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Still No Clarity on Brexit

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Key takeaways

- *Two key developments in the House of Commons this week have produced little Brexit-related progress.*
- *Financial markets' relatively muted response to this week's political developments suggest that markets broadly anticipated this week's votes and that some investors remain hopeful of a constructive outcome prior to Brexit Day (March 29, 2019).*

What it may mean for investors

- *Whatever the outcome, we remind investors to avoid complacency and expect volatility to resurface—so long as issues related to the withdrawal agreement remain unresolved.*

A week filled with political intrigue has produced little clarity on Brexit's trajectory, even with the U.K.'s scheduled European Union (EU) exit just a short 10 weeks away. On Tuesday, British Prime Minister Theresa May's much-criticized plan for an orderly exit from the EU suffered a crushing defeat in the House of Commons. Then on Wednesday, the prime minister managed to hang on to her leadership role after surviving an attempt by the political opposition to topple her government in Parliament. What now?

Without the British Parliament's ratification of the Withdrawal Agreement (Brexit Deal), which was negotiated by Prime Minister May and approved by Brussels last year, the U.K. moves closer to a so-called "no-deal" Brexit—an exit from the EU on March 29 without a new trade arrangement. Had members of Parliament approved the deal this week, the U.K., while formally exiting the EU, would effectively remain under current EU structures and rules past March 29, allowing time to settle crucial post-Brexit trade and border checkpoint-related issues with the key trading bloc. Market participants have, nonetheless, taken this week's developments in stride even as the Brexit question remains unresolved.

Muted market response

Indeed, the two votes have been expected, and financial market response has been rather muted over the past couple of days. The British pound has strengthened in recent days compared to a sharp drop in the currency following a delayed Brexit bill vote in early December. While stock prices in the country were somewhat softer following the votes, higher yields on 10-year gilts suggest that market participants are not entirely positioning themselves in risk-averse manner.

This more subdued market response likely follows from the fact that a host of actors, from both the EU and U.K., have increasingly suggested that it may be possible to avoid—or at least postpone—the chaos of a no-deal Brexit by agreeing on an extension to the March 29 deadline. To be sure, the market action this week in light of this news suggests that market consensus seems to allow that a Brexit Day extension is in the cards, granting time for the complex Brexit narrative to play out (new London-Brussels talks, cancelled Brexit, new referendum, etc.) in a way that could avoid the worst-case scenario of a no-deal exit.

Investment implications

While some market participants have grown increasingly comfortable with the idea that avoiding a no-deal Brexit is all but certain, we nevertheless expect the Brexit narrative to remain fluid in the coming weeks. This means that what may seem probable today could be off the table tomorrow. Depending on how political developments unfold over the coming weeks, we could see anything from a new vote on the current deal (following additional EU assurances on the Withdrawal Agreement), an alternative Brexit deal, a general election, or equally plausible, a new Brexit referendum that could result in cancelling the whole project.

Predicting how exactly the Brexit story will end is likely to be challenging. That said, we believe that the downside market risks related to a no-deal Brexit should remain contained so long as the willingness to agree to this extension is present—giving the country more time to determine its next steps. From here, the next stage in the process will be for Prime Minister May to present a "Plan B" to Parliament by next week.

Whatever the outcome, we remind investors to avoid complacency and expect volatility to resurface so long as issues related to the withdrawal agreement remain unresolved. More broadly, our take is that the recent rallies in global equities are part of a bottoming process. Parliament's votes this week and hope for an eventual deal support these rallies. History suggests, however, that confidence needs some time to recover from the damage done during the recent sell-off. While confidence recovers, a retest of recent equity market lows still remains possible. We believe investors should be mentally prepared to take advantage of such a scenario. Any news from Great Britain that raises the probability of a no-deal Brexit could delay progress or set back confidence in the recovery.

Looking ahead, we still expect the S&P 500 Index at year-end to be roughly another seven percent higher (at 2,800) from its current level. In the interim, investors should, in general, avoid getting carried away with the current equity market momentum, and in particular, avoid premature conclusions about a Brexit outcome. For now, we favor patiently managing expectations, and vigilantly maintaining allocations in line with the portfolio's investment objective and our recent guidance.

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