March 2019

An “Unfaithfully Yours” Brexit

Vincent Reinhart | Chief Economist & Macro Strategist

BNY MELLON | INVESTMENT MANAGEMENT

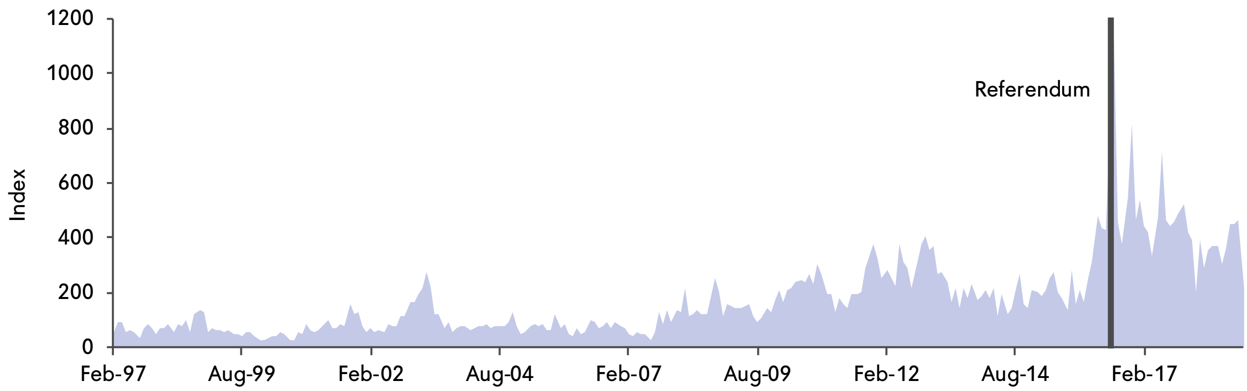
MELLON

In coming months, many conversations about global financial markets are likely to spiral down the drain that is Brexit (British exit from the European Union). This note attempts to organize the discussion.

As a first admission, I do not know the probabilities of various outcomes embedded in financial market prices for the trading relationship between the United Kingdom and the European Union (EU), and I doubt anyone does. I believe, however, the probability of a hard exit is too low given the puzzle of mapping significantly elevated uncertainty about economic policy into financial quotes. As shown below, a widely followed measure of policy uncertainty, developed by academics at the University of Chicago and Stanford, ratcheted higher after the decision by UK voters to exit the EU in the referendum held on June 26, 2016. The measure, which counts mentions of economic policy terms in major newspapers, has a long-run average of 100. At times, in the shadow of the referendum, uncertainty was an order of magnitude higher. Even now, it is about three times its pre-referendum level.

UK Economic Policy Uncertainty

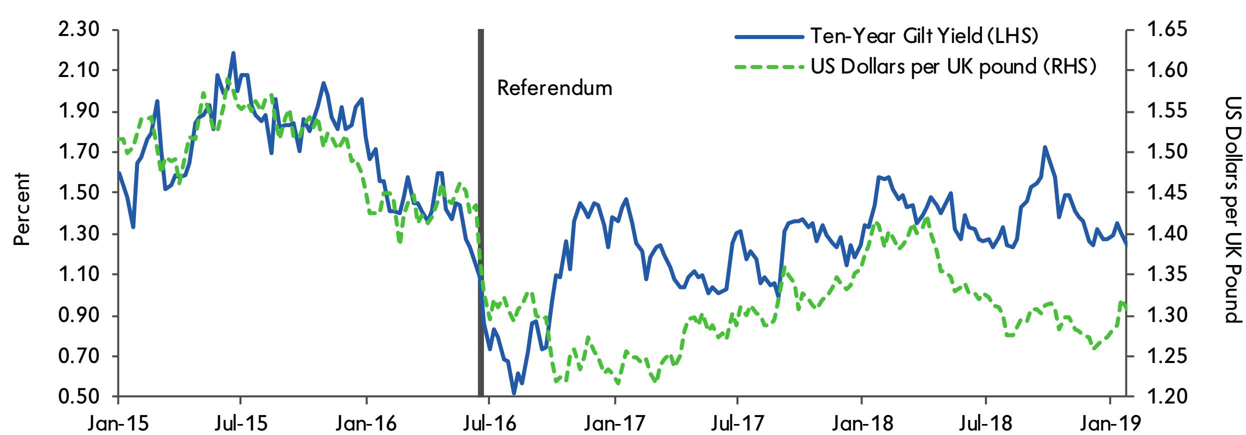
Long-Run Average = 100



Source: Baker, Bloom, and Davis, accessed via Bloomberg on February 7, 2019.

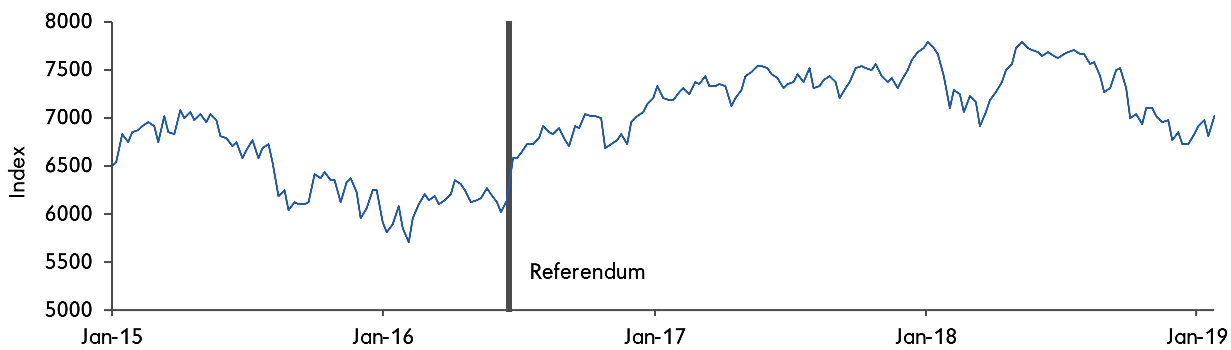
Financial market quotes, in contrast, have been volatile but not distressed. The British pound has lost about 4.4 percent of its value vis-à-vis the US dollar, and the ten-year gilt yield is up about 15 basis points. Equity prices (as measured by the FTSE 100) are up 14.4 percent.

Ten-Year Gilt Yield and UK Pound



Source: Bloomberg, accessed February 7, 2019.

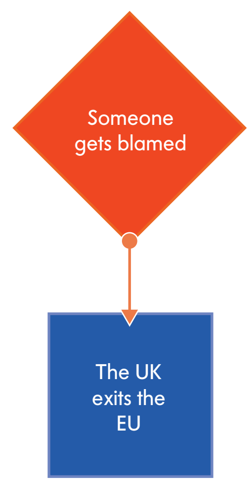
FTSE 100 Equity Price Index



Source: Bloomberg, accessed February 7, 2019.

Investors either hold a different view of the economic dislocations associated with exit from the EU (whether managed or unmanaged) than official estimates or put little probability weight on it happening. If it is the latter, then they harbor a misunderstanding about the bureaucratic and parliamentary process.

Any exercise in reverse engineering (or filling out the decision tree bottom up from failure) has a common feature; just above the final box "The UK exits the EU" is the necessary prior condition that some politicians and bureaucrats admit failure on their watch. That is, someone has to open themselves up for blame. This was the import of German Chancellor Merkel's warning in Tokyo last week. She asked about the judgment of history, fifty years from now, if officials don't act creatively to avoid a failure of the European project. EU President Tusk piled on that there was a "special place in Hell" for those prepared to leave the EU without a safe plan. This is not about moving negotiations forward. It is about advancing the blame game. The British relied on Parliamentary procedure to be able to fault the other person.



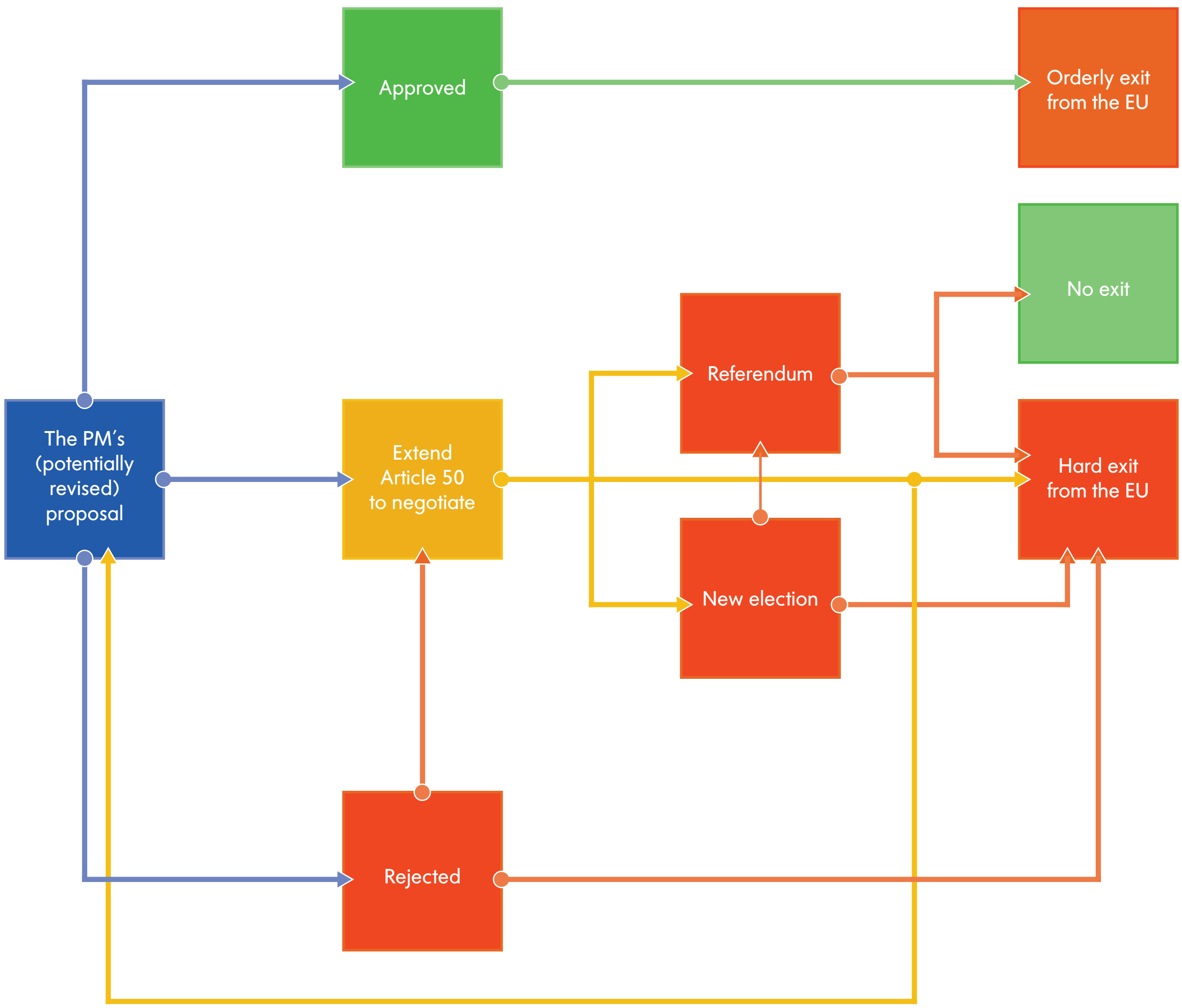
This has two elements related to framing and scheduling.

Do not view the upcoming vote on Prime Minister May's proposal (whether revised or not and whenever it happens) as an up-or-down decision on a specific treaty about exit. Rather, it is a decision on yes to an organized exit or yes to alternative outcome.

The difficulty is that there are several alternative outcomes in the event of a no vote. Parliamentary process narrows the path. In principle, the choices follow the decision tree on the next page. The proposal may be approved, leading to an orderly exit, rejected, or not presented to the Parliament before an extension of Article 50[1] is sought. A no vote might be taken as the instruction to barrel out of the EU, relying on World Trade Organization rules to govern trade formerly sheltered within the group, pending divorce payments, and leaving in abeyance citizens from both sets left on the wrong side of the border. Alternatively, a no vote might prompt Ms. May to seek an extension of Article 50 to buy time for a new vote after more negotiations (introducing the possibilities of an orderly or disorderly exit), a second British referendum, or a general election. The much-simplified schematic below still looks as complicated as the instruction diagram baffling Rex Harrison in Preston Sturges' classic *Unfaithfully Yours*.

Relevant to current circumstances in the UK, the movie is a dark, screwball comedy in which Rex's character fails to accomplish his ambition, which before the fact he imagined to be straightforward, because of the complexity of the task when attempted under pressure.

The Wiring Diagram of the Decision Process



This is why the January 29 Parliament votes on amendments were both important and darkening to an orderly process. If the alternative to a cosmetically renegotiated deal providing for an orderly exit were a second referendum, I believe many hardline Brexiteers would reluctantly approve what they view to be a bad deal on exit to protect against the chance that there would be no exit at all.

Instead, the Brady amendment[2] passed, drawing a hard line on what would be an acceptable renegotiation against the alternative of some delay, but with the distinct possibility of a hard landing. Why a hard landing? Central to the amendment is the instruction to improve that part of the deal that has proven intractable, as the UK desires an impossible trinity in its trading relationships. As for borders, it wants no customs checks between the Republic of

Ireland and Northern Ireland, and an invisible “pet fence” between the Republic of Ireland and itself. At the same time, it wants the freedom to negotiate non-EU trade deals. (How is that going, Ms. May? Reports only recently surfaced that trade talks between Japan and the UK have stalled).

To EU officials, unsecured borders will prove porous if the two sides treat trade differently. But, securing the borders would disadvantage Ireland, a faithful member of the EU, and open the way for renewed sectarian strife. For true-believing leavers, remaining in the EU customs union (to ensure equal treatment on both sides of those invisible lines) is a honey trap for never exiting (which is why they loathe the backstop the EU sees as necessary to protect Ireland by keeping the UK in the custom union until other arrangements sort out).

Note the framing about blame, which is another reason the “Unfaithfully Yours” theme holds. Neither side is bargaining in good faith. The UK government provided the features of a deal acceptable to the Parliament but anathema to the EU. If it inevitably gets no traction, UK officials can point to the EU for the failure to bargain in good faith, and EU officials can point to the UK for being unrealistic.

Investors, understandably with Brexit fatigue, may have assigned equal probabilities to all potential outcomes and concluded that sideways on asset prices is as good a bet as any. We, admittedly, have no edge on British politics but see more distinct differences across the scenarios. Ms. May probably views keeping her party together as more important than managing an orderly exit. Her best chance for an orderly exit is to run down the clock as an unstoppable force toward a vote while chipping away at the immovable object that is EU resolve. Say that gives a 30 percent chance of her proposal being put to a vote and passing. While a hard exit is not the most likely immediate option, say 10 percent, the alternative of admitting the end of the exit project is negligible at the gate because delay is also an option (at 60 percent), with the added advantage of fitting the bureaucratic imperative. As time elapses, the more pressure will hard-liners feel to compromise (we estimate another 40 percent for the May-path-lighted exit) or not (20 percent on a hard end), the more emboldened remainers will be (40 percent on a second referendum or general election). Working through the unconditional probabilities, the most likely outcome is a treaty-based exit (we estimate 54 percent) surrounded by the roughly symmetric alternatives of a hard exit (22 percent) and no exit (24 percent).

Vincent Reinhart
Managing Director, Chief Economist & Macro Strategist

Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. Article 50 of the Treaty on European Union (TEU) states that "Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements."

2. The Brady amendment has been tabled by Sir Graham Brady, a Tory backbencher. It demands that the 'backstop' arrangement, designed to avoid a hard Irish border, be replaced with an alternative.

Disclosure

For more market perspectives and insights from our teams, please visit www.mellon.com.

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

www.mellon.com