The Game Theory of Brexit

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In mid-January, we learned—to nobody's surprise—that the Brexit agreement devised between the United Kingdom (UK) and the European Union (EU) last year cannot pass UK parliament. And without passing parliament, it can't proceed.

Now the United Kingdom wants to change the deal, and the EU is refusing. This situation is a prime example of where we can apply game theory, which we use as a framework to analyze investment opportunities.

The Crux of the Issue: The Northern Ireland Backstop

The primary reason UK members of Parliament voted against the Brexit deal pertains to the "Irish backstop."

The backstop is a plan that sets out what will happen if, come 2020 (the end of the withdrawal transition period), there is no agreement on how to carry on trade between Northern Ireland, which is part of the UK, and the Irish Republic, which is part of the EU.

Right now, the Brexit withdrawal deal specifies that if there is no agreement on Northern Ireland/EU trade in 2020, Northern Ireland actually would remain in the single EU market (and the rest of the UK would remain in the customs union) until both the UK and EU agree to end it.

Fearing that this backstop could last in perpetuity, the UK is trying to change the deal with 32 days remaining on the clock.

It doesn't look very competent of the UK to spend two years negotiating a deal, then reveal that deal won't work at home—but that's exactly what it has done.

No Credible Threat

In a game theory framework, when you're negotiating in an attempt to get the other side to agree to your demands, you need a threat strategy. And your optimal threat strategy is to reveal what you will do if the other side says no. That is supposed to motivate the other side to say "yes" to your demands. "If you do not agree with X, then we will do Y."

In this case, the implicit threat of both players (the UK and the EU)—what they will do if the bargaining breaks down and everyone walks away from the table—is that there will be no deal. The UK will leave the EU on March 29 with no alternative trade agreement in place.

The problem with the no-deal Brexit threat—on both sides—is that it isn't highly credible. If the UK leaves the EU without a deal, both players will be damaged economically and politically. Therefore, it's motivating neither a panic nor an agreement.

Think about what the EU is threatening. It wants no customs border between Ireland and Northern Ireland. But with no deal, the UK would crash out of the EU, compelling the EU to safeguard its single market with a customs border between Ireland and Northern Ireland. The EU is essentially saying, "We must keep the Irish backstop, or else we'll threaten a situation in which we lose the Irish backstop."

Risks and Opportunities

The fact that the EU's threat doesn't safeguard the very thing its bargaining strategy claims it wants affects the EU's credibility. And that may be why the UK currency and equity markets remain relatively unfazed by all this noise. The market is pricing in an extension to the March 29 deadline—a scenario that doesn't solve anything, but does postpone the day of reckoning, and buys a bit more time.

If the markets aren't particularly worried, are we? The UK equity market and the pound are affected by the situation, and that presents us with a valuation opportunity to be long in both. We are long, but not as long as the valuation "signal" alone suggests. We dampened our long exposures because we have some concerns.

Our first concern is that a no-deal Brexit could occur in March. The probability isn't very high; it's almost nobody's favorite outcome. But unfortunately, it is not everybody's worst outcome either. And the dynamics of multi-player negotiations—and there are more than two players in this when you factor in the UK Parliament with all its factions—can lead to that kind of result prevailing.

Our other concern is that even if the deadline is extended, Theresa May—whose only major task since she took over as prime minister has been to figure out Brexit—could step aside. She likely won't be toppled by a vote against her leadership, but she could throw in the towel. And if that happens, any new conservative prime minister would probably be far less opposed to a no-deal Brexit.

So, extending the March 29 deadline likely doesn't reduce the probability of no-deal Brexit and, in fact, may even increase it. That adverse market scenario is behind the dampening of our long exposures in the region. Again, we're not as long as the valuation opportunity suggests is warranted.

That's the crux of our game theory approach to geopolitics. It helps us better understand these types of situations so we don't reflexively do what the marginal investor typically does, which is to automatically move to the sidelines when there's heightened risk.

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