BREXTENSION

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Just what is the probability of a "Hard Brexit," whereby Britain crashes out of the European Union with no deal? By 29 March, the deadline for the two-year saga may come to a head, it is possible but not probable. Critically, we think the market may not appreciate another contingency: Brextension. Kick the can down the road to a later date, courtesy of flighty markets and fear of the unknown.

As regional economic data stumbles this winter, it is important to realise that Britain's slowdown isn't half as bad when compared to the Eurozone. Sure, UK Prime Minister Theresa May is facing down softness in London real estate, though national home prices are still up over last year. And the dreadful teetering in Sterling is stark, falling to $1.265 from $1.4877 at the summer 2016 referendum. But the truth is the UK has thus far largely defied the gloom mongering put forth by hard-nosed Remainers. The big risk was supposed to be a mass exodus of financial professionals from the Square Mile to supposedly banker-hungry climes in Frankfurt and Paris. It has been more of a trickle than a flow.

Look at the data and it's clear: the EU is hardly in a position to allow a Hard Brexit.
The Markit/CIPS UK Manufacturing Purchasing Managers' Index (PMI) beat Street estimates in its latest print, coming in at 53.1 against a consensus of 51.7. [1] For context, that isn't too far off the still-robust US manufacturing PMI gauge by the same outfit, which was 53.9 on the latest tally. Don't look now though: France is in manufacturing contraction, while Germany's 51.5 on this measure is threatening to corroborate that nation's negative Q3 GDP. To be fair, it is widespread in officialdom that that total output was unfavourable because of "one-off" auto manufacturing production issues stemming from implementation of "Dieselgate" regulations [2]. Nevertheless, global stock markets on edge aren't going to let anything slide.

That was manufacturing. How about services, which captures finance industry activity? Here, Theresa May must be concerned. The Markit/CIPS UK gauge of this measure came in at 50.4 in November, flirting with the expansion/contraction line of demarcation at 50. German services appear okay at 52.5, though it is off the 56.0 reading this autumn around the market peak.

But as has been the case for a generation, Germany isn't the problem. France is. Services PMI there was 49.6 in December, confirming manufacturing's woes. With the death toll from the "yellow vest" gas tax protests at 10 and counting, French negotiators must be hoping upon hope for economic positives. They can hardly tow a hard line on the British if the clock starts ticking to 29 March.

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1 As of November 2018. Source: Bloomberg, WisdomTree. Data for the US, France and Germany are as of December 2018.

2 German auto manufacturers and engineering in general has been caught in an embarrassing cloud from revelations that the major players illegally gamed their computers to say that carbon emissions were in line with regulatory standards, when in fact they were not. I would argue that it is the biggest scandal to hit Corporate Germany in recent years, exceeded only by the Global Financial Crisis

Though the Franco-German alliance is always the key factor, let not Italy and Spain be ignored. The Italian composite index of manufacturing and services PMIs is in contraction mode, at 49.3. Its banks are under scrutiny after the state's sovereign yields blew out in 2018. In the meantime, what we call the "strange bedfellows" coalition government between the leftist Five Star Movement protest party and the anti-immigrant League is trying to figure out how to keep its promises of tax cuts, pension age reductions and guaranteed income minimums while somehow keeping its budget deficit-to-GDP ratio in the 2% range.

Spain is the bright spot, continuing its remarkable post-crisis recovery with a composite PMI of 53.9. We will call it three of the four major eurozone economies with some very real economic question marks that may be more troubling than the data coming out of Britain as 2019 gets rolling.

British and the EU negotiators had their Christmas dinners ruined, trying to put on a brave face as the VIX volatility index shot sky high and the stock market continued to crater. Both sides of this negotiation have heels on the cliff's edge.

Cue Brextension.

Rules meant to be broken

Article 50 of the Lisbon Treaty, the EU Constitution, is the one that Theresa May triggered in 2017, setting a two-year timeline to come to a deal with the EU. That is where 29 March comes from: the clock strikes midnight at that point. Yes, the PM is steadfast in her determination to get a deal done. But having survived a confidence vote in December, she may not be around for very long.

We fool ourselves at our peril if we believe that the 2016 Brexit vote is a "new" rejection of Common Europe, aligned with the embrace of populism that really hit running stride with the rise of politicians such as Donald Trump, Hungary's Viktor Orban and even never-electeds, like France's Marine Le Pen. In fact, there are numerous instances of the "European question" being put to a plebiscite across the bloc years ago, with the results ignored because they went against Brussels' tide.

Investors would be remiss to forget events that are becoming hazy in memory but did nevertheless occur during most of our adult lives.

We can take it back to the 62% of Dutch voters who said "No" on the European Constitution in 2005 – two years before the onset of the banking collapse and a decade before the populists gripped fascination. The Dutch were no anomaly; the French said "No" that same year. We know, those votes were different from Brexit; those countries weren't being asked if they wanted to leave the EU. But the plebiscite was being asked if they were keen on the way things were going with the EU, the Project, Common Europe, whatever it is that each voter wanted to voice an opinion about. The answer: No.

But the EU simply ignored them. Which is why investors should consider a concept we call the "Ireland-Norway" model for a Brexit outcome.

Norway model? No, try the Ireland model

First, let's cover the much-discussed "Norway model." This is the angle whereby Britain could join a little-known economic bloc that also includes Lichtenstein and Iceland, countries that are EU-friendly but not in the club. They enjoy free movement of labour and goods to and from the EU – classic Common Market stuff – without the headache of grand-plan Europe: continental militaries, socialization of foreign nations' debt mistakes, having Berlin and Paris call the shots, never-ending buck-passing on the migrant crisis, and so on.

But "Norway" presupposes the UK and the EU come to terms on a deal in time. A deal? We are still on the heels of May's "no confidence" scare, with the Tories clearly split asunder. Hardline Brexiteers can grab their own microphones now too, courtesy of the evolution in media from a few national newspapers to the web. Consider someone like MP Jacob Rees-Mogg, of the once-obscure eurosceptic tradition, using the great equalizer -- Twitter – to fight the party's civil war in the public square.

Meantime, pairing up with "Hard Brexiteers" is the sliver of Northern Irish Democratic Unionist Party (DUP) MPs who are vehemently opposed to May's "deal" with the EU. There are enough MPs between the more conservative factions of the Tories and the DUP to keep negotiations spinning indefinitely.

And Northern Ireland plays an outsized role in Brexit. The issue, in brief, is the so-called "backstop," which addresses a much-feared recreation of a real border boundary with Ireland. It's been a quarter of a century since the Catholics and Protestants finally put closure to "The Troubles." Brexit-induced economic frictions in the region, or images of armed guards, is not what anyone needs in that corner of the world. Fortunately, it appears The Troubles are still fresh enough in memory that both Britain and the EU realize that border checkpoints cannot reappear there under any circumstances. To reiterate: under any circumstances.

With the issue of the backstop remaining a source of contention, Britain stumbles forward to 29 March with a "deal with the EU" that is dead on arrival. A no-deal Hard Brexit is the outcome that neither the Continent nor the British at large desire given the onset of considerable economic question marks.

A curious reader may wonder why I stopped at the 2005 Dutch and French votes in citing the EU's history of simply ignoring votes on the EU question. Extra credit to those who also remember the Irish case, because that is the one that most closely resembles Brexit's "what next?" whispers. Ireland was duly put the European question too, but unlike in 2005, they went to the polls at the worst possible time for defenders of the status quo: 2008. That summer, with Irish bank stocks already sliced in half and fond memories of the Celtic Tiger dead under collapsed home prices, voters were asked to ratify the Treaty of Lisbon, the European Constitution. Again, No.

But Brussels and Dublin weren't keen on that result, so they put on a massive PR campaign and made the Irish vote again. This time they fell in line.

Which is why Brextension is not only possible but maybe probable, because the weak are negotiating with the weak. There may not be enough time between now and 29 March for all parties – Remainers, Hard Brexiteers, EU citizens working in Britain, Soft Brexiteers, concerned Northern Irish, French politicians battling economic fallout from the "yellow vest" riots, Germans trying to keep the experiment together, and legions more – to sit at the table and break bread.

The lesson that may be "learned" by the British comes in the form of a second referendum or a pushback on the Brexit deadline. Don't forget that Article 50 of the Lisbon Treaty only places a 29 March deadline because the Constitution as currently written is worded as such. The EU has no qualms about changing the rules. But when will they do it? We would think at the 11th hour. This is Brextension, a re-vote, taking place after 29 March. And if it is going to be after the "deadline," what's the urgency? Don't be surprised if a second referendum comes in the summer months.

This is the "Ireland Model," and if it comes to pass, bitterness will linger for generations, not only among died-in-the-wool Brexiteers, but maybe among a considerable proportion of the population that is simply "eurosceptic lite." This group will now never accept EU membership.

Should the regional economic slowdown turn into something harsher in 2019-2020, make no mistake: eurosceptics like Italy's Matteo Salvini, marginalised French politician Marine Le Pen and US president Donald Trump will be watching.

Below are considerations for UK equity bulls and bears.

For the Bulls

Investors of a contrarian bent note that UK equities are one of the most shunned asset classes. According to Bank of America Merrill Lynch's monthly fund manager survey, the degree by which investors are underweight the country's equities is the second highest on record.

Additionally, owners of UK equities can consider that sterling has taken a considerable hit in the 2+ years since the Brexit vote and also over the last decade. Sterling traded north of $2 for a spell in 2008 and was as high as $1.72 as recently as 2014. At $1.2645, a lot of damage is already behind it.

Because investors have been staying away from the country, the MSCI United Kingdom Index is now offering a dividend yield just short of 5%, while the country's 11.9x forward P/E ratio is about three points lower than the S&P 500.

Finally, a note on the "positive" of Brextension. Should both parties push negotiations back to some later date or give the British our "Ireland" model of voting-until-you-vote-the-way-we-want-you-to-vote, the stock market could cheer the elimination of the 29 March wall by bidding up Sterling and UK equities.

For the Bears

Bears argue that money managers are decidedly underweight UK equities for good reason: "Little Britain," alone in the region, could solidify the country as a second-rate power this century.

Additionally, with Sterling, it could be argued persuasively that its multi-year collapse from north of $2 was called for, as the GBP of yester-year was trading considerably higher than purchasing power parity when compared to the US Dollar. WisdomTree runs metrics on Sterling in our dynamically-hedged suite of ETFs, and those metrics aren't too keen on the currency, with both momentum and short rate indicators flashing warning signs relative to the US Dollar.

Broad UK equity valuations can also be taken with a grain of salt because of the construct of London's stock market. Traditionally heavy in financials, energy and basic materials, the UK will always appear "cheap" relative to other markets when tech stock valuations are elevated, because the country is light in that sector.

Finally, it could be argued that Brextension is negative in that 29 March could become 30 June, then 30 September, then 31 December, in a never-ending debacle. To the extent that UK equities have struggled since summer 2016, it was Brexit, Brexit, Brexit that caused the underperformance. Maybe the band-aid does need to be ripped off, and Brextension would disallow that.

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