MV CAPITAL MANAGEMENT

Weekly Market Flash

Let the Real Brexit Madness Begin

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This year, the month of March will serve up more than an endless succession of college basketball games and unappealing concoctions of green beer. Almost nine months after the surprise vote last summer, the United Kingdom will finally get to show the world what its exit from the European Union may look like as it triggers Article 50, formally kicking off divorce proceedings. Inquiring investors will want to know how this piece of the puzzle may fit into the evolving economic landscape over the coming years. We take stock of where things stand on the cusp of this new phase of the Brexit proceedings.

Here – Catch This

The UK's economic performance in the second half of 2016 turned out to be not quite what Remain doomsayers predicted. Real GDP growth for the third quarter – the immediate period after the Brexit vote – was twice what the economists had forecast. With a further strong performance in the last quarter, the UK economy ended 2016 with year-on-year real GDP growth of 2.0 percent, the strongest among the world's developed economies. Not bad for a would-be basket case!

For most of that time period – from July through November – the main growth driver was consumer spending. For whatever combination of reasons – giddy Leavers on a shopping spree right alongside gloomy Remainers stocking up for the apocalypse, maybe? – households let their consumer freak fly. The pattern changed in the last month of the year. A string of impressive reports from the industrial production corner of the economy in December showed that manufacturers finally appeared to be taking advantage of the sharply weaker pound to sell more stuff, including to key non-EU export markets. That in turn has led to talk of a rebalancing. Consumer spending is unlikely to continue at its recent fervid pace as inflation kicks in and wages fail to keep up – a trend that is already underway. If the services sector can pass the baton onto manufacturing, perhaps the UK could continue to overachieve and make a success of Brexit?

Your Check, Monsieur

The Bank of England has now twice raised its 2017 growth estimate for the UK, so maybe there is some cause for optimism (though it is somewhat hard to see how Britain sustains a competitive advantage as manufacturing powerhouse). A strain of optimism has certainly been coursing through policymaker veins. Prime Minister Theresa May has assured her constituents that the UK side of the negotiating table will push for a most favorable outcome and will fight any EU pushback with nerves of steel. Her government has even hinted at a Plan B should negotiations collapse; a sort of "Singapore on the Thames" financial haven with low tax rates and other incentives for global businesses. But there are a number of potentially thorny roadblocks between here and the promised land.

First off will be an unwelcome bill likely to present itself once the UK team shows up in Brussels. In the eyes of EU budget handlers, British liabilities for things ranging from pension scheme contributions to commitments for future spending projects run to about £60 billion. That is a large chunk of change that (for obvious reasons) has been given short shrift by the UK government in its white papers and other communications with the public on Brexit's likely cost. EU negotiators give every indication they will insist on the settlement of this account as an up-front divorce payment before any further negotiations on market access, tariff holidays etc. can take place. The British side will be unlikely to go along with that, as it will be in their interests to hammer out a comprehensive solution before they think about a reasonable way to settle accounts. So talks could go off the rails before they even get to the serious issues of economic substance.

What if the negotiations fail? Again, that question has gotten very little focus to date but remains a distinct possibility. An animosity-filled parting of ways between the UK and its largest trading partner (worth about £600 billion per year) would likely not be in anybody's interest. But each side has its own expectations, its own problems and its own unruly constituents not inclined towards compromise. Bear in mind that, ever mindful of the potential outcome of elections on its own territory, the EU side will be wary of showing any kind of blueprint for easy exit.

And there is a larger picture as well; the Brexit negotiations will be going on during a particularly fraught period for world trade. The Trump administration is hell-bent on scrapping multilateral deals and going after what it imagines to be opportunities for bilateral "wins" (using curiously befuddled and plodding scoring metrics like "surplus-good, deficit-bad"). China would love to lure more scorned partners into its Asian Infrastructure Investment Bank and consolidate supremacy in the Pacific. Brexit, then, will be a big part of an even bigger variable: the rapidly changing face of global trade. However this variable winds up affecting asset markets in 2017, it is likely to have a profound effect on growth and living standards for quite some time to come.

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