A Closer Look

Brexit: No Easy Answers

In Brief

- The U.K.’s deadline to arrange terms of its exit (or Brexit) from the European Union (EU) has been pushed back to October 31.

- We see a few specific issues, including trade, citizens’ rights, and the Irish border, as likely to provide clues in the coming months to the potential outcome of these broader negotiations.

- Overall, we remain very comfortable underweight U.K. and European assets in our portfolios, in part as Brexit uncertainty should act as a limit to economic growth.

Why is it so hard to find an acceptable Brexit Deal? Because any Brexit entails a choice: Either distance U.K. from EU (outside currency union and single market) taking a huge economic hit, or stay close (in currency union and single market) but following rules that we no longer have a say on. Neither is good for Great Britain.


Nearly three years after the pivotal U.K. referendum to leave the European Union (EU), the Brexit saga continues. There have been numerous failed votes in the U.K. Parliament to move closer to a deal, with little visible progress in negotiations between the Remain and Leave sides of the aisle.

The above quote by Richard Corbett, leader of the Labour Party in the European Parliament, highlights the difficulty of the situation. The U.K. is likely to take a significant economic hit leaving the EU and face potentially years of uncertainty as new trade and other frameworks have to be established. However, remaining within the EU, with perceptions of loss of sovereignty, is also unattractive to many. Corbett himself was once a “strong Brexiteer” in favor of leaving but concedes now that British leadership “must swallow [their] pride and think again.” As things stand, the only deal that has been finalized is the extension of Brexit talks to October 31.

While nothing has structurally changed since the 2016 Brexit referendum, we still closely follow developments on this front for at least two reasons. First, the possibility of an exit without a transition deal, while a very small risk in our view, would be material for global markets should it occur. Second, sentiment toward both the U.K. and also the broader European economy will continue to be influenced by Brexit negotiations. A sudden change for the U.K. could influence how much exposure we want to the country and region in client portfolios (we are currently very underweight both the U.K. and euro area). This A Closer Look recaps Brexit developments so far and discusses key unresolved issues, the latter likely to influence sentiment toward European and U.K. assets in the months ahead.

Kicking the Can Down the Road

Even without Brexit, the referendum outcome and subsequent uncertainty have taken a toll on British markets and politics. The pound immediately weakened against most major currencies, and local government bond yields declined following the referendum. Since then, the Bank of England has raised policy rates twice to support the currency and stem inflation, even though such monetary tightening will worsen an already materially downgraded growth outlook.
Meanwhile, British Prime Minister David Cameron resigned after the Brexit vote, and was replaced in July 2016 by Theresa May. As prime minister, she began the process of withdrawing the U.K. from the EU in March 2017. Triggering Article 50 of the Treaty of the European Union started a clock that meant the U.K. would leave the EU two years from that day. (As we know now, that deadline has been pushed back to October).

In an effort to bridge the gap between the U.K. being a member of the EU and a completely separate entity, the U.K. and EU governing bodies have tried to come to terms on a transition deal. To accomplish this, May and the EU agreed on a withdrawal agreement in October 2018, but it was rejected by Parliament in January 2019 and twice again in March (by large margins each time). May went so far as to announce that she would resign as the leader of the Conservative Party and prime minister if Parliament passed her agreement. With no additional progress, the EU extended the deadline to October 31 in an emergency session.

It comes as no surprise that the public is not impressed with how the government is handling talks with the EU. According to YouGov polls, the percent of British individuals saying talks are going badly has been steadily increasing since last year and is now at 86% (Exhibit 1).

Exhibit 1: Opinion Poll on the U.K. Government’s Performance on Brexit Negotiations

Key Takeaway: A large and increasing majority of U.K. citizens believe the Brexit negotiations are going poorly.

What Will It Take to See a Brexit Deal?

The inability of the U.K. to make progress on Brexit revolves around three central issues, in our opinion: trade, the Irish border, and citizens’ rights. Below we discuss each issue in an effort to put context around potential headlines this summer and fall that should, in turn, help assess the likelihood of a broader deal.

Trade. Brexit supporters have been vocal about their desire for the U.K. to operate as a separate entity from the EU, with distinct customs rules and border controls. That said, they have also expressed a desire to effectively have a free flow of goods and services with the rest of Europe. The EU has taken a firm stand that the U.K. cannot have it all. (Countries such as Switzerland and Norway, in order to have special trading relationships with the EU, must comply with EU’s free movement of people and with EU regulations.)

While the U.K. has to decide what concessions it will make to keep free trade with the EU, it also has to face agreeing on hundreds of trade details in what could be a very tight timeframe. While deadlines can be extended, in theory the U.K. only has until December 2020 to negotiate its trade agreement. Our expectation is that the U.K. will need to compromise, given its reliance on trade with the EU (nearly 45% of total exports). That may require the U.K. to accept some form of free flow of people and EU regulation in a final trade deal.

The Irish border. One of the most contentious Brexit issues revolves around the relationship between Northern Ireland and the Republic of Ireland. Northern Ireland, part of the U.K., and the Republic of Ireland, an independent country and EU member, share a physical border — along with centuries of political and religious strife. Since the U.K. is currently a member of the EU, the two nations (Ireland and Northern Ireland) operate as one in many ways — there is no hard border (i.e., physical borders or customs checkpoints), and there is a free flow of people. A key tenet of Brexit is for the U.K. to leave the EU’s customs union and the single market (discussed above). However, a majority of citizens in both Northern Ireland and the Republic of Ireland would prefer to keep the status quo in terms of free trade and movement, including across Ireland.
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The EU has proposed a so-called backstop to maintain open trade, applying only to Northern Ireland, while other negotiations continue. The view is that such a backstop is needed to maintain stability in Ireland after the U.K. leaves the EU and as other trade negotiations occur (Exhibit 2). Note that no such trade negotiations can commence until after the U.K. leaves the EU, potentially leaving Ireland vulnerable during this period. This proposition states that Northern Ireland will remain in the EU customs union and in large parts of the single market, as well as within the EU value-added tax (VAT) system, until further trade negotiations are finished.

Brexit supporters do not support an Irish backstop; they do not want any portion of the U.K. to remain subject to EU rules and do not want Northern Ireland to operate as a separate entity from the rest of the U.K. This camp also fears that the backstop could weaken the U.K.’s leverage elsewhere in Brexit negotiations. Prime Minister May, however, has included a backstop in her proposal, a detail that has contributed to her proposals being rejected multiple times in Parliament.

We have a difficult time envisioning a Brexit deal that does not include an Irish backstop. A hard physical border would be met with significant backlash on both sides of the border, due to the likely hit to respective economies but also the greater risk of political and social tensions. Should the pro-Brexit camp make this a nonnegotiable point, we believe a hard Brexit that is more disruptive to the U.K. and European economies and financial markets would become more likely.

Citizens’ rights. While May’s transition agreement would leave the U.K. subject to all EU rules and regulations in order to receive the benefits of being a member, it would give up EU voting rights. Put another way, the U.K. would no longer have influence over future EU rules and regulations in a lot of areas, including pensions, healthcare, and employment. This has angered members of both the Leave and Remain camps and left a lot of EU citizens feeling anxious. More than 3.4 million EU citizens reside in the U.K., and 1.3 million U.K. citizens reside in the EU. It would be complicated to protect the rights of these people in the event of Brexit. We believe the U.K. and EU will need to negotiate a deal that allows citizens currently residing in the counterpart region to have the opportunity to stay there — they will be “grandfathered in.” A deal that does not include this provision will likely be met with significant political backlash.

Overall, we believe progress on any of these three main issues would be a positive sign that the two sides may reach a deal to avert a hard Brexit on October 31. However, there is a long way to go. In the last several months, the U.K. Parliament could not generate enough support for even a single indicative (nonbinding) vote. We believe the most likely outcome is that political unease compounds in the coming months, potentially triggering a change in government. Even then, it is unclear to us if this new government would have a much higher probability of success resolving all three issues quickly.

Political Unease in the U.K. and Beyond

The improbability of striking a near-term Brexit deal is likely to put strain on an already tenuous outlook for the U.K. Parliament. May’s Conservatives are governing from a minority position, and many
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members of her party do not support her withdrawal agreement. The prime minister barely survived a confidence vote in January (325 to 306) after her withdrawal agreement failed to gain sufficient support the first time lawmakers voted on it.

A possible outcome is that another government is formed during this interim period if no progress is made. While another no-confidence vote cannot take place until December 2019 under party rules, it is possible May would step down. A full political analysis of the U.K. parties is beyond the scope of this note, but we highlight that there would be additional implications for markets if the Labour Party manages to control Parliament given risks around major changes to taxation and other rules that would likely impact the country’s economic outlook.

Another complicating factor in the Brexit debate is that elections for the EU Parliament will occur May 23. EU parliamentary elections take place every five years. The number of seats per member country is based on relative population size, and there are currently 751 seats in total. Given that the U.K. is still a member of the EU, it has no choice but to participate in the elections, selecting its 73 allotted representatives. In both the U.K. and across the EU, Euroskeptic parties, such as the newly formed Brexit Party, are expected to gain seats in the EU Parliament this month. Exhibit 3 highlights current projections, which suggest that Euroskeptic parties will have a larger share of seats in Parliament than ever before, especially with the U.K.’s participation.

This is the main reason why EU elections, which are normally a nonevent from a market perspective, are gaining more attention this year than in the past. More Euroskeptic parties in Parliament may change the dynamics of Brexit negotiations and also increase the risk of developments, or just headlines, that question the long-term prospects for further European integration and reform.

Despite the growth in Euroskepticism, the one benefit to Brexit from the perspective of the EU is that it has served as an example to other nations of the difficulty of exiting the bloc. For instance, Italy’s populist government has been vocal about its issues with the EU, but there have been no plans to call a referendum on EU membership. There have been calls from groups within other nations, such as France, to exit the EU. However, in total, since the U.K. referendum in 2016, there has been a slight uptick in the net share of surveyed individuals who would vote to stay in the EU across the region (Exhibit 4).

Exhibit 3: EU Parliament by Two-Party Coalition

Key Takeaway: There is likely to be an increase of Euroskeptic representatives in EU Parliament following this month’s elections.
Business Planning in an Uncertain World

As expected, the high level of uncertainty has weighed on the region economically in recent years, with the U.K. bearing the brunt of it. Consumer confidence declined following the Brexit vote and remains subdued, with the outlook on economic growth in the coming 12 months now around levels seen during the European debt crisis of 2011. Real GDP growth has remained sluggish, trending slightly downward from over 2% prior to the Brexit vote to 1.3% in the fourth quarter of 2018. Both headline and core inflation measured using the U.K.’s Consumer Price Index (CPI) increased following Brexit, partially due to sterling’s depreciation. The rise in inflation was a key reason that the Bank of England raised policy rates twice since the Brexit vote. Even as the U.K. has seen GDP growth emerge from recessionary levels in this cycle, business investment has remained modest, likely due at least in part to the uncertainty around Brexit. Exhibit 5 shows that the rebound in business investment that ensued following the 2008 recession plateaued at lower levels versus historical examples around the timing of the referendum. We see this trend in anecdotal news as well. Honda Motor Co. announced it will close a major production plant in the U.K., citing Brexit uncertainty as the rationale. This plant employs 3,500 workers. Nissan Motor also announced that it has forgone plans to produce a crossover sport-utility vehicle in the U.K., and Ford Motor is examining whether or not to continue manufacturing parts in the U.K. It is difficult for companies to justify large, forward-looking expenditures without clarity on how the trade and economic landscape will evolve in the coming years.

London’s reputation as one of the global financial capitals is also at risk for similar reasons. Barclays has web pages dedicated to Brexit outlining how the company is planning to adjust to the new economic environment. The bank has expanded its subsidiary Barclays Bank of Ireland, which will become the new entity servicing EU clients if Brexit results in a loss of market access for the U.K. Bank of America has announced that Dublin is now its new headquarters for European banking. Other major banks such as Goldman Sachs, Citigroup, and JPMorgan have announced that they plan to move some staff to continental Europe. Insurance companies AIG

Exhibit 4: Survey of Individuals on How They Would Vote on a Referendum on Their Country’s Membership in the EU

Key Takeaway: Since the Brexit referendum and ensuing uncertainty, there has been a slight uptick in the number of individuals across the EU who would vote to remain.

Exhibit 5: Cumulative Growth in Business Investment from the Start of a Recession to the Next Recession

Key Takeaway: Business investment in the U.K. is lower than historical levels at this stage of the business cycle, as Brexit uncertainty has lowered business confidence.
and Liberty Mutual have moved their European headquarters to Luxembourg in preparation for Brexit. Ernst & Young (EY) also announced it is shifting its headquarters to Brussels from London. According to results from the EY Financial Services Brexit Tracker through March 2019, 23 financial services companies have publicly declared that they are transferring assets out of the U.K. to another EU nation, as many as 7,000 jobs could be relocated to the EU, and Dublin remains the top place to relocate operations, followed by Frankfurt, Luxembourg, and Paris (Exhibit 6).

Financial Markets: Once Burned, Twice Shy

U.K. financial markets have failed to recover from the declines experienced around the Brexit vote in 2016. The British pound saw the steepest decline following the referendum. It is now cumulatively over 12% lower from its levels prior to the vote. Specifically, it moved from 1.49 on June 23 to as low as 1.20 by January 2017 and is currently trading around 1.28 versus the dollar. U.K. government bond yields have been under pressure following the Brexit vote as well. The 10-year yield fell from 1.37% on June 23, 2016, to 0.52% by August 12. Since then, and amid two Bank of England rate hikes, the yield has risen to over 1%, but this level is among the lowest seen in decades. Equity markets have been volatile as well, and despite significant rebounds, they have lagged the markets of other regions. Inclusive of the initial steep declines around the Brexit vote, the FTSE 100 has gained 16% in local currency terms but only 3% in U.S. dollars, which incorporates the currency effect mentioned above. In comparison, the S&P 500 is up 39% cumulatively over the same time period (Exhibit 7).

We believe that much of the bad news surrounding Brexit has been priced into financial markets, but it will be difficult to see significant outperformance absent a comprehensive, “soft Brexit” deal being struck. The tail event of a hard Brexit, while a relatively low probability, would have such negative ramifications that investors would be shy to add meaningful risk in the region. This year, the FTSE 100 is underperforming most other developed markets. We expect more volatility to ensue as developments in the coming months highlight how difficult negotiations will be. Meanwhile, we expect bond yields to remain low and the pound sterling to remain weak as growth prospects are subdued.

Exhibit 6: A Sampling of Companies Adjusting or Planning to Adjust Operations in Light of Brexit

As of May 8, 2019.
Source: Company news reports

Exhibit 7: U.K. Equities Versus Other Developed Market Equities

Key Takeaway: U.K. equities have trailed their developed market counterparts since the onset of Brexit.
Another Brexit Referendum?

Given the stalemate in Parliament, some U.K. politicians have called for another Brexit referendum, and pundits have postulated whether this might be the best approach. While not impossible, we believe this is unlikely as the path to a new referendum is complicated politically and legally. In order for another referendum to occur, Parliament would need to pass legislation that would stipulate the rules and regulations behind the vote and campaign. There is currently not nearly enough traction to have a majority in favor of a second referendum. Some members of Parliament feel so strongly that a second referendum is not the best way forward that they have formed a party based only on this specific issue — the Brexit Party led by former U.K. Independence Party leader Nigel Farage.

Additionally, the U.K. now has less than six months to prevent a hard Brexit, and it took Parliament six months just to pass the legislation that allowed the original June 23 vote to take place. Moreover, while U.K. polls have proved to be imperfect predictors of the final vote, a recent poll suggests that a new referendum may not generate a different outcome (Exhibit 8). Only 6% of the surveyed individuals said that they would change their vote if they could. The percent of those who voted to leave is just negligibly higher at 7%.

Exhibit 8: Percent of Surveyed Individuals Asking if They are More or Less Sure on How They Voted in the 2016 Referendum

Key Takeaway: Polls suggest the outcome of a second Brexit referendum may not be different from the initial vote to leave the EU.

Positioning Around Brexit

Leading up to Brexit, Bessemer mandates were underweight the U.K. markets and the pound within our equity mandates, with positions at about half of the benchmark weight. This underweight positioning has naturally become more significant as other markets — notably the U.S., where the mandates have a large overweight — have outperformed over this period. As of April 30, the U.K. exposure within equities is 2% versus the benchmark at 5% (Exhibit 9). At this moment, we do not envision increasing our exposure to U.K. assets. Bessemer’s emphasis on capital preservation and the uncertainty in the outlook discussed above do not suggest to us there is good risk/reward in adding exposure to the U.K.

More generally, Bessemer mandates have also maintained a significant underweight to developed Europe equities and the euro. While Brexit uncertainty is a contributing factor, our positioning also reflects a view that a structurally slowing China will impact Europe more than the U.S., that political uncertainty
Exhibit 9: All Equity Mandate Versus Benchmark Regional Weightings

Key Takeaway: Bessemer equity mandates hold little exposure to U.K. equities and significantly less than the benchmark.

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<th>Bessemer All Equity</th>
<th>All Equity Benchmark</th>
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<tr>
<td>Emerging Markets 10%</td>
<td>Emerging Markets 11%</td>
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<tr>
<td>Other Developed Markets 5%</td>
<td>Other Developed Markets 7%</td>
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<tr>
<td>U.K. 2%</td>
<td>U.K. 5%</td>
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<tr>
<td>Developed Europe ex U.K. 6%</td>
<td>Developed Europe ex U.K. 14%</td>
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<tr>
<td>Cash 2%</td>
<td>Japan 8%</td>
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<td>U.S. 72%</td>
<td>U.S. 55%</td>
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As of April 30, 2019.
Source: Bessemer Trust, MSCI

in a number of European countries (including Italy) will limit investor enthusiasm for regional assets, and that the European Central Bank (ECB) is lacking the necessary tools to quickly and effectively fight sluggish growth and disinflationary trends. Where the mandates do have exposure in Europe, it is through actively managed strategies where portfolio managers identify attractive company prospects that may be more exposed to non-European revenues in many cases, even if they are domiciled in Europe.
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