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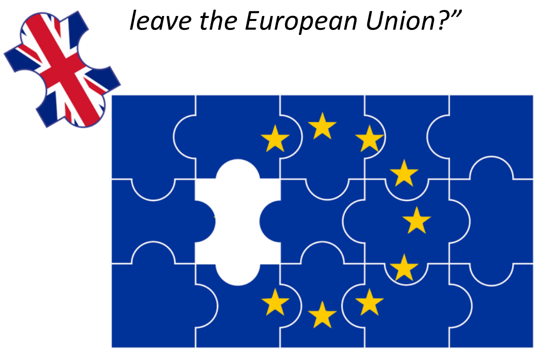
Brexit:

Britain's Pending Exit from the EU

By Kevin Chambers

On June 24th, 2016, the results of the now famous UK referendum were announced. The question posed to the electorate of England, Scotland, Wales, and Northern Ireland asked:

"Should the United Kingdom remain a member of the European Union or leave the European Union?"



The results

Remain: 16,141,241 (48.1%)

Leave: 17,410,742 (51.9%)

Remember that? It was one of the unexpected election outcomes of 2016. I remember texting with Tommy that night, as it was happening, in disbelief. All the polls pointed towards 'Remain' winning. Most of the experts expected the UK to stay a member of the continental political and economic union. Almost everyone was surprised. This event became known to the world as Brexit.

For the last 2½ years, the process has been underway for the UK to officially leave. And there are still quite a few important steps before the UK officially leaves on March 29th, 2019, the historic point of planned departure.

On December 13th and 14th, the last European Council Meeting of 2018 occurred. The exit agreement needs to be approved by the EU member states. Then it gets sent to the UK Parliament for secondary approval. Then back to the EU Parliament for final approval and ratification (Blitz, Barker, & Parker, 2018). That is a lot of legislation to happen in the remaining months before March 29th. Therefore, we are no doubt going to be hearing about Brexit in the

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European Union member countries:

- Austria
- Belgium
- Bulgaria
- Croatia
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Romania
- Slovakia
- Slovenia
- Spain
- Sweden
- *United Kingdom*

news. So let's review the story of Brexit, discuss the important points facing the ratification processes, and how this event will affect the US economy, US companies, and our portfolios.

Birth of the European Union

European History has been plagued by violence and wars between all of their members. Recent climaxes of this struggle peaked in the first and second World Wars. In post-war western Europe, nations accepted democracy and sought to create economic and political ties between countries, to preserve peace and create a European economic force. This eventually led to the signing of the treaty Maastricht which created the European Union in 1993 and eventually the creation of the Euro in 2002.

The European Union currently has 28-member countries, 19 of which use the Euro. From 2002 until 2008, the Euro and the EU were very successful. They capitalized on the economic gains from globalization and increased their ability to spread their wealth around the world. However, the 2008 credit crisis that originated in the US, hit Europe arguably harder.

2008 US Stock Market Collapse Has Global Ramifications

In Europe, Greece was the first casualty of the 2008 crash and the epicenter of the crisis in Europe. After a major election in 2009, the new Greek government realized they had a "black hole" in their accounts, and their budget deficit was double what the previous administration reported. Many European economies, already weakened by the stock market crash in the United States, worried their large budget deficits could turn them into the next Greece. This was the start of what is now known as the European Sovereign Debt Crisis. The crisis spread to the countries of Portugal, Italy, Ireland, and Spain. These countries, along with Greece were collectively known as the PIIGS.

This was the first major test of the strength of the European Union, exposing a fundamental problem with how the EU was organized. Similar to the US states, the EU member countries vote on representatives to act on their behalf at the continental congress. As part of the union, the countries share the economic wealth by eliminating trade barriers, taxes, and tariffs. They also allow for free movement between their borders. In this way, they do act a lot like the United States. Traveling between Germany and France is as easy as traveling between Oregon and Washington. To be a part of this union, each country had to give up some autonomy. For the Eurozone members (those countries that use the Euro), the main concession was giving up monetary policy to the European Central Bank. However, these member countries were allowed to maintain control over their fiscal spending.

To over-simplify, Greece got into trouble because they were able to borrow way too much. Investors looked at Greece, a member of the Eurozone, and figured if they got into trouble the other member countries in the Eurozone would be forced to bail them out. Therefore, they rated their bonds way higher than they should have been rated and issued Greece considerably more debt than their economy could sustain. The Greek government spent this money and their economy didn't grow. This was the debt "black hole." This problem was systemic. Countries with weak economies were borrowing on the backs of the stronger economies in France and Germany. This crisis has remained a problem for the European economy ever since. The European Central Bank has taken steps to have a bigger hand in domestic fiscal policy, and European bond yields have been dismally low. The crisis made more people skeptics of the EU in general.

The Coal and Steel Community (1950) became the European Economic Community

France | *Italy*
Germany | *Luxembourg*
Belgium | *The Netherlands*

History of British Involvement in the EU

Tension between the UK and continental Europe is a common theme throughout history. The precursor of the EU was called the European Economic Community (ECC) and was formed by France, Germany, Belgium, Italy, Luxembourg, and the Netherlands. These countries, known as "The Six," started their political alliance with the creation of the European Coal and Steel Community (ECSC) in 1950, a supranational organization to control and oversee the production of metal works. This organization marked important coordination between France and Germany, two countries who had been at war only a few years earlier. Because of Britain's reliance on coal and steel as major exports, their need to join a coordinated organization made it hard for them to be involved in early negotiations. Coupled with the large task of dismantling their colonies and forming the commonwealth, Britain was largely disengaged from the process of uniting Europe, led by Germany and France. Without British support, and even much British criticism, the Treaty of Rome was signed by The Six in 1955 and the ECC became official (Ludlow, 1997).

The European political climate left the UK out of European involvement for the next few years. In 1960, the UK created a competing international organization called the European Free-Trade Association (EFTA). Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the UK signed the agreement and dubbed themselves the "Outer Seven" (Economist Data Team, 2015). In 1961, the UK applied to join the ECC. Although they had support, then French President Charles de Gaulle veto their application. France was concerned that allowing the UK into the partnership would overshadow French interests and increase US influence in Europe. De Gaulle also vetoed a British application in 1969. However, De Gaulle resigned in late 1969, and Britain was allowed membership in 1973 (UK Parliament, 2013). Then in 1975, the Labour Party took control of British politics and immediately put the question of European membership to the British people. Several cabinet members publicly supported withdrawal. However, 67% of voters supported a commitment to stay in the ECC (BBC, 2015).

As the ECC transformed into the EU, Britain remained engaged despite some arguments, mostly between France. In 1988, Prime Minister Margaret Thatcher made a famous speech in Bruges opposing further British involvement in Europe (Wilson, 2014). The EU was officially formed with the signing of the Maastricht Treaty. The EU consisted of three pillars: Economics, Security, and Justice. The treaty also started the process of creating a single European currency. From the beginning of this process, British involvement was stipulated on their ability to not be involved in a single currency and retain their Pound Sterling (Eur-Lex, 2010).

The Brexit referendum was called by Prime Minister David Cameron, a member of the center-right Tory Party that has a majority in the House of Commons, the main legislative body of English politics. Within the Tory party, a movement of 'Eurosceptics' had been growing. Some high-profile government ministers started to urge Cameron to take a harder line with the EU government in Brussels. To appease the growing number of anti-European members of the Tories, he passed the European Union Act in 2011. This required any new EU-wide treaties that would pass new powers to Brussels, the seat of the EU government, would be required to be put to a British referendum. Then, as his reelection campaign started to heat up, Cameron promised that if his party continued in majority control of the government, they would hold a referendum on British inclusion in the EU.

The Brexit Vote

The debate over Brexit was spearheaded by two political groups: "Britain Stronger in Europe" and "Vote Leave." Pretty self-explanatory names. Leading up to the vote, the Economist categorized the positions of the two sides into 5 buckets: Trade, the EU Budget, Regulation, Immigration, and Influence. However, the basis for most of the opposition to European involvement is pretty simple: Britain gives up too many resources and autonomy for too few benefits in return. The proponents of staying in the EU argue essentially the opposite: the economic and political benefits dwarf the cost of being part of Europe (The Economist, 2016).

In the leadup to the referendum, David Cameron put a stake in the ground. He believed that Britain should stay in Europe. He tried to work with Brussels to broker some deals that might appease those in his party arguing for leaving, and to help downplay the complaints coming from his rival conservative party UKIP. However, the European leadership was too busy dealing with the immigration crisis of refugees from Syria and the continued problems in the weakest members of the EU that were still facing pressure from the credit crisis. Cameron put his political career on the line for the Brexit vote, but the outcome is now history. The UK voted to leave the EU and David Cameron resigned as Prime Minister less than 3 weeks after the referendum (Kettle, 2016).

With the resignation of Cameron, the Tories nominated to replace Cameron with Theresa May as the leader of their party, sworn in as prime minister in July 2016.

Unlike the US system of government, British Prime Ministers can call for elections at any time. Eleven months after becoming prime minister, May and her party called an election, hoping to gain more seats in Parliament in an attempt to bolster support and power going into Brexit negotiations, which would have made it easier for her to pass a Brexit bill. But her plan failed. The 2017 special election called by May actually caused the Tories to lose their majority.

Therefore, to retain May's post as prime minister, and the Torie's control of the government, she needed to convince another party to pledge their support of her. The Democratic Unionist (DUP) gained 2 seats in the election, to bring their total

On May 29, 2017, Prime Minister May officially triggered the legal process to set Brexit in motion. *"This is an historic moment from which there can be no turning back. Britain is leaving the European Union," she said. "We are going to make our own decisions and our own laws. ... [W]e are going to take this opportunity to build a stronger, fairer Britain — a country that our children and grandchildren are proud to call home."* [1]

[1] *https://www.biography.com/people/theresa-may-071116*

to 10. DUP's seats gave May the votes she needed. DUP is one of the two major parties from Northern Ireland. Through the agreement, Northern Ireland received the promise of government spending in the region and other concessions. The estimated value of the package was £1 billion. Although supporting May through most of the Brexit initiatives, they split with the Tories recently, causing doubt on May's ability to hold together her coalition and the Brexit negotiations (Pickard, 2018).

Recent Developments

In mid-November 2018, May brought a 588-page draft of the treaty agreement for the UK to leave the EU in front of the House of Commons. She had the support of the majority of her cabinet after a 5-hour debate ridden meeting. Although she received the support sought, she lost two ministers. Esther McVey (Work and Pensions Secretary) and Dominic Raab (Brexit Secretary) both resigned. Yes. The secretary who was in charge of negotiating with Europe and crafting this deal thought the draft agreement was so bad he quit. John Oliver quipped about this outcome on his show 'Last Week Tonight':

> ***"It's like if you woke up after major surgery and the surgeon told you he quit being a doctor because of how your operation went."***

McVey wrote in her published resignation letter: "We have gone from no deal is better than a bad deal, to any deal is better than no deal." McVey is echoing the sentiments of many other politicians that have worried May is rushing to get any deal with Europe while she still has some semblance of power (Crerar & Weaver, 2018). The one constituency that even allowed May to continue as prime minister has also waned in their support, as the DUP abstained from many amendments in May recent Finance Bill and actually voted with the Labour party on another. The leaders of DUP are quoted in saying their lack of support is to do with provisions in the EU withdrawal agreement for a Northern Ireland Backstop. Essentially, this would exclude Northern Ireland from Brexit. Making them, or all financial purposes, no longer part of the UK but part of Europe. The exclusion of an Irish backstop was a strong condition of DUP support of May's government (Pickard, 2018).

The Brexit negotiations are attempting to smooth the transition. It should be noted that there doesn't have to be an agreement. Secretary McVey alluded to this possibility. If May can't get enough support for an agreement in Parliament, the March 29th deadline may arrive with no treaty passed. If this happens, the UK will face what many people have called a "hard Brexit." The UK would immediately be excluded from all of the travel and trade advantages associated with the EU. They would also be immediately not responsible for any reciprocal advantages they may give the EU. A hard Brexit is still on the table as May's power looks anything but strong (J.P, 2018).

Hard Brexit

A hard Brexit could have immediate and serious effects on British citizens. Some of the outcomes would be:

Pharmaceutical Shortages

The National Health Service (NHS) warned that a no-deal or hard Brexit would hurt "the entire supply chain of pharmaceuticals" (McKee, 2018) as doctors and pharmacies rely on suppliers in Europe.

European's currently in the UK

A no-deal result would leave thousands of Europeans that have entered the UK through the EU open border agreement in a state of flux. English Universities house many students from the continent (WHITFIELD, 2018).

Flights

With no agreement in place, UK and EU licensed airlines would lose the ability to operate their routes between the island and continent. This would even affect US citizens traveling between the US and Europe with transfers at London Heathrow. (WHITFIELD, 2018)

Food

A lot of food transfers between Europe and the UK. No doubt companies will figure out how to trade, but prices would no dauntedly increase without an agreement. Shipments might be disrupted for a time period as organizations try to deal with new regulations and requirements.

Workers

The Bank of England reported that they would move 5,000 jobs immediately to the continent as a result of a no-agreement. Other organizations have confirmed as much. It is unclear how many Europeans living in the UK will move back to the continent and leave jobs in the UK (WHITFIELD, 2018).

The main worry of a no-deal or a hard Brexit is the unknown. No one really has good answers to what would happen. Supporters of hard Brexit downplay the potential costs. Supporters of softer Brexit downplay the advantages. The main problem is that no one knows the truth. Corporations and investors do not like unknowns. You can't plan. You can't predict. This has most investors and businesses on the side of some deal, regardless of how bad, vs no deal (J.P, 2018).

The current proposal addresses most of the concerns of a no-deal Brexit. The current agreement allows for a transition period in which new changes will happen slowly over the course of a few years. This would allow issues of employment and citizenship to be resolved and not have people worried about deportation or unemployment. It would also give companies time to figure out new regulations without a significant break in service. The length of this transition is left open in the current agreement. Area of concerns in the bill include the Irish Backstop, no security and police cooperation agreements, no decision on fishing rights around the island, and no deadline to start trade negotiations.

On January 15th, 2019, May suffered a huge set back in her quest for an easier Brexit solution. Her proposal was rejected by the House of Commons 432 to 202. The opposition party, the Labour Party, immediately called for a vote of no confidence on Teresa May (Mance, Barker, & Parker, 2018). That motion failed and May continues as prime minister, with DUP voting with her and swinging the motion in her favor. May will continue to fight for a solution to Brexit that she can pass through the House of Commons, and that will pass muster with the Europeans.

Going Forward

Right now, the outlook isn't great. But there is still some time for a deal to be reached. The first step will be for the UK Parliament to approve a treaty. Without the DUP, May's government has a very thin margin to pass any legislation.

It is hard to say also how this will affect citizens of the United States, and specifically our clients at Headwater Investments. We feel that some sort of deal needs to be reached. Uncertainty is one of the strongest motivators in the financial worlds. After the initial Brexit decision, global stock markets fell. We would expect the same thing if no agreement is reached. The good news is that it seems it is really in the best interest of all parties for the EU and the UK to work out some sort of arrangement. They both have strong financial incentives as the last few decades have inexorably linked their economies. But if the last five years have taught us anything, don't rely on the expected.

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