Brexit Means Brexit… *But We Still Don't Know What It Means*

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> *"Brexit means Brexit."* – British Prime Minister Theresa May, July 11, 2016 (and repeated numerous times since).

It sounded so simple, but to any observer it was anything but. So here we are in the late stages of this tortuous saga when anything is still possible.

Three potential market outcomes

1. **A no-deal Brexit.** A scenario in which the U.K. crashes out of the European Union (EU) is the most damaging. This would cause disruption to supply chains throughout Europe and negatively affect economic activity. The U.K. could also experience a severe recession. Even though the U.K. parliament recently voted against a no-deal Brexit, it doesn't mean this option isn't possible, particularly if no alternative is found. In fact, it is currently the default option.

2. **May's deal** (*see below*). This would be mildly positive for markets as it removes uncertainty. However, this is now off the table as the speaker of the House announced he won't bring May's deal back to the floor of the house.

3. **A "customs union".** This arrangement would keep goods in European supply chains moving tariff-free in and out of the U.K. An EU or a Norway type of deal could be positive for markets.

Theresa May's deal was signed after two years of negotiations with the EU but hasn't been ratified by the U.K. parliament – despite two attempts – because of the "Irish backstop*". (*See an explanation below*). A third attempt is possible this week if May can get more conservatives on board as well as the Democratic Unionist Party (DUP), the minority Northern Irish party holding the balance of power. The chances of passage on the third attempt are low and now unlikely with the speaker refusing to bring the vote to the floor.

The result? May has declared that failure to pass her deal would result in asking for a long delay (possibly two years) in leaving the EU. As things stand, the U.K. is set to leave the EU at midnight on March 29.

The problem with the extension

There are several complications with any extension that requires the unanimous agreement of all EU governments, but a long extension is problematic.

The first issue is that the U.K. would have to participate in the European elections scheduled for the third week in May of this year. All European citizens are required to have a vote and if the UK is still a member of the EU at that date, then a vote will need to be scheduled.

Most European governments would rather the U.K. not participate and the same can be said for most Brits, who in Signature's view are increasingly frustrated with their politicians and their inability to get on with the process.

European governments are concerned that a long delay would continue to eat up valuable resources on this ongoing issue and probably empower the radical elements in the European elections not just in Europe but the U.K. itself, possibly shifting the balance of power in the forthcoming European parliament.

The French will be resistant to any lengthy extension while the Germans are more open to the idea. Opinions on the short or long extension are divided.

A long extension increases the chances of another Brexit vote, or possibly no Brexit, which may prompt a positive market reaction. Politically in both the U.K. and the EU, the risk of further empowering radical elements could increase, creating greater uncertainty. France's "yellow vest" protesters are a perennial headache for the French government and it will try and avoid anything that might further motivate their cause.

What happens if the EU only agrees to a short extension?

A short extension would last until the May European vote or possibly June, when the new EU parliament sits, so that the U.K. avoids going to the polls. This is where the risks for markets could rise, at least initially given the short and strict deadline. It may also allow the U.K. parliament to finally take control and discover what U.K. MPs can agree on with respect to Brexit.

It is likely under this scenario that May or MPs reach out to moderate forces, including Labour, and propose a "customs union" or Norway-type deal. A customs union is something

Labour has advocated for. It is believed that a customs union would garner the support of a parliamentary majority, but it has not yet been tested. It seems parliament has a responsibility to at least attempt it under a short time horizon.

Such a scenario could be positive for markets as it would be the least disruptive of all alternatives.
If this is the ultimate direction, there remain several situations to overcome and navigate, any one of which can send markets off in different directions. There is a European summit on March 21-22, when this is likely to be played out

Positioning
The European economy has been weakening for some time but is showing signs of stabilizing. We believe it will re-accelerate later this year providing a positive backdrop for equity prices. However, a no-deal Brexit would likely see a relapse towards weakness in Europe due to disruptions and a loss of confidence. We believe the U.K. will find a solution such as a customs union or Norway-type deal; however, a long delay is neutral in the short term to potentially negative in the medium term because the political repercussions could undermine confidence.

***Irish backstop**
Any agreement on Brexit requires the approval of all EU states. Northern Ireland – which is part of the U.K. – is of concern to existing EU member the Republic of Ireland. In 1998 the U.K., Ireland and Northern Ireland signed the Good Friday Agreement that agreed to a power-sharing deal in Northern Ireland between Protestants and Catholics, and several other measures including open borders between the Republic of Ireland and Northern Ireland. When the conservatives agreed to a referendum on Brexit, they ignored or chose to downplay the impact it could have on Ireland and the Good Friday Agreement since leaving the EU would technically mean putting borders back between Ireland and Northern Ireland.

The Irish backstop addresses this issue and recognizes the increasingly close economic and cultural ties between the Republic of Ireland and Northern Ireland. The backstop would only come into force under May's current agreement if (after the two-year transition period) a final agreement cannot be found. (Note that what is currently under debate in the U.K. is the divorce agreement with a road map to a final agreement. The two-year period to negotiate the final agreement would technically be called a customs union). If no agreement is found after two years, the backstop stipulates that Northern Ireland would remain part of the EU customs union, allowing Northern Ireland to trade freely with Ireland and avoid any borders. While Northern Ireland would remain part of the U.K., this would see it get one step closer to Ireland and the EU, leaving Northern Ireland isolated from the U.K.

One of the main criticisms of the backstop is that such an outcome would be unacceptable to the U.K., leaving it hostage to the EU and forcing the U.K. into an indefinite customs union with the EU.

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