

Draft Brexit Deal

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Smart Investment Management

Yesterday it was announced that, after nearly two years of negotiations, a draft agreement had been reached for the United Kingdom (UK) to leave the European Union (EU). Such an agreement seemed a long way off as recently as September, when a disastrous summit in Salzburg brought tensions between the two sides to the surface. The fact that a draft agreement has been achieved at all is no mean feat. Whilst arriving at this point has required rapid progress in the last few weeks and, in other circumstances, would be a major staging point in the UK's journey towards the EU exit door, several steps remain that are fraught with risk for the deal as it stands and maybe even Brexit as a whole.

The first requirement was for Theresa May to secure the backing of her Cabinet and yesterday evening she announced that this had been achieved. The language used in her announcement hinted at difficult discussions, saying that Ministers had engaged in a "long, detailed and impassioned debate". The BBC is reporting that up to ten Ministers spoke out against the deal but May managed to avoid any immediate resignations. However, as happened in July when she summoned her Ministers to a summit to discuss what became known as her 'Chequers Plan', this unity has been short-lived. Whilst her Cabinet initially backed the Chequers Plan, then Foreign Secretary Boris Johnson and Brexit Secretary David Davies resigned within days saying that, having had time to consider the plan, they could not support it. This morning has brought a sense of déjà vu, with Brexit Secretary Dominic Rabb and Work and Pensions Secretary Esther McVey resigning (as well as three Junior Ministers), the former saying that he cannot support an agreement that contains "an indefinite backstop arrangement". This refers to what has proven to be the last and trickiest of the issues in the negotiations, namely how to avoid a border between Northern Ireland and the Republic of Ireland. It is intuitively challenging to work out how to have a border without a border, and some might say a contradiction in terms that makes a solution impossible. However, it is this part of the agreement that appears to be most problematic for Brexiteers within the governing Conservative Party, as within the solution they see a risk that the UK remains within the EU's sphere of influence indefinitely.

It remains to be seen whether further resignations will follow but, should many more Ministers leave her Cabinet, it may be that Theresa May is weakened (if she has not been already) to the point that she never gets to present the agreement to Parliament. Talk of a leadership challenge is rife and, whilst this is not new, the possibility of such a move is elevated now that people can see exactly what is on offer. Even if she survives the next few days, the task of convincing her Cabinet may be simply a dress rehearsal for an even bloodier fight in Parliament. It can be said that a fair compromise ends with both parties leaving the table unhappy and, if that is the case, the draft agreement appears to be a very fair compromise between the desires of both Remainers and Leavers, as both appear to dislike it. Therefore, it is possible that both sides of the argument will vote against the deal. The fact that the Democratic Unionist Party (DUP), on which her government relies for support, are openly angry about the possibility that Northern Ireland is treated differently to the rest of the UK, which appears to be a possible outcome of the deal, and that the opposition Labour Party having long indicated their intention to vote down any deal that the government was likely to present makes the challenge clear. May's strategy for convincing MPs was outlined in her speech yesterday evening with her saying that "The choice before us is clear: this deal, or leave with no deal, or no Brexit at all." Clearly, she hopes that Remainers can be persuaded to back an agreement that avoids 'No Deal', with Brexiteers tolerating it to avoid the risk of a second referendum, which could bring the possibility of the decision to leave being reversed. However, with emotions running high, it is very hard to know how events will unfold. Of course, this takes no account of any objections raised by the 27 countries that will be remaining in the EU, as they have only seen the draft agreement last night and, with 585 pages of text, it is certainly possible that one or more clauses will be problematic for one or more countries. However, for now, the focus is all on the UK, as the agreement remains at genuine risk.

The continuing uncertainty has been reflected in the movement of sterling in the last 24 hours, a currency that has been highly volatile recently, driven by news flow about the negotiations. It rose one and a half cents against the US dollar on the announcement of a draft agreement, gave back about one third of that gain straight away as investors realised that they had little more clarity than they had prior to the announcement and then fell by nearly two cents when Dominic Rabb resigned as investors saw the deal at real risk. Such volatility is likely to continue in the short term until events play out and it was in order to remove some of that volatility that we hedged a significant proportion of our sterling risk away recently. The reality is that, in spite of the UK and EU managing to get to a draft agreement, we have no more ability to assess the prospects for sterling and UK equities than we have done for the last 2 years so, for now, we will continue to tread carefully and use hedging to control risk, especially when we see the range of likely movements as being asymmetric against us.

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