Great Britain made global headlines in 2016 when its citizens voted to leave the European Union and operate as a completely independent nation. Buzz around "Brexit" has quieted in the years since, but the March 29, 2019, deadline to leave the EU is approaching fast, and there still aren't trade agreements or an economic plan in place to facilitate a smooth transition.

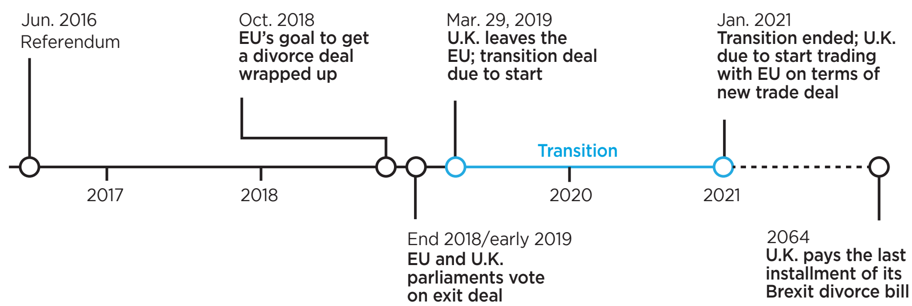
AS BREXIT DEADLINE NEARS, FINANCIAL QUESTIONS REMAIN UNANSWERED

Overview

The result of the 2016 referendum was so unexpected that then-Prime Minister David Cameron opted to resign. His replacement, Theresa May, has yet to successfully pass a plan through Parliament that will help the country move forward with its newfound independence.

The uncertainty surrounding the split has been considerably disruptive — for the U.K. government, for businesses, for British citizens and immigrant residents. The country's economy has suffered immensely in terms of lost investment and global influence. In less than three years, Great Britain has slipped from one of the fastest-growing G7 economies to one of the slowest.[1]

Key Brexit Dates[2]



The country now faces three possible options moving forward:[3]

- A "soft" exit would keep key customs agreements intact and reduce the overall negative economic impact.
- A "hard" exit would keep the U.K. "half and half" in the EU with a renegotiated trade deal.
- A "no deal" Brexit means when Britain withdraws from the EU, it will have no trade or regulatory agreements. This option would place the greatest strain on Britain's financial sector and stock market, disrupting contracts, international financial flows and deteriorate confidence in the global economy.

Financial Sector

If Britain works out trade agreements with EU countries by the March transition deadline (or conducts a second referendum vote resulting in Great Britain remaining a part of the EU), the continuity would be positive for global stock markets.

While leaving the EU without a transition plan would generate some volatility, there are actually some positive factors that may help mitigate the damage. First of all, the U.K. stock market is dominated by multinational corporations. Since approximately 70 percent of these companies receive their revenues from abroad, they are somewhat insulated from the worst impact of a market decline. Even if the British pound suffers a further decline in value, foreign-earned revenues will prove move valuable in the home currency. Second, London is largely considered the financial hub of the world, and almost 20 percent of the British stock market is comprised of financial securities.[4]

While some banks have proactively initiated plans to expand branch operations in other major European cities, London's widespread dominance will help cushion the impact of these moves. To date, JPMorgan, Goldman Sachs, Citigroup and Morgan Stanley have announced they will make their offices in Frankfurt, Germany, their mainstay hub in the EU.[5] Bank of America/Merrill Lynch selected Paris as its EU hub, and HSBC is moving a handful of its subsidiaries and branches from London to France, but says it has no plans to move its headquarters out of London. Most bank moves are largely being made to accommodate EU customers, while London offices will remain in place for now.[6]

Assuming negotiations improve as the transition date approaches, the markets could respond in the following ways:[7]

- If the value of the pound increases, this will likely drive down global large caps while supporting domestic mid caps.
- The U.K. continues to have the highest dividend yield among the world's largest markets.
- A favorable trade agreement could improve European stocks prices by reducing their equity risk premium and attract more investment capital.
- Note that while the U.K. lost about $8 billion in equity outflows over the past year, the U.S., Japanese and emerging-market stocks have benefitted with increased inflows. As such, U.K. stocks look cheap in comparison and would become extremely attractive to foreign investors should Britain pull out of the Brexit scenario with a positive outcome.

Economy

One reason the stock market is impacted by the ongoing uncertainty is British companies have the difficult task of trying to plan for the future. The lack of a three- to five-year spending and growth strategy has handicapped investments and reduced capital lending. Ongoing trade disputes make it difficult to plan for tariff and trade expenses, not just with European countries, but with the U.S. and other countries across the globe.

According to a midyear forecast by the Bank of England, GDP was expected to land at 1.4 percent in 2018 (down from 1.7 percent in 2017), with a pickup to 1.8 percent in 2019 — assuming a smooth exit from the EU.[8]

Trade Agreements

In the past, American investment in the U.K. — valued at £487 billion in 2015 — has been largely predicated on the country's EU membership and access to those countries as a single market. When Britain leaves the EU, expect that to change going forward.[9]

While Britain would forge a trade deal directly with the United States, it will clearly be fraught with limitations that negatively impact the U.K. more than the U.S. With the Trump administration bearing down on all of its global trade agreements, Prime Minister May is already in a weak negotiating position, and loss of EU leverage does not bode well for the standalone nation.

The EU will likely remain the largest, wealthiest and most important foreign market to U.S. companies even without Great Britain. As such, the U.S. will benefit more from an aggressive trade agreement with the remaining EU, a prospect that has been met with some trepidation by EU leaders.[10]

Brexit will also negatively impact U.S. businesses, at least initially, because Britain has traditionally been the principal gateway to Europe. In addition to language and cultural traditions familiar to the U.S., London serves as a geographical first air travel stop as well as guide for European public policy and business issues involving intelligence and security, trade, transportation, data connectivity and financial services.[11]

"We're concerned that a hard Brexit would have an immediate and significant impact on the global financial system, including U.S. banks, which account for between 40 to 60 percent of activity in the global derivatives markets."
- J. Christopher Giancarlo, chairman of the U.S. Commodity Futures Trading Commission[12]

Final Thoughts

Despite problems associated with Great Britain's exit from the European Union, this does appear to be the course set for this spring. While some political leaders have called for a second referendum to let voters decide if leaving is still the right course, Prime Minister May indicated she won't call for a second vote — as it is up to the government to honor the first vote regardless of the complexity of the ensuing process.

May has a draft agreement scheduled to be voted on by Parliament in January. This bridge agreement maintains the U.K. should remain part of EU's single market, subject to its laws and regulations, until the end of 2020.[13]

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