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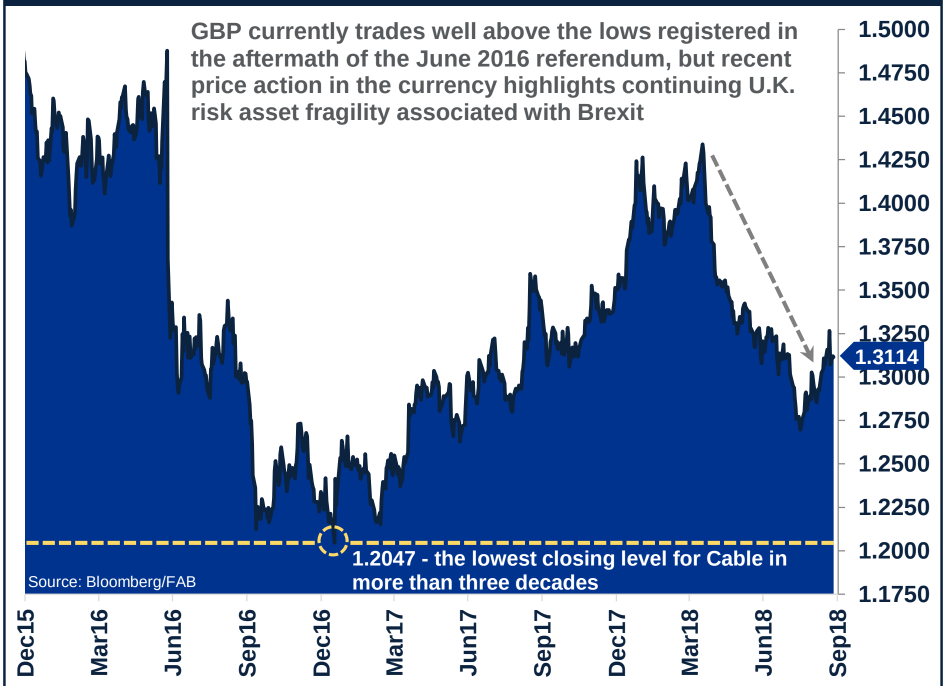
Brexit: What next?
We try to demystify the polemic

The Brexit process, or lack thereof, in the U.K. is currently raising more questions among investors than it is answering. What we do know is that the U.K. will exit the EU on March 29th 2019, with or without a 'deal'. If there is a 'deal' then a two year transition period will follow for settling all the minutiae. With the deadline for reaching a deal between Westminster and Brussels – the need to agree terms on the future trading, economic and political relationship between the two regions – becoming ever closer, investors want clarity.

Below we attempt to offer some answers to investors' current concerns and questions on this topic, as well as to offer some clarity on where the Brexit story and the direction of U.K. risk sentiment may go from here. All questions and feedback would be gratefully received.

Cost of Brexit



- Brexit – the acronym for the process of Great Britain exiting the European Union – was an event triggered by the right-wing factions of the ruling U.K. Conservative party by calling for a referendum on EU membership. On June 23 2016, the U.K. voted by a (slim) majority of 51.9% in favor of leaving the EU, to 48.1% in favour of remaining an EU member.
- After the vote, the U.K. invoked Article 50 of the Treaty on European Union on March 29 2017, thereby commencing the country's two year countdown to exiting the EU on March 29, 2019.
- Many commentators refer to the Brexit 'debate', but this may be misleading. This is not a debate about whether the U.K. leave the EU. The U.K. has voted to leave the EU, which it will do on March 29, 2019. Prime Minister May has stated that her government will adhere to this plebiscite and that there will be no second referendum. As such, the Brexit process is now all about determining the terms of the divorce.

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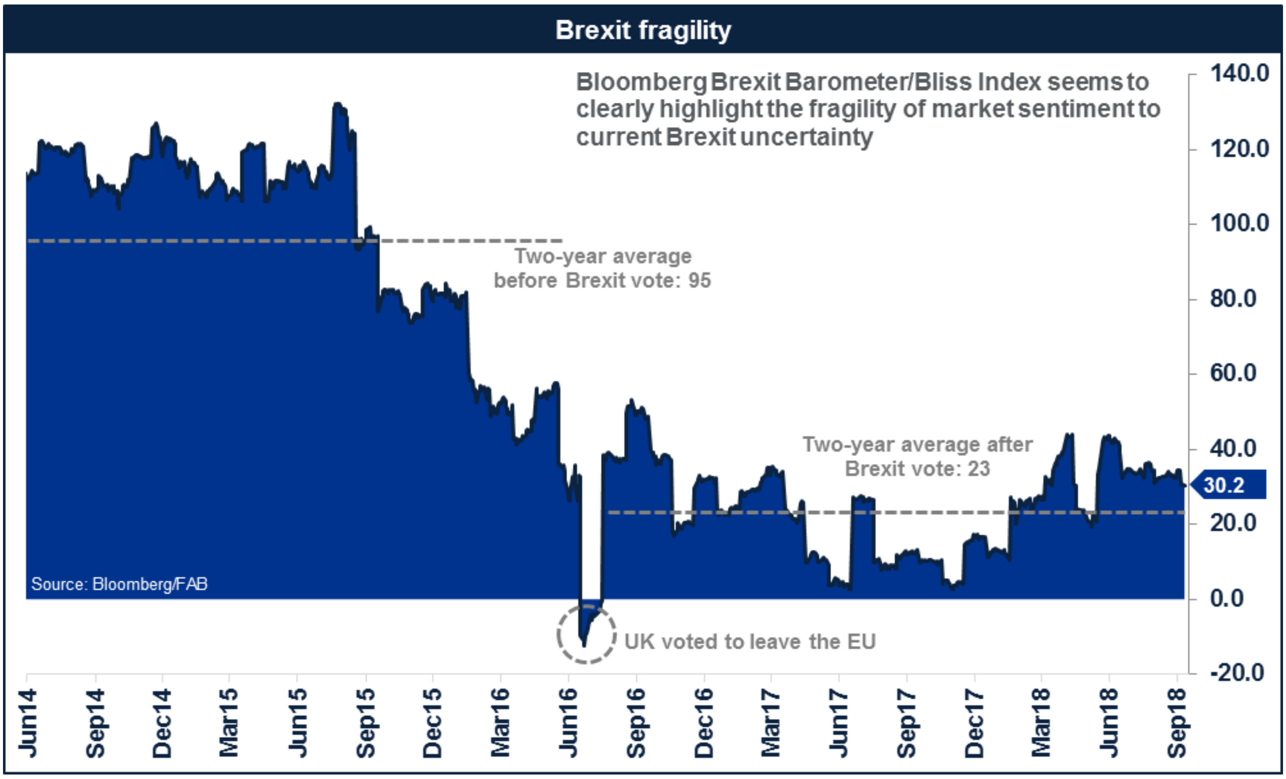
- Therefore, after some 45 years of EU membership, the U.K is set to leave the bloc – the political and economic union of 28 member states – on March 29 next year. A seismic change, antagonized by many in the 'Remain' camp feeling that they are being forced to sacrifice so much by such a marginal majority. But that's democracy for you; a majority, marginal or not is still a majority.
- The root of the problem – and the seeming inability to find a common ground solution – may lie in the fact that while David Cameron pampered to his nationalist Conservative party colleagues by calling the historic referendum, it was never seriously contemplated that the U.K. electorate would vote to leave. As such, there was never any preparation of an 'exit plan' or thought given to what Brexit really meant or entailed. This is why the government has been scrambling ever since the referendum to come up with a credible plan for extricating the country from the EU while trying to minimize any negative economic consequences.
- At the heart of the macroeconomic considerations and current political uncertainty is the role of the EU internal single market. This 'market' is based on a standardized system of laws that apply across all member states. Importantly, the EU allows for the free movement of people, goods, services and capital within the internal market. As such the UK will lose these 'privileges' when it rescinds its EU membership and will need to establish new, independent trade deals with individual countries, both within the EU and globally.
- The current situation surrounding Brexit and the outlook for the U.K. economy now seems to be confusing at best. At worst it is chaotic and suggesting possible imminent collapse of the incumbent government.
- Current concerns and areas of conflict in the negotiations include the impact on future trading flows between the two regions, the treatment of EU nationals living in the U.K. and that of U.K. nationals residing in the EU, the Ireland Republic/Northern Irish border
- Indeed, the Brexit process of negotiating divorce terms between the EU and the U.K. now appears to have hit an impasse, a situation that is being compounded by domestic political infighting within the Conservative party in the U.K. as well as across the U.K. political spectrum.

So what now?

We see myriad possibilities for how this sage evolves, but three key outcomes may be:

1. Perhaps the greatest near-term threat to market stability from the Brexit polemic would be failure of Mrs. May to advance any further in talks with Brussels, which then feeds continued U.K domestic political upheaval and the specter of a (leadership) challenge to prime minister May's authority. Whether a Conservative challenger would want to grab the poisoned chalice at this (late) stage though remains to be seen.

   A preferable strategy may be to leave May to deal with Brexit and then look to replace her post-March next year. Moreover, a near-term challenge could trigger a general election, raising the not insignificant risk of a shift to a hard-left administration under Labour leader Jeremy Corbyn. Such a scenario would likely put sustained downward pressure on GBP (cable toward $1.20 in the near-term) and U.K. risk appetite more broadly and trigger a flight to quality market reaction. ***Probability 30%***
2. Mrs. May succumbs to the hard-right of her party, sticks her heels in with regard to Brussels negotiations and prepares the U.K. for a 'no deal' Brexit in March. While she may be able to hold onto her position as PM for now by taking such a stance, the market would price in more adverse short-term economic consequences and social unrest/protects would likely spike higher, led by Labour activists and the ardent 'Remain' campaign. Cable declines initially to $1.20 amid 'hard Brexit' result. ***Probability 30%***
3. The most likely outcome may be an 11th hour compromise between Westminster and Brussels, after Mrs. May adjusts her Chequers plan. Brussels yields some ground in the negotiations in order to arrive at a 'deal' and this helps to quell political unrest within the Conservative party. Brussels will not want to be seen as giving in to the U.K. though, for fear of other EU members then wanting to negotiate 'better deals'. Nonetheless, this scenario would see Mrs. May remain as PM as the U.K. enters the 2 year transition period on March 29th. GBP assets would recover much of the recent lost ground. Cable rallies toward $1.40. ***Probability 40%***



Jargon busting for non-Brexit speakers

- **Brexit:** The process of the U.K. ending its membership of the European Union, thereby taking control of its own trade policies, borders etc
- **Soft Brexit:** A scenario where the UK remains closely aligned to the EU. It would imply staying within the EU's Single Market, with the associated trade and freedom of movement agreements. This could involve becoming a member of the European Economic Area (like Norway). Soft Brexit could also result if the U.K agrees to stay within the boundaries of the European Customs Union.
- **Hard Brexit:** This would be the case if the U.K. were to seek an abrupt exit from EU membership, without establishing trade deals beforehand. This scenario would imply giving up access to the single market and to the EU customs union. The U.K. would effectively take back full control of its borders, set its own laws (not fall under Brussels/EU jurisdiction) and be required to forge new trade deals. A 'Hard Brexit' would mean the U.K. falling back on World Trade Organization (WTO) rules for trade with its former EU partners and further afield.
- **Article 50:** The clause in European Union's Lisbon Treaty that sets out the procedure for a given member state to leave the European Union

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