Investment Service

The Fry Group

Brexit, the Certainty of Uncertainty

November 2018

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Even by the standards of the extreme political melodrama that has consumed the UK in recent years, the events of past days have been quite extraordinary. In the last few days, the Cabinet has debated for five hours a 500 plus page draft European Union Withdrawal Agreement. The Cabinet approved this draft late on Wednesday. The next round of political fallout started the following morning. Dominic Raab, the UK's Brexit Secretary, who led the Brexit negotiations resigned. Subsequently, two senior ministers resigned, and the press is speculating that further resignations are pending.

The UK Prime Minister is meanwhile witnessing her authority implode as cabinet discipline collapses. Mrs May now faces a potential leadership election. The prospect of parliamentary approval of the by-then finalised agreement looks much diminished at this point.

Mrs May will hope that Remain supporters within the Tory and Labour Parties will ride to her rescue and vote the deal through Parliament. Given the aversion of the many to a “No Deal” outcome, what is left is a choice between this agreement, a general election or a second referendum. Like their Brexit colleagues, they may instead choose to vote the deal through than face the electorate.

So how are matters likely to play out if as appears likely there is insufficient support in the House of Commons to approve the settlement? First, the special EU Council summit on November 25 is still expected to happen but with a focus on “No Deal” contingency planning by members. What alternative is on the table is very much down to the UK side to determine. It is unlikely Mrs May will put the agreement to an EU vote if there is a high probability of defeat, so the summit may have to focus on a request to stop the clock on the negotiations or more formally a request to grant an extension to Article 50 negotiations.

A reworking of the current withdrawal draft seems unlikely, but interest may turn to a Norway type arrangement that would see the UK remain in the European Economic Area for a time with a temporary customs union added on. Such an agreement would give businesses some greater certainty, but no more clarity in the longer term. Such a scenario would allow sterling to recover lost ground under this arrangement, but it would likely peter out after a time.

The other option would be for the government to offer to append a clause in the approval bill that would allow for final agreement via a referendum. This still looks a long shot. It would have to be supported by the EU, but it may be enough to get backing from Labour and other opposition parties. The main casualty would be Tory party unity, which is coming under increasing scrutiny. Sterling would again benefit though volatility would spike as uncertainty around the eventual result builds.

The least favourable outcome for sterling is the government losing a confidence vote. However, this may be a less likely outcome before March 29, 2019. Under the Fixed Term Parliament Act this could lead to a general election. A significant rift between the government and the Democratic Unionist Party would make this more likely if they rejected the agreement. In a general election there is a realistic chance of a Corbyn government (even if Brexit is lost). Such an outcome could see sterling tumble to the levels lower than that following the referendum in 2016.

Throughout the entire Brexit process, both pre- and post-referendum, sterling price action has been the main barometer of the risk assessed by the markets. Sterling volatility has fed through to equity prices and therefore it should be no surprise that weaker sterling caused by increased uncertainty has led the FTSE100 large cap stocks to outperform more domestically focused small to mid-cap stocks in the short term, similar to the behaviour immediately post the referendum result. As the latest political drama plays out, expect heightened sterling volatility to continue until some of the uncertainty has been removed.

If you would like to discuss any of this or your own personal financial planning in more detail, or have any feedback regarding this update, please contact your dedicated Fry Group Financial Adviser.

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