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Brexit: The Beginning of the End, or the End of the Beginning?

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It was a head-spinning week in the U.K. where three significant votes took place in Parliament, along with several arguably less important amendment votes along the way also. To recap the key votes:

- On Tuesday, March 12, Prime Minister Theresa May's Brexit deal with the European Union (EU) was once again defeated (391-242), although by a narrower margin than in January (432-202)
- On Wednesday, March 13, the House of Commons voted (321-278) to rule out leaving the EU with no deal on March 29, aka "Hard Brexit"
- On Thursday, March 14, they voted to extend the Article 50 period which expires on March 29 (412-202)
- On Monday, March 18, Speak of the House of Commons John Bercow refused to put the prime minister's deal up for a re-vote if the content was "the same in substance."

So where does this leave the process? May had expected to present her Brexit deal for a vote for the third time in two months. Why did she do this? Probably because the votes last week put her deal in a different light—with Hard Brexit theoretically off the table and an agreement to extend the Article 50 negotiation period, some members of Parliament who previously voted to reject the deal may be forced to reconsider their vote. This is particularly true of the Eurosceptic wing of the Conservative party who now have to choose between supporting this deal or face the prospect of a long extension of the Article 50 period, which creates the time—and possibly the momentum—to negotiate a softer Brexit, or perhaps even put the prospect of a second referendum on the table, which the Eurosceptic wing wants to avoid at all costs. Furthermore, a long extension will then require the U.K. to participate in elections for European Parliament in May. Now, the speaker has complicated her negotiation strategy, and the prime minister will go to Brussels later this week to negotiate the duration of the Article 50 extension.

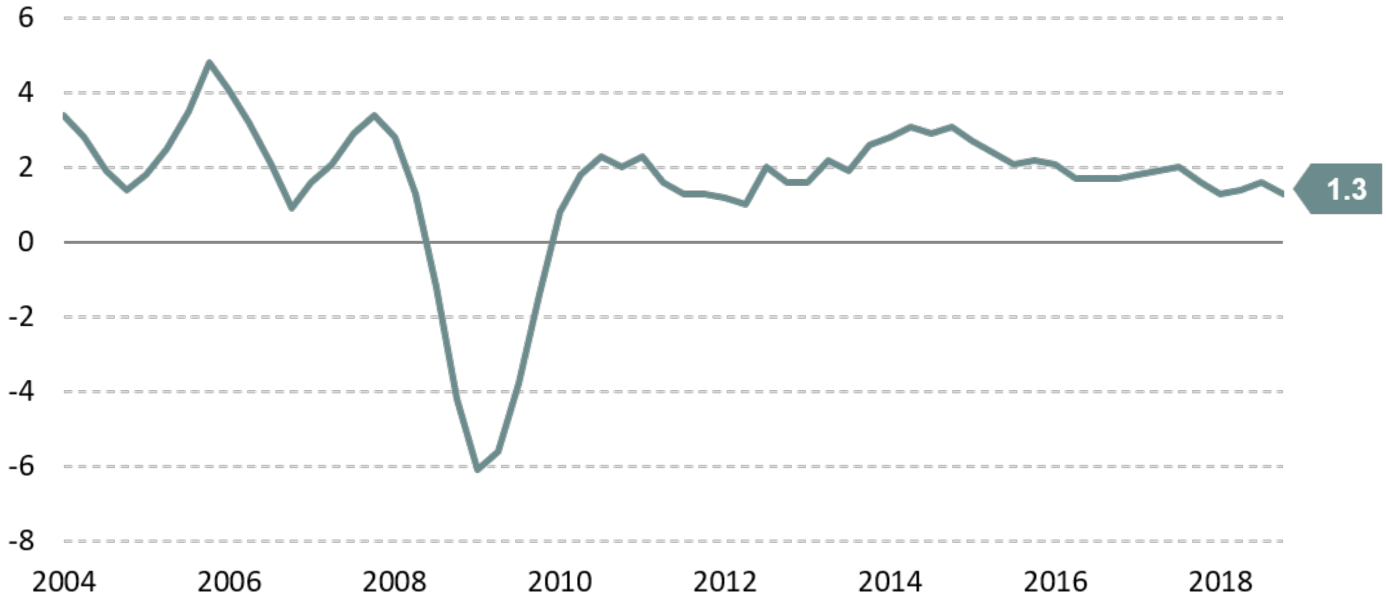
Meanwhile across the English Channel, EU member countries are watching the eleventh hour drama and trying to decide whether a long-term extension of Article 50 even makes sense. The EU's lead negotiator, Michel Barnier, has indicated that it only makes sense to extend Article 50 if the time is then used productively: to accept the Brexit deal, completely re-think strategy, or hold a second referendum. In other words, the EU is not predisposed to allowing an extension just to kick the can down the road. To quote French Prime Minister Emmanuel Macron, "we don't need more time—what we need most of all is a decision." It takes the unanimous agreement of all 27 EU member nations to ratify an extension. This could get interesting.

What makes Brexit truly unique is the struggle that Parliament is clearly having to follow through on the 2016 referendum result. One reason for this is that Parliament as a body did not support the result; while 48% of the voting public voted to remain, 75% of members of Parliament (MPs) voted to remain. This was the first time in U.K. history where the public vote outcome differed from the Parliamentary outcome.

Meanwhile, the U.K. economy has sputtered a little, but thus far has continued to display remarkable resilience in the face of such uncertainty, particularly given that the global backdrop has also weakened over the past two quarters. Economic growth, while slower, remains positive and above EU growth:

Chart 1: U.K. Chained GDP at Market Prices

Last Price, YoY, As of 12/31/18

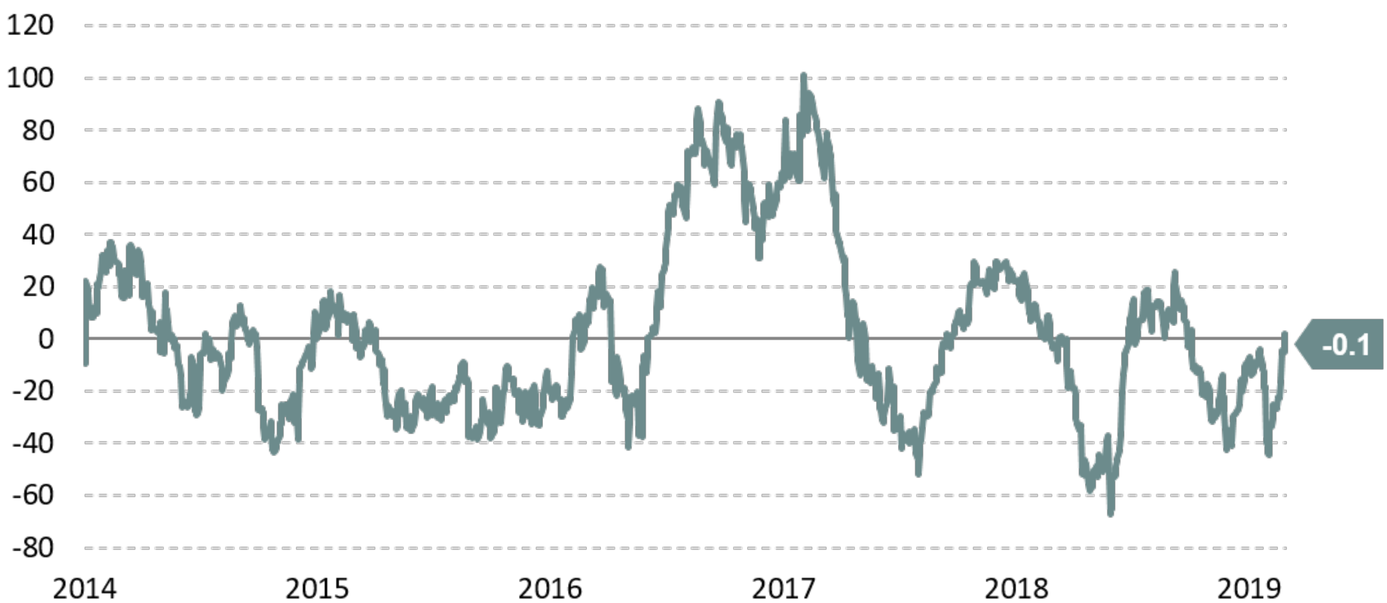


Source: Bloomberg (© 2019, Bloomberg Finance LP)

The economic surprise index has moved higher again, indicating that economic data is coming in better than analyst expectations:

Chart 2: Citi Economic Surprise Index – U.K.

Mid Price, As of 3/15/19



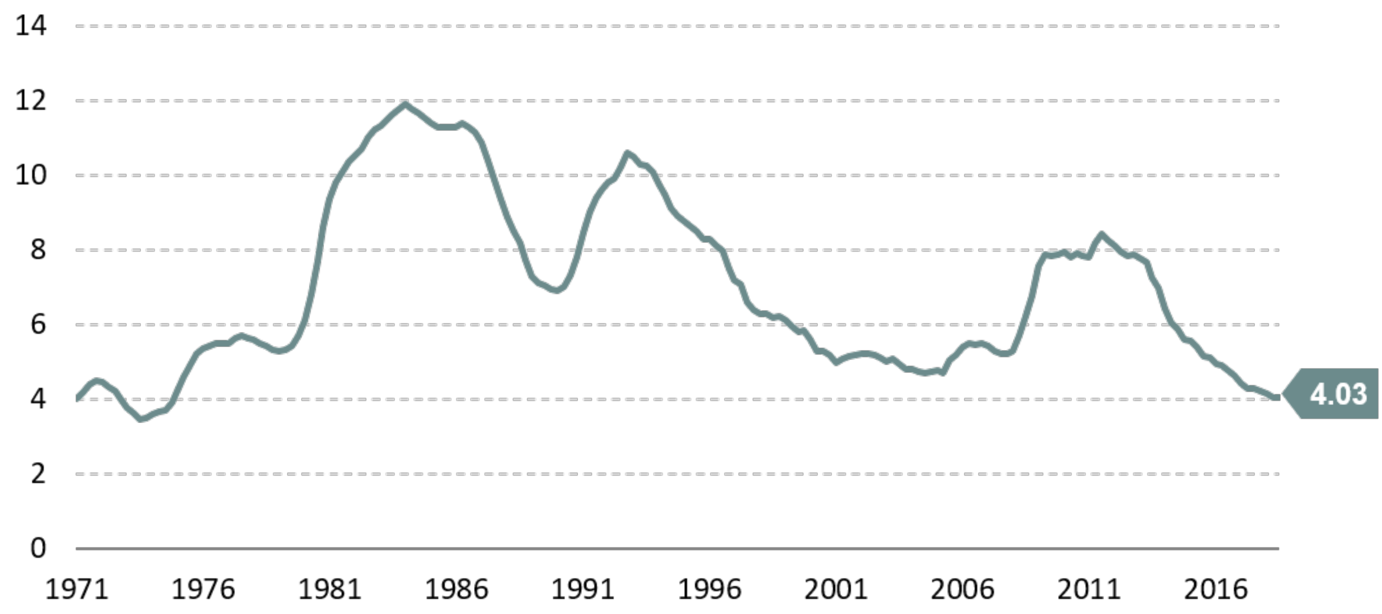
Source: Bloomberg (© 2019, Bloomberg Finance LP)

The labor market still looks strong: unemployment remains near its lowest level in 40 years but inflation

pressures remain muted, suggesting that stability in the currency and a flat Phillips curve are allowing the Bank of England to remain on the sidelines for now:

Chart 3: U.K. Unemployment Rate

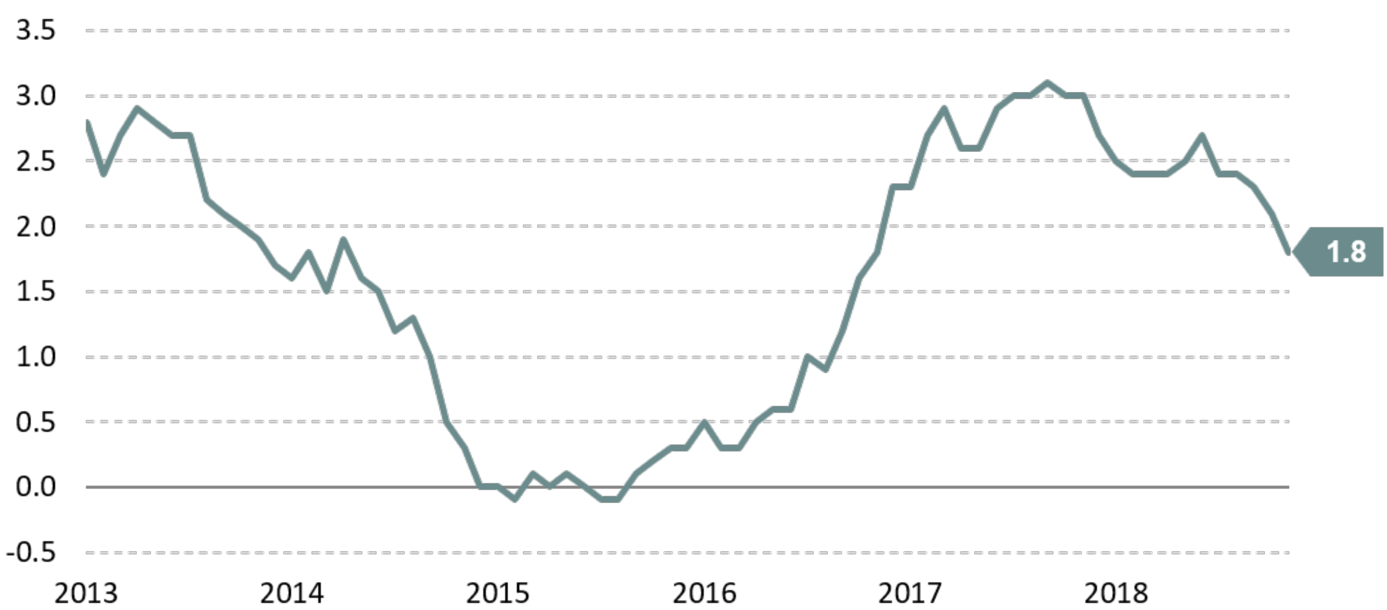
Mid Price, As of 12/31/18



Source: Bloomberg (© 2019, Bloomberg Finance LP)

Chart 4: U.K. CPI Harmonized

Last Price, YoY, Not-Seasonally Adjusted, As of 1/31/19



Source: Bloomberg (© 2019, Bloomberg Finance LP)

However, all of these indicators are about what has happened, not what is going to happen. A veil of uncertainty is dampening the outlook for future activity. Companies such as Honda and Nissan/Infiniti have announced

plans to cease auto production in the U.K. and dozens of financial firms have announced plans to move traders and operational staff from London to Paris, Frankfurt, and Amsterdam. By one estimate, €800 billion euros of assets have shifted out of the U.K. to EU banking hubs.

With regard to the impact on U.K. asset markets, the picture has been mixed so far in 2019. The FTSE 100 has underperformed other European markets, while the more domestically focused FTSE 250 has performed roughly in line. U.K. bonds continue to trade at overvalued levels, suggesting that the benign inflation outlook coupled with the uncertainty is keeping Gilt yields artificially low. Finally, the British pound has defied the odds and outperformed all other G10 currencies. In the event that May's deal is passed, look for equities and the pound to move higher along with Gilt yields, but if we end up in a longer extension of the Article 50 period, expect markets to be range bound by the prolonged uncertainty.

Are we near the end of the beginning, or the beginning of the end? Hopefully we will know soon.

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