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Boris Brings On Brexit

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Thomas Clarke, Partner
PORTFOLIO MANAGER
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Although Boris Johnson's appointment as prime minister of the United Kingdom (U.K.) in July has spiced up the Brexit story, the political risks around Brexit are consistent with what we had anticipated and prepared for earlier this year.

Johnson was Theresa May's foreign secretary for about a year, mayor of London for eight years before that, and leader of the campaign to leave the European Union (EU) in 2016. He inherits a narrow parliamentary majority—which could quite easily be wiped out—and a significant stalemate in regard to agreement on terms to leave the EU.

A New Strategy

May's strategy was to delay and seek consensus. That didn't work out and effectively brought May's tenure to an end. Johnson's strategy is different—more hardline and more tolerant of the risk of a "no-deal" Brexit.

With no deal in place, the default outcome written into U.K. law is that the U.K. will exit the EU on October 31, 2019. At that time, the U.K. will relinquish all tariff-free trading arrangements with the EU, and the free migration of people between the EU and the U.K. will come to an end. The U.K. will then start from scratch in forming trade agreements with all the countries it had previously traded with as a member of the EU.

We believe a “no-deal” Brexit would be an adverse shock to the U.K. economy and negatively viewed by the markets.

How Likely Is No-Deal Brexit?

Since May resigned more than two months ago, a no-deal Brexit has become more likely than the markets originally thought. Bookmaker odds of a no-deal Brexit were 25% at the end of May (both the month and the conclusion of May’s premiership). Now they’re at 37%.

We don’t think Johnson actively desires no deal, but he knows—and the markets know—that the likelihood of getting a deal is quite small.

The options are to delay Brexit again, cancel Brexit, or crash out of the EU with no deal. And of those alternatives, the relevant consideration in our view is that Johnson likely believes crashing out of the EU is politically less costly than the other options. It’s more costly to the U.K. economy, certainly, but we believe that he thinks it is less costly to his premiership and his government, which, incidentally, has been staffed (by Johnson) with ministers who are all more tolerant of no deal than May was.

A Snap Election?

There is a scenario that delays no deal, and that’s a snap (general) election. That means the government could lose a vote of confidence. Because of the extremely narrow effective majority, that outcome would only take one or two defections from the Conservative Party in the House of Commons.

That scenario may be more probable than a deal being agreed on. It won’t happen immediately because Parliament is now out of session for several weeks. But it could happen in September, somewhat before the exit deadline.

If there is a new election, that probably would bring on another debate about Brexit. However, a new election itself carries a great deal of uncertainty, and in no sense does it point to a better Brexit outcome or economic outcome than no deal.

Investment Implications

So those are the politics of Brexit. Looking at the investment implications, as the expected probability of a no-deal Brexit has risen, the pound has fallen. It was the worst-performing currency in our universe in July—5% lower against the U.S. dollar and 3.5% lower against the euro than it was on May 24 when Theresa May announced her resignation. Given the risk, we exited our position in the pound in our strategies.

We have kept our exposure to U.K. equities, but that exposure is smaller than the fundamentals alone suggest we should be.

Our caution there exists for the same reason we exited the pound, but we didn’t think we needed to exit U.K.

equities entirely partly because a weaker pound serves as a bit of a shock absorber for Brexit's potentially negative influence on the equity market. To wit, U.K. equities have performed well year-to-date.

We continue to navigate these market events.

Thomas Clarke, partner, is a portfolio manager on William Blair's Dynamic Allocation Strategies team.

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