uncertainty: two prominent Brexiteers Foreign Secretary Boris Johnson and Brexit Secretary David Davis felt unable to support the plan and resigned, prompting questions as to whether Mrs May will be able to retain the support of the Conservative Party.

Meanwhile, EU negotiators have already criticised previous trial balloons that outlined these positions as "magical thinking."

…or Decide Later

The delayed version of soft Brexit is similar but with final decisions on key institutional arrangements being made over time.

However, whatever the short-term agreements, under this scenario the United Kingdom would exit into the unknown. This is a classic "kick the can down the road" political fudge which avoids having to set out exactly what is being agreed to until it is too late to change.

It is important to note that this “decide later” scenario does not necessarily mean a soft Brexit will result. It only means the hard decisions have been postponed beyond the point where the electorate can have an influence. Moreover, the subsequent negotiation would be conducted where an “exited” United Kingdom will have significantly less influence.

Both markets and the key political power groups are only likely to accept this compromise for a limited period and, increasingly, one would expect unrest to bubble up.

US Disdain for WTO Raises Questions about Hard Brexit

The alternative, or third option, is one where there is simply a “hard Brexit” and the United Kingdom exits without any deal. This is an equally opaque version.

The hard-Brexit camp relies on the fallback interim position of working under World Trade Organization (WTO) tariff rules to support the view that UK trade would remain relatively unscathed.

However, the WTO rules only exist to the extent that they represent a framework within which the United States is willing to operate. The Trump administration has made it clear that it views the existing trade framework with some disdain. The implication of this for the United Kingdom is obvious: more uncertainty.

All Options Remain in Play

Given the institutional hurdles to an agreement in the necessary timescale, we are sceptical that the relatively benign soft Brexit scenario would be the most likely outcome.” Our view is that the position is much more finely balanced and perhaps there is an equal probability of a range of different outcomes.

All of these outcomes offer uncertainty in relation to the terms of Brexit itself, and in terms of the consequences for political stability. Since the likelihood of a negotiated “soft” settlement within the exit period is very low, the mechanics and sequence of how any future decision might unfold assume much greater importance.

Potential Scenarios Indicate a Possible Path to Remaining

Having taken soundings from a range of experienced lawmakers, diplomats and business people, we believe there are six possible scenarios:

1. **Parliament Approves**: Parliament accepts an October/November deal with the EU, in order to deliver Brexit.
2. **No Deal**: Hard-line Brexiteer Tories reject the deal, or there is no deal because the UK government still rejects any form of customs union.
3. **A General Election**: Parliament rejects both the deal and the prospect of no deal. To break the deadlock, we could see a change in Conservative leadership and/or a fresh general election, raising the possibility of a new Labour-led government.
4. **Parliament Kicks the Can:** Rather than approving the deal, or leaving with no deal, Parliament might mandate the government to continue negotiations. The UK would then need to persuade all 27 other EU member states to agree to relax the Treaty’s two-year limit on negotiations.
5. **Scrap Brexit:** Parliament could require the government to withdraw the Article 50 notification of intention to leave. Constitutional experts believe this is legally feasible. Since the UK would not have left, the terms of its membership would be unchanged. But for the government, such a volte-face would be well-nigh impossible. It would probably take a referendum to overturn a referendum.
6. **People’s Vote:** Parliament could pass the decision back to the people for a second referendum in which the choice would be to leave on the terms negotiated, or to stay. Current polls suggest that there now is majority support, including among Labour Party members, for a referendum on the deal, with particularly strong support among the under 35s.

These scenarios suggest two things: first the likelihood of political turmoil is significant and the threat of a change of government must be seriously considered; second, the probability of the United Kingdom remaining within the EU is a lot higher than markets are assuming.

The Rationale for a Second Referendum

A second referendum could arise because it provides an escape route for both major UK political parties to avoid taking the blame for the eventual outcome. The risk of the "wrong" outcome makes this anathema to hard-core Brexiteers, but a second referendum is probably the path of least resistance for everyone else.

Moreover, the lack of clarity in the first referendum on what Brexit constituted leaves a legitimate argument that the electorate should be given a clear choice when this is finally defined. It is not unreasonable to suggest that the electorate may warm to this view.

On the other hand, the converse argument from the "Leave" campaign is that such an option would encourage the EU to take a hardline stance precisely to end up in a position of a second referendum. Which path is followed will most likely be determined by the narrow guidelines of party advantage, given the finely balanced parliamentary majority and underlying voting patterns.

Implications for Investors: A Possible Change in UK Economic Policy

The market-sensitive information is twofold. First, there is a higher probability of the UK remaining than hitherto thought, albeit against a backdrop of even greater economic uncertainty. Second, the turmoil that could ensue as the United Kingdom winds toward an outcome is fraught with political danger.

At least one of the paths to a decision on the EU is associated with the fall of the Conservative government and its replacement by a Labour government whose economic policies may cause concern to some investors.

Up to now, much of the rhetoric from the Labour Party has been ignored but it is worth remembering that nationalisation of utilities, transport and financial institutions is high up the list of priorities. From a position of tight fiscal and loose monetary policy which favors asset markets, we would move to the reverse.

This leads to a classic investment dilemma. There are probably equal chances of a "fudge/delay," a "hard Brexit" and "remain."

In our view, at the moment the soft Brexit or fudge option is not a solution as much as a way of avoiding the hard choices. It looks increasingly likely that at some point, this realisation will be brought into stark relief.

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