OCT
19
2020

Around THE Curve

Wake Me Up When This Is Over

J. Patrick Bradley |

The Soon-to-be-over, Never-ending Brexit Story

On June 23, 2016, in a populist shift, the U.K. electorate did the unthinkable. It voted to leave the European Union (EU) and to forge new trading relationships with the eurozone and the rest of the world, including the U.S. Now, we sit amid a global economy threatened by a pandemic and a U.K. with no clear path for exiting the EU. At the end of the year, the U.K. will leave the EU, either with or without a trade treaty. However, there is guarded optimism a trade treaty can be forged.

What a Long, Strange Trip

The U.K. invoked Article 50 at the end of March 2017, setting in motion the process for leaving the EU. The next two years would witness the wrangling over the withdrawal agreement, the relationship road map that would be followed until a free trade agreement (FTA) was produced. It cost Theresa May her office and led to a sweeping election victory for Boris Johnson's Conservative Party in the 2019 elections. Johnson won on the promise of a clear directive to get the U.K. out of the EU. The withdrawal agreement was almost immediately approved; negotiations on the FTA started; and, the new government would ask for no more extensions. Prime Minister Johnson would announce that if there was no progress on the FTA by October 15, the U.K. would leave with no deal and submit to World Trade Organization (WTO) tariffs in its trade relationship with the EU.

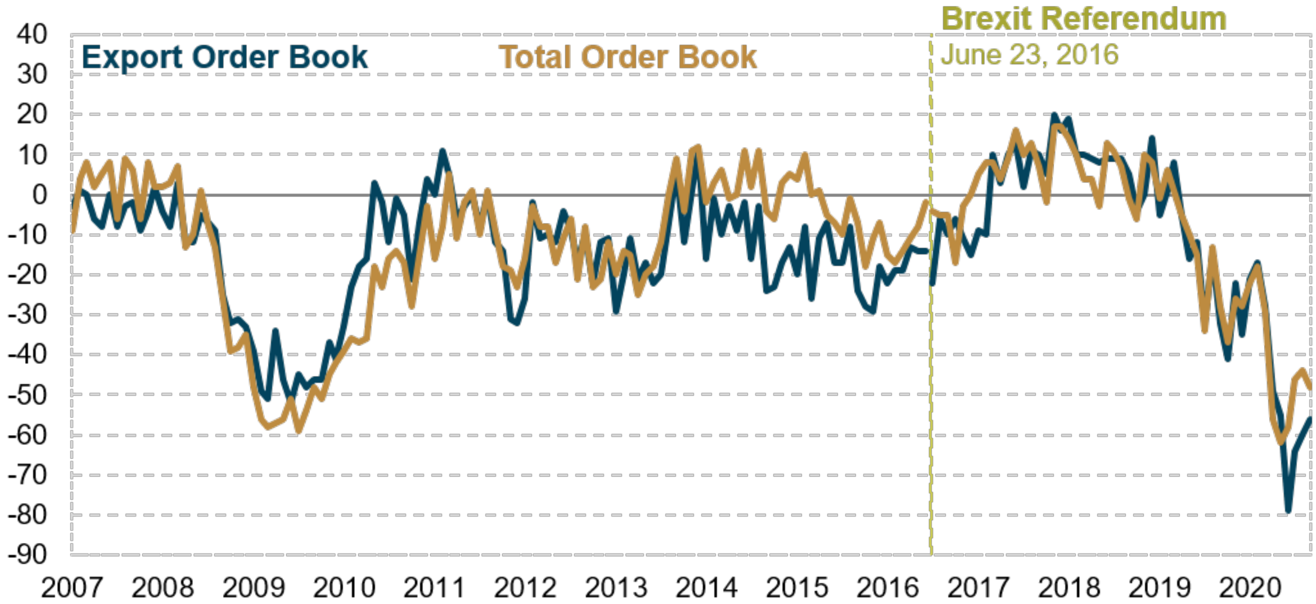
Navigating Past Scylla and Charybdis

The European Council meeting last week had the U.K. relationship on its agenda. In recent days, conversations between the President of the European Commission, Ursula von der Leyen, and Prime Minister Johnson gave some hope of a resolution. Most importantly, COVID-19, new economic restrictions in the U.K., and the possibility of a no-deal Brexit put the U.K. in the difficult position of navigating an economic path between Scylla (the virus) and Charybdis (the no-deal Brexit). Charts 1 and 2 show an economy that is struggling to emerge from the coronavirus-induced recession. Order books remain weak while manufacturing continues to decline, albeit at a slower rate, and exports are only barely recovering.

1

U.K. CBI Industrial Trends

% Balance, As of 9/30/2020

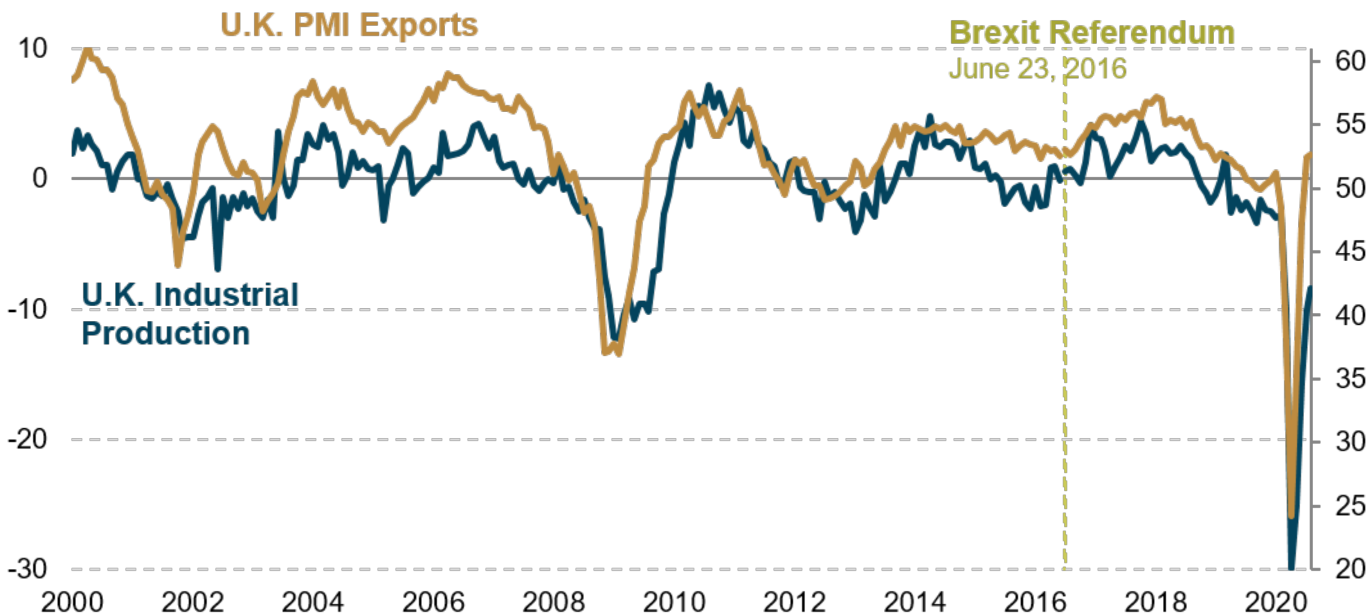


Source: Haver Analytics

2

U.K. Industrial Production and PMI Exports

Exporters Index, As of 9/30/2020



Source: Haver Analytics

Stakes Are High

What you learn about Brexit is that it is never over until it is. That day is coming, and it is December 31, 2020, the first bit of certainty that surrounds Brexit. On December 31, 2020, the U.K. will leave the EU and, hopefully, embark on a new, independent relationship. If the U.K. leaves without a deal, however, then costs will be imposed on trading with the EU. That means World Trade Organization (WTO) terms. Tariff and non-tariff barriers will affect U.K. and EU trading. The tariff on U.K.-produced autos, for example, would go from 0 to 10%, boosting car prices for EU citizens. Border checkpoints will have to be installed. The cost of commerce will rise, creating an economic cost in the form of slower growth. What must be emphasized is that the economic cost is not de minimus and will drive the process likely beyond the October 15 deadline.

The U.K. cannot abandon the EU. The EU is the U.K.'s largest trading partner, receiving 43% of the U.K.'s exports. The U.K.'s imports from the EU, which also consist of intermediate goods and services, total 51% and represent nearly 18% of its gross domestic product (GDP). The U.K. needs these goods and services for its economy. Its supply chains are largely in the EU, and any short-circuiting of these chains is likely to be costly to the U.K. economy. Both the U.K. and the EU will be economically impacted by a no-deal crash-out; however, the U.K. will be hit harder than the EU. Three sectors stand out as the biggest losers in a no-deal scenario: transport equipment, chemicals, and electrical equipment.

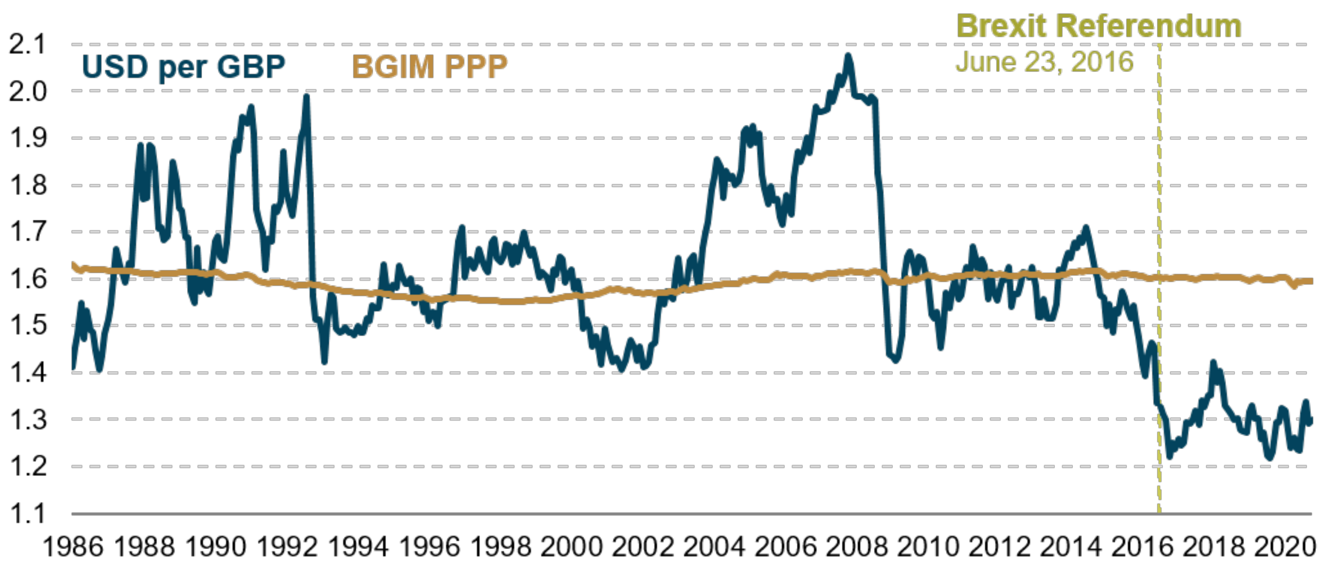
What Say Markets?

Financial markets have become increasingly jaded about the prospects for a Brexit resolution, never getting too high or too low based on the latest news flow. Pound sterling (GBP) is the best barometer of the market's view of Brexit and the potential outcomes. Chart 3 shows the movement of the GBP compared to its "fair value" as gauged by its purchasing power parity (PPP). Chart 3 also provides a window on the market's view of pound sterling. Chart 4 depicts trader positioning.

3

Pound Sterling Purchasing Power Parity (PPP)

USD/GBP, As of 10/18/2020

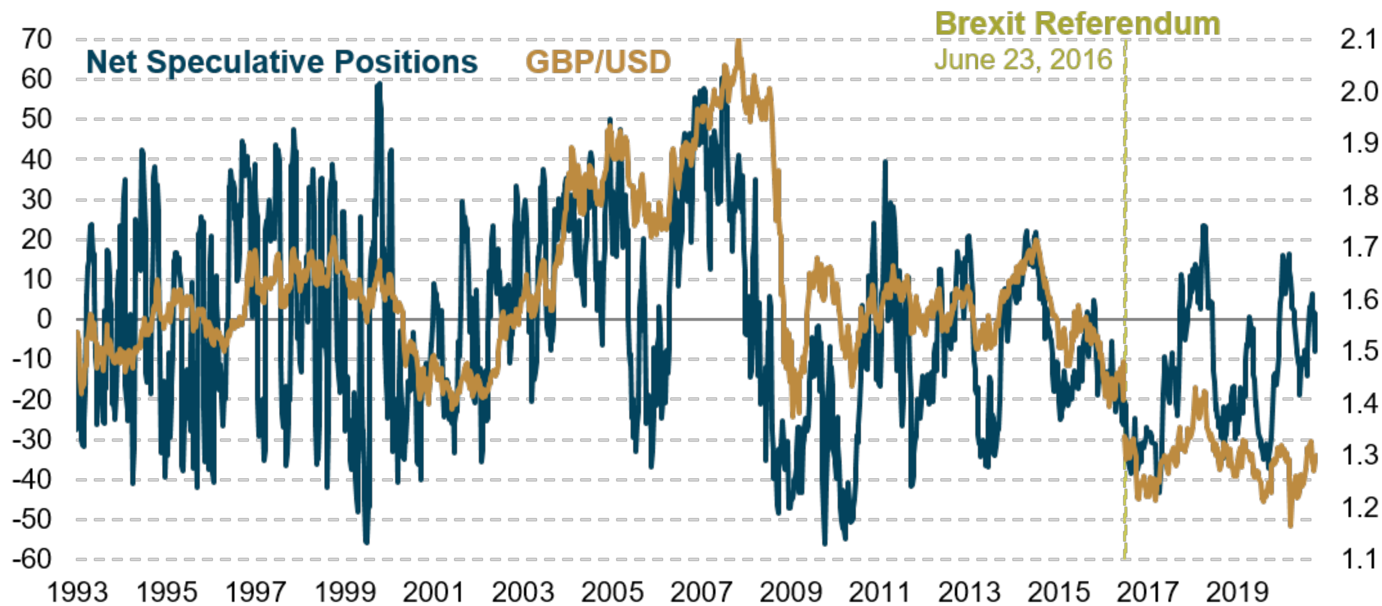


Source: Macrobond

4

Trader Positioning

% of Open Interest, As of 10/02/2020



Source: Macrobond

Prior to the Brexit referendum, sterling was depreciating but still around $1.50, compared to its current value of roughly $1.30. A decline to $1.20 marked the post-referendum low. Bouts of Brexit optimism and disappointment can be seen in the chart. In 2017, sterling climbed on optimism that then-Prime Minister Theresa May would successfully shepherd a withdrawal deal and proceed to the actual trade negotiations. The currency peaked at around $1.44. May lost her parliamentary majority in an ill-conceived June snap election, forcing her to make a deal with Northern Ireland's Democratic Unionist Party (DUP), which essentially doomed any hope of her moving Brexit forward. The same ebb and flow can be seen in the bullish sentiment and trader positioning charts.

Now, the markets have adopted a wait-and-see approach to the Brexit outcome, but a hint of optimism can be gleaned. Sentiment toward sterling has turned positive, reflecting a growing market view that a treaty is possible. Traders, on the other hand, continue to hold a small net negative position in sterling. Nonetheless, the short currency positions are not increasing, suggesting traders could be waiting for a treaty deal. The betting market odds indicate a 70% probability of a trade deal in 2020. The outbreak of the coronavirus in the U.K. and globally stifled what could have been fruitful negotiations. Both Prime Minister Johnson and the EU's chief negotiator, Michel Barnier, contracted COVID-19, and governments' attention was directed toward the virus at the sake of any Brexit urgency...until now. That growing urgency should permit further negotiation beyond the October 15-16 European Council meeting.

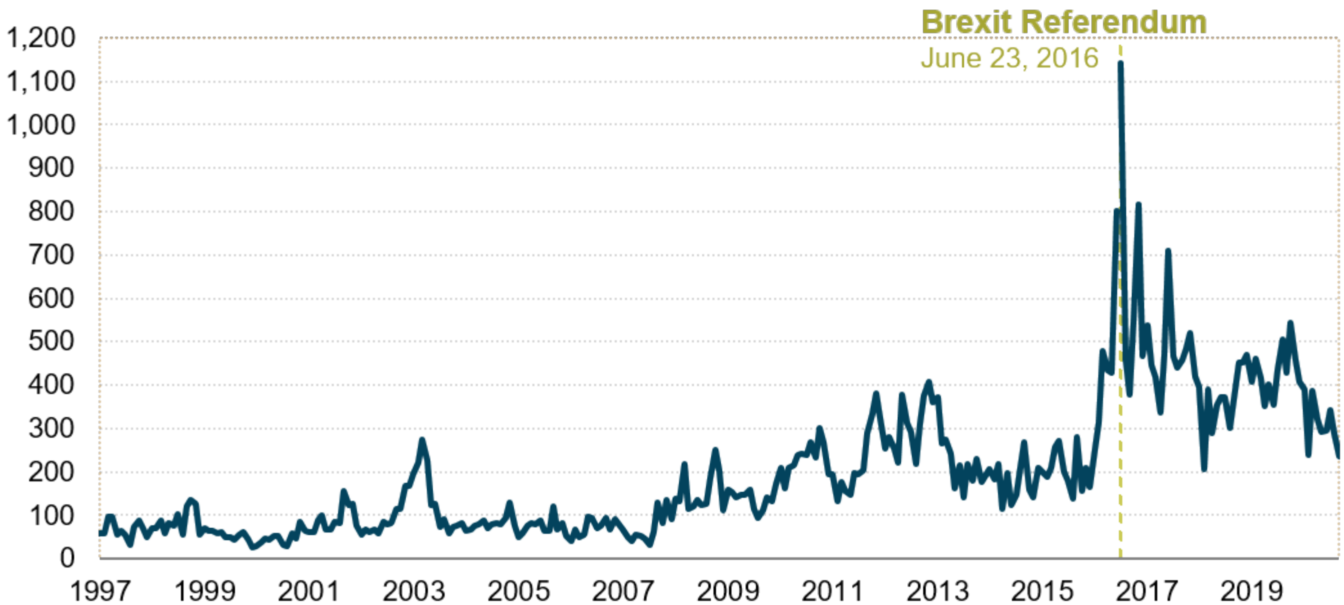
The outlook

All through this Brexit process there has never been clarity about the outcome. Markets, however, never panicked. For example, there were doomsday forecasts of a currency that would plunge in value, a forecast that has yet to be validated. Other than the short-lived drop to $1.15 during the worst of the coronavirus, GBP has maintained its range of $1.20-$1.30, moving toward the low on bad news and to $1.30 on good news. The higher bound, at approximately $1.30, is where the currency resides now. One might interpret through the currency that markets are reflecting a positive outcome but are not positive enough to willy-nilly increase U.K. asset exposure, nor are they willing to sell out of positions either. Chart 5 indicates that uncertainty has not been rising, something that would be occurring were the U.K. about to crash out of the EU. Uncertainty spiked dramatically following the Brexit referendum. Since the Conservative Party landslide in December 2019, policy uncertainty has been receding. Some closing thoughts include:

5

U.K. Economic Policy Uncertainty Indices

News Based Index, As of 9/30/2020



Source: Macrobond

1. No-deal Brexit. The possibility of a crash-out has been a Boris Johnson leitmotif. This theme always seems to be more posturing and bluster than an actuality. If past is prologue, Johnson will compromise. The U.K. economy cannot withstand the double shocks of the coronavirus, including the recent restrictions aimed at curbing the spread, and a no-deal Brexit. The economic cost would be extreme, even as the Bank of England (BOE) would expand its asset purchase program and the Johnson government would provide additional stimulus to offset the economic fallout. However, the deterioration of the economy would largely negate the proffered stimulus, plunging the economy into a double-dip recession. Crashing-out would make the Johnson government appear incompetent, something Boris Johnson does not want. Crashing-out would mean different rules for Northern Ireland. Crashing-out would fuel Scotland's desire for independence. Hence, crashing-out will be avoided.
2. The 'skinny' deal. It would be wildly optimistic to believe the U.K. and EU negotiators would be able to cobble together an overarching trade deal, including both goods and services, especially the all-important financial services industry, which has been shunted aside for now. Negotiators need to come to an agreement on fishing rights and state aid before proceeding to creating the technical language in the trade agreement. A compromise is possible. Once this interim deal occurs, the negotiators could focus on the goods treaty and create a treaty in time for the enabling legislation to be approved before the end of the year. The Internal Markets Bill remains in the House of Lords and should not be a constraint. Other parts of the trade relationship will be left to be considered later, including financial services, data, and security. The U.K. also needs to establish its own trade treaties with the rest of the world. Trying to attain a treaty with the U.S. is a first order of business, although the U.S. presidential election could influence the negotiations.
3. Pound Sterling. As discussed above, sterling (the Brexit barometer) has not sold off materially as the trade negotiations enter a critical stage. Even gilt yields have begun to move higher. Because investors have yet to bet overwhelmingly on a positive outcome, when one occurs there is an opportunity for U.K. assets to rally. Take GBP's PPP, for example. We estimate that sterling is undervalued by nearly 20% against the U.S. dollar, suggesting that sterling could appreciate to the mid $1.50s. Even against the euro, sterling is significantly undervalued and is poised to rally if the Brexit overhang can be removed.

4. **The Heavy Lifting Starts** **The creation of an FTA is not the end of the road for the U.K. It is the beginning of a long journey. Risks abound. Membership in the EU provided the U.K. access to trading with many countries under the EU treaty umbrella. Now, the U.K. will have to create a trade infrastructure to negotiate treaties with these countries. The UK will become a player in a global economy. It will address the path to a low carbon economy. The country had begun earlier to speak of a long-term industrial strategy, attempting to exploit its economic strengths in certain sectors. In short, the end of Brexit marks the beginning.**

Conclusions

One way or other, the U.K. will be leaving the EU. A trade treaty is necessary, and the WTO most-favored nation treatment is not the best option for the U.K. A crash-out remains a huge economic and political risk for the U.K., one that should be avoided even as negotiations run past the end of the European Council meeting. The possibility of a deal, skinny or otherwise, would unleash the potential of U.K. assets and, indeed, the U.K. economy. However, a deal now merely signals the start of another journey, one that will include new obstacles and opportunities.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.