GREENLEAF TRUST

Perspectives

FEBRUARY 2019
VOLUME 28, ISSUE 2

Brexit: Where Are We Now?

Lucas W. Mansberger, CFA®, CAIA®
Investment Strategist
Senior Manager Selection Analyst

On January 15, the UK Parliament voted overwhelmingly to reject a plan presented by Prime Minister Theresa May outlining terms of the UK's exit from the European Union. This action heightened the uncertainty of the Brexit outcomes and increased the possibility of a "hard" or un-negotiated Brexit. The rejection of May's plan had negative impacts on markets, and UK stocks and the pound Sterling continue to price in significant uncertainty for the UK.

Where does the UK Parliament's rejection of Prime Minister May's plan leave the Brexit negotiations, and what does this mean for Greenleaf Trust clients' international equity exposure? Below, we offer an overview of the current status of Brexit and how Greenleaf Trust's portfolios are managed.

> "Where does the UK Parliament's rejection of Prime Minister May's plan leave the Brexit negotiations[?]"

Brexit: Overview and Current Status

In June 2016, the United Kingdom held a referendum on whether the country should leave or remain in the EU. In a surprise outcome, the "Leave" vote defeated the "Stay" vote 52% to 48%. After a period of review and analysis of the outcome, on March 29, 2017, UK Prime Minister Teresa May triggered Article 50 of the Treaty of Lisbon. According to the Article, the UK and the EU had two years from the time the article was triggered to negotiate the terms of the UK's exit, meaning that a deal needs to be finalized by March 29, 2019.

With Prime Minister May's negotiated deal with the EU rejected by the UK Parliament, the UK approaches the March 29 Article 50 deadline with no clear direction. Broadly speaking, there are four paths that the country could take, as follows.

A "No deal" or "hard" exit

If the UK Parliament cannot approve any deal negotiated between May and the EU by 3/29, then the UK will simply leave the EU. Of the many abrupt changes to the relationship between the UK and the EU that would occur under this scenario, their trade relationship would revert to WTO rules, which are much

For additional analysis of Brexit and its implications, interested readers may refer to three articles previously published in these pages authored by John Graham, a long-time friend of Greenleaf Trust specializing in foreign economic and financial markets. John was a founding member of Rogge Global Partners headquartered in Great Britain and former head of JP Morgan's Multicurrency Asset Management Practice in London.

Brexit: Will the United Kingdom Leave Europe?
https://greenleaftrust.com/wp-content/uploads/2016/03/Perspectives-March-2016.pdf

Brexit: An Emerging Reality
https://greenleaftrust.com/wp-content/uploads/2016/07/Perspectives-July-2016.pdf

Populism in Europe – European Elections 2017
https://greenleaftrust.com/wp-content/uploads/2017/02/0217-Perspectives-February-2017.pdf

less favorable. More immediately, no arrangement will exist for the movement of goods and services between the UK and the EU. This might well lead to severe disruption of trade including but not excepting shortages of certain food stuffs, transport disruption at airports and ports, and impediments to the movement of goods between the two economic blocs. This is considered to be the worst case outcome and would create significant volatility in UK and European markets.

> "UK and Eurozone equity markets will continue to operate with an underlying sense of uncertainty, and will be buffeted periodically by news related to Brexit negotiations in the coming months, until a definitive outcome presents itself."

New negotiated or "soft" exit before 3/29 deadline

Prime Minister May's government is currently working to negotiate a new deal with the EU that could be brought to the UK Parliament for approval prior to the 3/29 deadline. However, this outcome appears unlikely. Not only has the EU taken a hard line on the deal that was struck previously, but the UK Parliament has a number of competing bills related to Brexit currently under consideration, making it difficult to evaluate, reconcile, and pass the bills prior to the deadline.

Extension of the Article 50 deadline beyond 3/29

This would allow the EU and the UK to continue to work on a negotiated exit. Increasingly, this outcome appears to be viewed by market participants as the most likely outcome, with the pound strengthening against other currencies through the time of this writing (1/31). However, there is considerable disagreement on the likely terms of such an extension, including on its length.

Second referendum on Brexit

Polls today suggest that a majority of the UK citizenry would vote in favor of remaining in the EU if a new referendum were held. However, the majority Labour government has remained committed to implementing the results of the original referendum and many "Leave" proponents remain staunchly opposed to revisiting the referendum. If this were to occur, markets would likely respond favorably.

As our friend John Graham observed in his Brexit article in these pages back in July 2016 (just after the original referendum), markets dislike uncertainty and reflect high uncertainty with heightened volatility. Given the considerable uncertainty in the Brexit negotiations, it is likely that heightened volatility will continue at least through the March 29 Article 50 deadline, and possibly for months (or even years) afterwards should negotiations be extended that long.

UK Positioning in Greenleaf Trust Portfolios

Greenleaf Trust uses external managers to access non-US equity markets. Our current recommendation includes three funds which are diversified by investment style, investment philosophy and approaches to portfolio management and construction, specifically:

- Hartford International Opportunities Fund
- Fidelity Advisor® Diversified International Fund
- American Beacon International Equity Fund

One of the primary benefits of this multi-manager approach is that the recommendation reflects a variety of viewpoints and analyses from differing firms, helping to mitigate risk. Below, we offer a summary of the viewpoints and the portfolio positioning of the underlying managers with respect to Brexit.

Hartford:

According to Wellington (subadvisor to Hartford), a "hard Brexit would be awful for the UK and bad for Europe. Because of that, it is in no one's interests to go that route. We expect some type of soft Brexit which would benefit UK assets." The firm notes that the pound Sterling moved higher after Parliament rejected May's deal on January 15, reflecting some increased optimism that a "no deal" scenario could be avoided.

Fidelity:

This team stated that they try to remain humble in predicting outcomes when it comes to political activity, as the failures of many pollsters and political strategists in recent years regarding Brexit show that it is very difficult to do so accurately. They believe that nobody has a very good sense for the most likely outcome, and note that the UK Parliament vote against May's deal made the potential for a disorderly exit from the EU much more real.

American Beacon:

Franklin Templeton (one of three subadvisors to this fund) argues that the "most realistic" option for the UK is to ask for an extension of Article 50, though they note that the EU has clearly indicated that they will not agree to an extension simply to allow more time for negotiations.

UK Portfolio Positioning

To put things in perspective, a typical Greenleaf Trust client portfolio with a 60% allocation to global equities would hold less than 2% in UK-domiciled stocks on average. This modest exposure is composed of dozens of companies selected for differing reasons by our developed international fund managers. All three of our currently recommended fund managers employ bottom up security selection supported by fundamental research. In other words, our managers are not betting on Brexit outcomes, but seek to own high quality companies with sustainable competitive advantages and strong management teams.

"To put things in perspective, a typical Greenleaf Trust client portfolio with a 60% allocation to global equities would hold less than 2% in UK-domiciled stocks on average."

Summary

Another trenchant observation John Graham made in his 2016 article was that negotiations over Brexit could extend well into 2019 given the history of the EU making decisions in the "25th hour." Unfortunately, this approach to decision making means that UK and Eurozone equity markets will continue to operate with an underlying sense of uncertainty, and will be buffeted periodically by news related to Brexit negotiations in the coming months, until a definitive outcome presents itself. As for Greenleaf Trust clients, they can be assured that the effects of the resulting volatility will be managed and mitigated within their portfolios through proper allocation sizing, prudent diversification, and the dynamic positioning of their underlying managers.