

Weekly Note

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Investment Team

Robert Jukes
Global Strategist
T: 44.207.523.4594
robert.jukes@canaccord.com

Kevin Vandermeer
Managing Director, Investments &
Advisory Solutions & Lead Portfolio
Manager
T: 416.867.2643
kevin.vandermeer@canaccord.com

Ice Ice Baby

We can only imagine that Trump had an icy welcome from the UK Prime Minister at Chequers (British Camp David, but with more history) last week. In his interview with the Sun newspaper, Trump endorsed Boris Johnson and said he would make a fine Prime Minister (the verbal equivalent of regime change) whilst simultaneously torpedoing the prospect of a trade deal with the UK should May pursue her White Paper with the EU and the “facilitated customs agreement.” Trump made clear that in his opinion, that was not what the British people voted for at the last referendum. From Prime Minister Mays point of view, this must be one special relationship she could do without, but while he almost certainly missed it, the baby blimp was such an appropriate British riposte. The problem for May, is that babies have no filter and they often speak uncomfortable truths. The White Paper is such a fudge, we suspect it will ultimately get rejected by the EU, or Parliament, or her party.

Figure 1: UK BREXIT possibilities



Source: Canaccord Genuity Wealth Management

To be fair, Trump must have looked ahead to his UK visit with some trepidation after his friend, Boris Johnson, resigned as home secretary, and ahead of the turbulence around BREXIT. If the Prime Minister can hold on until July 20th when Parliament breaks for summer, she should be safe until Autumn. That would allow her time to negotiate the White Paper with the EU. If she can get the basis of an agreement, then her next challenge is to get that past Parliament before Christmas. Neither negotiation will be easy, and there is every reason to expect this process to fall down at one stage or another, but if some form of this White Paper is accepted, Trump has made clear that the US will not approve. Trade deals beyond the EU look much less likely as a result.

This week we define each of the four most likely outcomes of the Brexit debate (Figure 1). Before we do that, however, we want to be clear about a few points. First, the EU exports more goods to the UK than the UK exports to Europe. In many ways, the UK is negotiating the wrong part of the deal first. It has been forced into this position by the Northern Ireland border problem, and a BREXIT that leads to anything other than a frictionless border there will almost certainly lead to the fall of the government, and possibly the breakup of the UK. Second, the UK exports more services to the EU than the EU exports to the UK. On that basis, Europe would be delighted to reach a deal on goods, but not services as is the negotiating position set out in the White Paper last week. Finally, “goods” and “services” are largely an artificial statistical construct and in no way helpful for companies such as Rolls Royce which exports expensive aircraft engines (goods) but also provides even more expensive servicing contracts (services).

Fudged BREXIT

Starting with the most likely outcome, a fudged BREXIT, we think that this will be sterling negative and FTSE neutral. That is because of the trade deficit the UK has with Europe in goods, and the increased friction for providing services going forward. That all means that Sterling will most likely have to devalue to compensate for that loss of competitiveness. A transition period will almost certainly have to be agreed because the technology and agreements for a frictionless border are simply not a reality yet, and some fear that it may become a permanent state of limbo, where the UK is neither in nor out of the EU. That will not help the UK attract inward investment and will almost certainly put the EU at an advantage. A customs union for goods, in all but name, is the most likely agreement in this fudge outcome. That will commit the UK to maintaining equivalent laws for exporting goods, and to abiding by rulings of the European Court of Justice. Not really the transfer of sovereignty BREXITers campaigned for, and likely to be seen as a firm betrayal.

The position on services is being presented to the hard liners as a hard BREXIT on the basis that they do not form part of the negotiations and therefore no deal on services. We have also seen government ministers

saying that 20% of the economy is made up of goods output, and the other 80% is services. That's a little disingenuous based on the latest GDP numbers, the traded services element of GDP amounts for more like 30% of output. Note that Government and real estate alone account for 30% of GDP. So, to market this as a hard BREXIT for 80% of the economy is not really correct.

Sadly, the most important issue for most people that voted for BREXIT is likely to be immigration, and the fudged position in the White Paper is unlikely to satisfy these demands. Not only that, but the four indivisible freedoms enshrined tightly within the EU, namely the freedom of movement for goods, services, labour and capital is something that the EU has previously been unwilling to pick apart. The Brexit vote meant at least two things for those that voted for it; more control over immigration and lower government spending on the EU. Delivering on that would require separating these four freedoms, something the EU has already refused to consider. It will be all but impossible to reach a satisfactory outcome to negotiations unless May, or the EU back down on immigration.

Unfortunately, the public position taken by prominent government ministers such as Michael Gove and Liam Fox has been to leave at all costs. That means that they are prepared to support May with her white paper now but will come back and make further changes once BREXIT is complete. That weakens Mays bargaining position with the EU considerably – she is unlikely to survive as PM until the next election, so commitments given to the EU now, will be seen as relatively feeble given the very public position of many others in her own party – namely that BREXIT is a process and not an event.

The further through this process we travel, the less likely this fudged outcome seems to be and the more likely one of the tail risks, particularly elections (General Election or another referendum) are becoming.

Soft BREXIT

The soft Brexit position is the unicorn outcome, by far the most desirable in the short-term economically, but also the least likely. That said, after the Chequers agreement which marks a clear softening of the government position, this outcome has become more likely. It is the most desirable outcome because it is most like the current position and would immediately remove all investment uncertainty, protect finance and the service industry more generally. It is unlikely from an EU point of view because of the four indivisible freedoms outlined above. This outcome is also unlikely to get past the Parliamentary Conservative party, so leadership challenge almost inevitable at this point, but it probably would get through Parliament. Sterling positive and FTSE positive.

Elections*

Just as the soft Brexit option has become more likely, so has the possibility of further elections in our view. That could either mean a General Election should the government fail, or another “People’s Vote” as it is being called, basically a second referendum. There are many routes towards this outcome, and a rising parliamentary body of opinion from all areas of the house that another people’s vote would be a good idea, knowing more now about the process now than before. There are many that want to put any deal reached with the EU back to the people, at the very least it will have to get through Parliament. Should the government fail to negotiate a deal with the EU, it is likely that the government would also lose a no confidence vote and elections would be a likely outcome at that point. In some senses, elections may prevent a hard Brexit as the EU would most likely want to wait for a new government (or referendum result) before going down that calamitous route. Clearly elections will add to the uncertainty and unlikely to be short term positive for either the currency or equity markets, although the longer term may well be.

Hard BREXIT

Notwithstanding the points above on elections, a hard Brexit is the next most likely option in our view. The current Chequers agreement, and the “facilitated customs agreement” in particular, may not be legal under the WTO rules. The whole basis of negotiations could easily unravel before the Europeans have the opportunity to extract concessions. Time is running out, and if we get anywhere near Christmas and there is no agreement, the UK seem most likely to crash out of the process producing a hard BREXIT. Sterling negative and FTSE negative, and the possibility of an exit extension, another UK referendum and or fresh General Elections. Any which way we look at this, the outcome involves a great deal of market volatility.

Conclusion

We find it interesting that the EU has so far been fairly silent on the White Paper. It may be that they fear a change of leader, or government, and do not want to add more heat to this hot topic. When we look through the likely options on BREXIT, a fudge is the most likely and the market outcome is weaker Sterling and a neutral stock market. The apparent stability in both markets is really a testament to how far the debate has polarised and how the tails of the outcome distribution have widened. Our central case is one of a fudged outcome, but the tails of the outcome distribution are definitely widening with time. Trumps welcome last week may have been “Ice, Ice baby,” but the chances of another peoples vote on BREXIT could yet become “Baby One More Time.”

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