EQUITIES | MARKETS AND ECONOMY

Brexit: The long and winding road toward resolution

By: Ian Kirwan | December 24, 2020

London - For anyone living in the United Kingdom (UK) over the last four years, the word "Brexit" has been synonymous with division, uncertainty and confusion. As deadlines have come and gone, apathy has set in. With the December 31 deadline looming, there have been furtive negotiations in recent weeks, trying to hammer out a trade deal. The consensus still expects a free trade agreement, but concerns over a "no-deal' outcome are dominating headlines again.

The current deadlock in negotiations centers on three areas:

- **A level playing field** — the trade policy for a set of common rules and standards that prevent a business in one country from gaining a competitive advantage over similar operations in other countries.
- **Governance** — the mechanism for resolving any future disputes.
- **Fish disputes** —despite this industry only accounting for 0.2% of the UK economy, it has become a symbolic battleground for both sides. The UK gave away a lot of their fishing rights to the EU when it joined the European Economic Community (EEC) back in 1973, and hard-core "Brexiteers" in the UK want them back.

So far, global investors have been much more focused on vaccine news and US elections, and have largely ignored the threat of another no-deal stalemate. UK equities have been shunned for much of the last four years. However, we expect Brexit headlines may gain prominence in the coming weeks.

Deal or no-deal: The impact

Regardless of what the outcome is from these negotiations, there are no winners. The impact on the UK, Republic of Ireland and other EU countries like France is a short-term negative. What will a no-deal mean for the UK economy? JP Morgan estimates that a no-deal scenario will cost -2% more to UK GDP than a negotiated trade deal. However, this impact will be sharper and more up front versus the slow motion drag of a negotiated deal.

If a deal is not signed, then both sides will move to World Trade Organization (WTO) rules. This will mean tariffs for goods and services bought and sold between the UK and EU, resulting in higher prices. There is also a likelihood of disruption at ports throughout the UK and EU in the early days, absent a deal.

On the investment side, our international equity strategies' exposure to the UK market is neutral, in terms of the domicile of our holdings. However, from a practical standpoint, most of our holdings derive the majority of their profits on a global basis, with a weak currency (sterling) being a benefit to earnings.

In a no-deal scenario, we would expect the greatest pressure to be on UK-focused companies, such as banks, homebuilders and real estate. There would also be a likely sell-off of small-cap stocks versus large caps, as the latter is dominated by big internationally focused companies.

No material risk

So, is Brexit a material risk we are worried about? In short, no. The UK market is one of the cheapest developed markets and these concerns are discounted to some degree in today's share prices. Longer term, the UK is an interesting area for investors. Valuation and sentiment are weak and this naturally makes us interested. As a result of the COVID crisis, stimulus has been strong in both the UK and EU. With an early-stage economic recovery under way, this favors economies like Germany and Sweden. Europe is cheap relative to the US, has underperformed for much of the last decade and does not have the same worrying benchmark crowding and concentration that we see in the S&P 500.

Our international equity strategies are designed to weather economic shocks, as we focus on sustainable business models. Brexit will be no different, whatever the outcome. Opportunities are likely to present themselves in the coming months and that is where our focus lies today.

Bottom line: Regardless of the outcome of the Brexit negotiations, we believe our strategies are positioned to weather market turmoil. From a long-term perspective, many factors make the UK an attractive area of investment relative to the US, including valuation, sentiment and market cyclicality.

About risk: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Investments in foreign instruments or currencies can involve greater risk and volatility than US investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Investing primarily in responsible investments carries the risk that, under certain market conditions, a strategy may underperform those that do not utilize a responsible investment strategy.*

Ian Kirwan
Global Equity Analyst
Eaton Vance Advisers
International Ltd.

"We do not view a Brexit 'no-deal' scenario as a material risk. Europe is cheap relative to the US and does not have the same worrying benchmark crowding that we see in the S&P 500."

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.