Join the conversation: Brexit and financial markets

December 14, 2018

The deadline for the U.K. to leave the EU is March 29, 2019. Here's our London-based investment team's expertise on the topic.

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After 40 years of being an important part of the European Union, the U.K. voted to leave the EU in a decision commonly known as Brexit in June 2016. In a letter to the president of the European Commission, British Prime Minister Theresa May began the proceedings for Britain's departure by invoking Article 50 (a section in the European Union agreement that allows member countries to voluntarily leave).

"…the people of the United Kingdom voted to leave the European Union. As I have said before, that decision was no rejection of the values we share as fellow Europeans. Nor was it an attempt to do harm to the European Union or any of the remaining member states … We are leaving the European Union, but we are not leaving Europe — and we want to remain committed partners and allies to our friends across the continent."

Negotiations have been underway in the more than two years since the announcement. And with the exit date set for March 29, 2019, there continues to be uncertainty about the final outcome. Questions have come up about the outlook for Britain's economy, as well as the outlook of the wider European continent. People are unsure about the future of the European Union, and there are still several potential outcomes, including the possibility that the separation does not occur at all.

Examining the range of potential outcomes

While the invocation of Article 50 was a straightforward process, the aftermath has been anything but. The U.K. and EU have negotiated a withdrawal treaty that outlines the terms of their future relationship, but it has yet to be approved by British Parliament. The current issues are detailed below:

1. **The U.K.'s membership in the EU ends March 29, 2019:** The United Kingdom will cease being a member of the European Union after March 29, 2019 unless it submits an application to extend or revoke Article 50. According to a landmark European Court of Justice decision, Britain is free to revoke its decision to leave the EU without the unanimous consent of other EU member states.
2. **There's a transition period until December 31, 2020:** If the U.K. signs a withdrawal treaty — ratified by EU member countries — and passes what has been termed a

meaningful vote in the House of Commons, the U.K. will enter a transition period that's anticipated to last until December 31, 2020. During this transition period, the U.K. will have the same regulatory and treaty relationship to the EU as it does today, but it will no longer have a voice in the decisions the EU makes (such as decisions in the European Parliament, European Commission or regulatory agencies). The transition period will be used to negotiate the future relationship between the U.K. and EU.

3. **There are multiple options if a withdrawal treaty isn't approved:** If the British parliament doesn't approve the treaty, there will likely be three main paths open to the government:
   - Exit the EU without a transition period
   - Apply to withdraw the decision to leave the EU
   - Hold a "People's Vote" or second referendum in very short order and seek to apply the outcome
4. **Political leadership is uncertain:** British Prime Minister Theresa May's position as leader of the country and the Conservative Party has been a source of uncertainty. There was recently a vote to replace her as prime minister, but she was victorious and remains in her position. Under party rules, this can't be challenged again for a year.
5. **Interim elections could affect the likelihood of a withdrawal treaty approval:** Holding a general election doesn't change the Brexit options. But it may change the electoral balance in the House of Commons, and this would influence the country's decisions to accept or not accept the Withdrawal Treaty.
6. **Elections after the Brexit deadline would affect the negotiating period:** Holding a general election after March 29, 2019 could change the form of Brexit that's negotiated during the transition period, which concludes at the end of 2020.

Regardless of which political party or leader has control, they would likely face the same roadblocks and challenges as British Prime Minister Theresa May in drawing up a final proposal and navigating the negotiation period.

How an abrupt exit would impact economic growth and stocks

The immediate focus is whether the U.K. will begin a transition agreement on March 29, 2019 or if it will do what is being referred to as "crashing out" or exiting the EU without a transition agreement. While there appears to be broad consensus across the Houses of Parliament that they want to avoid this path, the question is: How significantly would it hurt financial markets? The International Monetary Fund (IMF) says this scenario could cost the U.K. almost 4% of GDP by 2030. With the United Kingdom ranking among the EU's three largest trading partners and accounting for 13% of trade in goods and services, the IMF also predicts that it would inflict economic damage on the EU, causing growth across the trading members to be 1.5% lower over the same period.

Some manufacturers like BMW have said they could be forced to close their U.K. operations if Brexit makes trading more difficult. Many larger U.K. stocks may be better sheltered from a no deal than their smaller competitors because they generate more of their earnings globally, outside the EU. Domestically focused U.K. shares, which have underperformed since the initial Brexit vote, are expected to be harder hit. Investors should expect U.K. stock markets to remain volatile.

Across Europe, we expect the effect on economic growth to negatively affect corporate profits. In the day following the U.K. referendum vote, European stock markets were hit hard, and the Pan-European STOXX 600 Index went down around 7% — partly because of fears that other EU countries could follow the U.K. out of Europe. But not all sectors and companies would be equally affected, and most market analysts believe that the negative impact on European stock markets will be less than that for U.K. equities.

Assessing the risk

While the prevailing view is that the U.K.'s departure from the EU will be negative for the economy in the long run, we could be missing the bigger picture with this fixation on Brexit. With the inversion of Treasury yield curves, increasing levels of government debt and continued geopolitical risks in the rest of the world, there are still a range of risks for investors to navigate while constructing suitable portfolios. Specifically, investors in European stocks should be aware of other risks, including increasing government debt in Italy, the impact of trade discussions from the U.S. and the impending end to quantitative easing from the European Central Bank. Brexit is an important consideration for investors with international portfolios, but arguably it's reinforcing what should be an ongoing approach: Invest with managers who are able to evaluate the risk and return profile of individual investments and who have expertise in the regions they're investing in.

Bottom line

Brexit has led to increased uncertainty around the outlook for Britain's economy, as well as the outlook of the wider European continent and the future of the European Union. There are still several potential outcomes, including the possibility that the separation doesn't occur at all. Active managers who have done scenario planning can help weather the range of potential outcomes. Now that you understand some of the details directly from one of our U.K.-based investment professionals, it's time to join the conversation as the events unfold.

The STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region. The FTSE 100 Index is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization. It is not possible to invest directly in an index.

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