Innealta CAPITAL SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS

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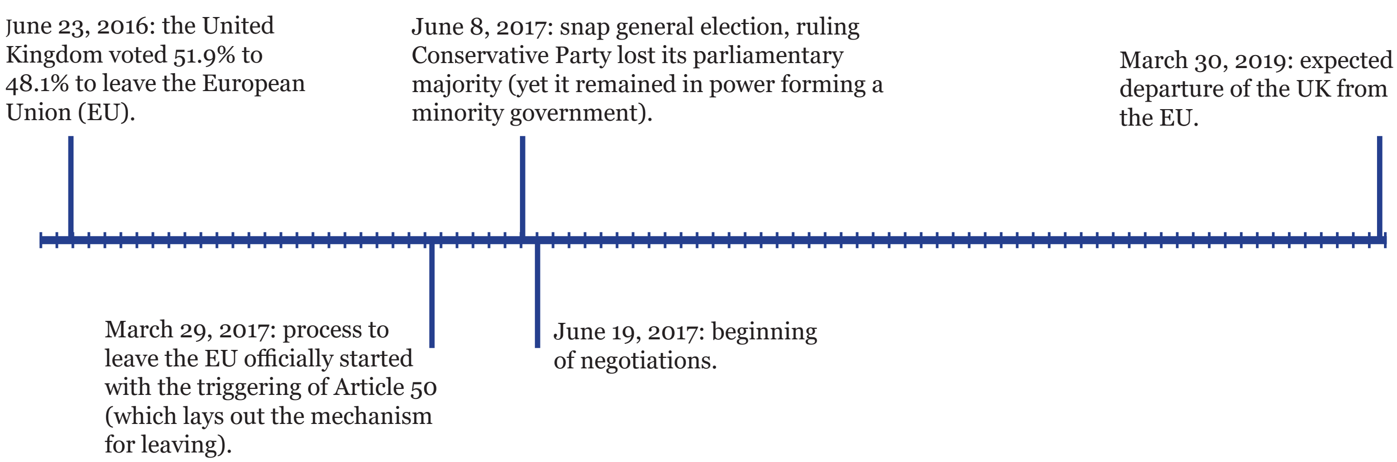
Brexit, a Matter Still Pending

KEY TAKEAWAYS

- The decision to leave the European Union ("EU") has created uncertainty over the future of the United Kingdom's ("UK") economy and has coincided with significant depreciation of the UK's currency against other major currencies.
- The complexity of altering the trade and political relations between the UK and EU will continue to create uncertainty.
- The most topical question is to what extent will the UK be a part of the EU's single market.
- Exporters, which have recently benefitted from a weaker currency, may experience negative performance if negotiations eliminate the viability of EU as an export destination.
- Overall we anticipate that the volatility created by the negotiations to create investing opportunities both within UK industries but also equity market throughout Europe.

BREXIT TIMELINE



THE BIGGEST LOSER SO FAR: THE BRITISH POUND

The reaction of financial markets to the Brexit vote has been noticeable in FX markets. The British pound has lost roughly more than 11% of its value against the dollar since June 23rd, 2016 (the day of the Brexit vote), reaching $ 1.3208 on August 1st, 2017. The day after the results were known (June 24th), the pound lost approximately 8% of its value against the dollar. The situation further deteriorated in October 2016, after the Prime Minister confirmed on October 2nd that she would trigger Article 50, which outlines the process for a country that wishes to withdraw from the EU, in March. The pound hit $1.2632 on October 6th –with a flash crash to $1.18 the next day– over fears that negotiations would lead to a so-called "hard" Brexit, which would pull the UK out of the single market and the customs union without a special agreement to mitigate the effects of these measures. November 3rd saw the pound gaining ground (1.44% against the dollar) after the High Court ruled that Parliament needed to approve the triggering of Article 50, lifting the hopes of a "soft" Brexit. On top of that, the Bank of England stated it did not expect to cut interest rates for the remainder of the year 2016.

On January 9th, 2017, after an interview with the Prime Minister was interpreted as suggesting a "hard" Brexit, the pound once again fell, reaching a new low of $1.22. The pound would creep further down a week later, for the same reason ($1.1985). That represented, the lowest level since 1985 (please see Figure 1 on the next page). Finally, after the early election of June 8th, the pound took its biggest daily hit of the year after the results gave no party a majority (falling 2%). However, it climbed back after a coalition deal was reached and the prospect of a softer Brexit became more likely. Based on the observed reactions of currency markets, the uncertainty around Brexit is rattling investors.

FIGURE 1

GBP/USD FOREIGN EXCHANGE RATE PLOT

Data from 06.01.2016 to 08.01.2017
SOURCE: Innealta Capital using data from Bloomberg

Beyond the pound, the economy has started to show signs of being affected by the uncertainty surrounding Brexit. The UK's GDP rose by only 0.3% in 2017 Q2, after expanding 0.2% in Q1. The head of the Office for National Statistics, a UK governmental agency, described the first half of 2017 as a "notable slowdown." Moreover, the depreciation of the pound, which has lost 18% of its value since November 2015, has had an impact on domestic prices. Inflation as of July 2017 stands at 2.6% year-over-year, which is greater than the Bank of England's 2% target. Inflation is also outpacing nominal wage growth, which has exhibited a shy 2% year-over-year, as of July 2017. This means that real incomes are being squeezed, reducing the real disposable income of UK households. This affects spending, which in turn affects GDP.

Uncertainty around the Brexit is also impacting investment. According to the Bank of England, investments in the UK are expected to be 20 percentage points lower in 2020 than what it had been previously predicted before the Brexit vote.

Interest rates have not been raised since 2007, but the central bank has hinted this will change in the short run. However, the decrease in real incomes mentioned earlier will make an interest rate hike more difficult for the central bank. On the bright side, unemployment is at historic lows, reaching the lowest rate since 1975 (4.5% in July 2017). Moreover, the FTSE100 index– which tracks the 100 companies with highest market capitalization listed on the London Stock Exchange–, has moved in the opposite direction of the pound recently. The reason is simple: multinational companies, which tend to benefit from the fact that a weaker pound makes their exports more competitive in the global market, dominate the index.

NO CLEAR PATH FORWARD

The governor of the Bank of England, Mark Carney, has repeatedly stated that there will be volatility in the markets throughout the Brexit negotiations. Carney has conveyed that he expects the relationship with the EU to be the main driver of UK prosperity in the medium term. Today, trade between the UK and the EU is significant (please see Figure 2 on the next page). Brexit negotiations will be further complicated by issues outside of trade, like the rights of EU citizens in the UK and the Irish border. The ideal agreement for the UK –remain in the single market, but ending the free movement of people– seems out of the question. The EU fears this cherry picking would undermine the union, and create perverse incentives for other members to seek a way out, and/or renegotiate current agreements. The alternatives for the UK range from a Norway-style relation with the EU to reverting back to trade under WTO rules.

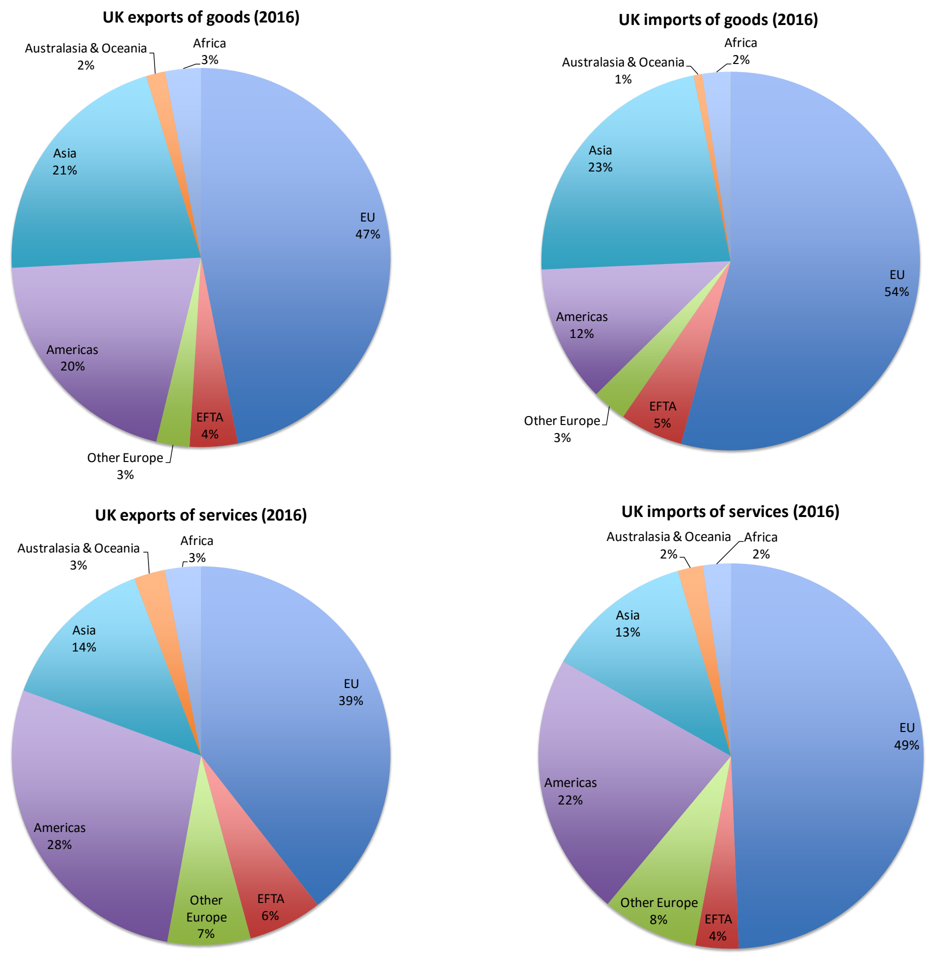
The easiest way to analyze the effects on trade is by separating trade barriers into tariff and non-tariff barriers. Currently, EU membership grants the UK access to the single market (which eliminates tariff barriers) and its customs unions (which does away with non-tariff barriers, like rules-of-origin inspections). The alternatives for Brexit are to leave the EU with some kind of association agreement, or just leave with no special agreement. The latter would allow the UK to pursue a free-trade agreement with the EU, as many nations have already, and other countries, which it is forbidden to do as a member of the bloc. The main problem of this approach is the time it would take to finalize these agreements. The first option, a special accord, could be modeled after some of the special arrangements the EU already haswith non-EU countries in Europe. The countries that currently have a special relationship are those (i) in the European Economic Area (EEA) – Norway, Iceland and Liechtenstein-; (ii) those in the European Free Trade Association (EFTA) –which adds Switzerland to the previous three–; (iii) the ones that are part of the customs union (to a large extent), but not the single market (e.g., Turkey); (iv) and those that have free-trade agreements (e.g., Japan, Chile).

The agreements with Norway, Iceland, Liechtenstein, and Switzerland entail contributions to the EU budget, plus acceptance of free movement and many EU regulations. Additionally, Norway and the other EEA members are not part of the customs union, meaning non-trade barriers do exist between them and the EU. What many are missing is that non-trade tariffs are extremely important when it comes to exporting services, an area where the UK has a comparative advantage. A study from the Centre for Economic Performance (CEP) at LSE estimates that a Norway-like deal would see the UK reduce its national income by 1.3%, even after accounting for the reduced fiscal contributions to the EU. (An important element to consider here is that Norwegian contributions to the EU, on a per-capita basis –relevant to the calculation–, are not that much lower than the ones the UK currently makes.) The same study estimates that trading under WTO rules (hard Brexit) would make the UK's income drop by 2.6%. Not even unilateral liberalization (elimination of all tariffs) would suffice to offset these effects. These estimates are just static, not accounting for the effects of policy. Therefore, the negative effect could be even larger. Companies could lose part of their business with the continent, and/or start relocating staff to Europe in order to move part of their operations there (this may be especially relevant in the case of financial services). With services accounting for 80% of the country's economy (share of GDP), employment could also take a hit if the UK leaves the single market.

FIGURE 2

UK IMPORT AND EXPORT CHARTS

Data from 01.01.2016 to 12.31.2016
SOURCE: Innealta Capital using data from UK Balance Payments, The Pink Book 2016 (Ch. 9)



LOOKING AHEAD

The last election has been and will continue to be interpreted as voters rejecting a hard Brexit. On top of that, pro-EU candidates have won important elections, after the Brexit vote, in the Netherlands, Austria, and, most crucially, France. This has done away with the perception that Europeans were ready to reject the Union, and has reinvigorated the remaining countries' position in dealing with the UK. The UK government appears to have heeded these changes, and we believe some version of soft Brexit will be the UK's target. Although the current UK cabinet appears to be divided over which course of action to take, it is our belief that those who are prioritizing the economy will prevail. The problem is that a soft Brexit is much more difficult to agree upon than a hard, clean Brexit. We think it is very likely that either the two-year negotiation period will be extended –for which unanimous support in the EU is required–, or a long transition period will be agreed. The main hurdle will be political, as those who would rather leave with no special deal will frame a soft Brexit as "EU-lite." To further complicate matters, the size of the UK's exit bill will be an extremely sensitive issue for politicians to deal with. In any case, the UK probably will not withdraw from the single market and the customs union in March 2019 (the end of the two-year negotiation period), as many anticipated a few months ago. The Norway model is the best way to preserve access to the single market, plus membership of the EFTA would come with 27 operating free trade agreements (covering 38 countries). Moreover, the UK would be free to pursue its own trade deals, which it cannot do today. Still, the task of building its own customs system will be challenging, and we doubt it can be completed before 2019. This increases the likelihood of a transition period, or a "soft" Brexit. A middle-of-the-road solution will most likely be hammered out. Additionally, ratifying that agreement will consume even more time. National parliaments, even some regional ones, will need to approve the deal. Some countries may even call referendums.

How long the Brexit process will take is anyone's guess at the moment. What we do know is that all this uncertainty creates market volatility, and that volatility can create attractive investment opportunities. Our team of economists and quants closely monitoring the political and economic developments in the UK and Europe and tracks the way in which the developments affect our international portfolios. As we explained before, UK exporters benefit from a weaker currency as imports become relatively more expensive (in the local currency). However, if those exporters rely heavily on the EU market, a hard Brexit would constitute bad news. Across industry groups, we view consumer discretionary and real estate with caution given the range of outcomes, particularly if the UK economy stagnates. Within specific industries, financial services and airlines are likely, in our opinion, to experience the most impact from any deal. We also anticipate relocation of British companies and foresee both positive and negative impacts on other international equity markets. Given the close link we have observed between the value of the pound and political events, following the negotiations between the UK and the EU closely is paramount.

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IMPORTANT INFORMATION

Chart Definitions

The **GBP/USD** (British Pound/U.S. Dollar) is the abbreviation for the British pound and U.S. dollar (GBP/USD) currency pair or cross. The currency pair tells the reader how many U.S. dollars (the quote currency) are needed to purchase one British pound (the base currency). The GBP/USD is affected by factors that influence the value of the British pound and/or the U.S. dollar in relation to each other and other currencies. For this reason, the interest rate differential between the Bank of England (BoE) and the Federal Reserve (Fed) will affect the value of these currencies when compared to each other. When the Fed intervenes in open market activities to make the U.S. dollar stronger, for example, the value of the GBP/USD cross could decline, due to a strengthening of the U.S. dollar when compared to the British pound. **UK imports** are goods or services brought into the UK from another. **UK exports** are a function of international trade whereby goods produced in the UK are shipped to another country for future sale or trade. The sale of such goods adds to the producing nation's gross output. If used for trade, exports are exchanged for other products or services in other countries.

It is not possible to invest directly in an index.

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