KHIC FLASH UPDATE

Brexit Update

The United Kingdom's (UK) Brexit talks with the European Union (EU) reach the deadline set by UK Prime Minister Boris Johnson this week, with both sides openly acknowledging big differences after concluding the latest round of formal talks. The German business lobby BDI commented that they see the failure to reach a deal "as good as inevitable". David Frost, the UK Brexit negotiator, stated he does not see a July deal, while Michel Barnier has said "there are risks of a no deal". The problem is, as Frost put it a few weeks ago and echoed by Barnier, "significant differences … still remain between us on a number of important issues".

Both sides agree they want a trade deal without tariffs or quotas, and to include as broad a range of the economy as possible including goods and – as much as possible – services. However, the stumbling blocks to attaining a deal are well known.

The first is the scope of the agreement. The EU want one overarching deal, where a breach of one element carries consequences across the deal; the UK wants a range of mini-deals each self-contained in itself. The EU idea allows for broad compliance with the deal, while the UK format limits systemic disruption over what could be a minor infraction. It also allows for piece-meal renegotiation if need be. Both have their virtues and failings, but the trouble with the EU approach is that it does not play well to the short deadline. No wonder Michel Barnier is more pessimistic for a deal.

A second point of contention is the EU's insistence on a "level playing field". They want the UK to maintain the same restrictions on state aid and subsidies as are presently in place, to uphold the same workers' rights, and adhere to the same environmental standards. The UK position is that such rules are not necessary for free trade to function and it is essential for the UK to regain regulatory autonomy. Moreover, the UK has in many ways set higher standards. The key risk for Europe is the UK could significantly reduce or eliminate taxes to improve competitiveness. There were some signs that the EU might water down its stance on this, but it also appears they want the UK to meet it in at least the middle under the idea of non-regression – that each party will not dilute the rules already in place. Michel Barnier has recently stated that the key is "consistency or some kind of equivalence". There are signs, therefore, of compromise by Europe.

The EU also wishes to maintain its ongoing rights to fisheries access while the UK is insisting on annually agreed access. The UK has been steadfast on this, and while only a small part of the deal, it strikes to the heart of sovereignty. Again, it appears as if the EU is beginning to accept the position, but may link access to the capacity of UK fishermen to sell into Europe. Indeed, European Commission (EC) President Ursula von der Leyen has stated in the EU Parliament: "no one questions the UK's sovereignty on its own waters … we ask for predictability and guarantees." An agreement here might be more accessible than thought.

Food standards is a fourth area in which the EU is accepting divergence, but looking to protect itself from imports from third party countries – think US chlorine washed chickens. Given the high level of food standards maintained by both sides, it is likely there will be a compromise on this area, but the exact parameters will likely be complex.

A fifth point of contention is Northern Ireland. Here, however, there does appear to be a path forward. One measure that appears to be gaining favour is the idea of a "landing zone" – a cut-down agreement that inches the UK towards a full trade deal while also inching it towards the end of the transition period. It allows for Northern Ireland to be outside the EU customs union but inside an "all-island regulatory" zone. It allows for a basic agreement but allows for future refinement. Given that Barnier has also noted that an October deadline will still allow for a deal, it does appear that an agreement – albeit watered down – has a higher chance of success than the rhetoric might suggest, and it is likely the reason for the stability in the pound over the last three months. Moreover, the idea of landing zones fits to a degree with the UK desire for small encapsulated deals, and despite the seeming British rigidity on the end-July deadline, David Frost did allow that a deal could still be completed in September.

Perhaps the trickiest area is the involvement of the European Court of Justice (ECJ), which goes to the philosophical heart of Brexit. The UK cannot accept a higher extraterritorial court having ultimate say on what could become domestic law. Similarly, the EU cannot accept not having the highest court interpreting what may be a matter of EU law not being in the EU – and it is indeed a requirement of EU law. It is ultimately a question of sovereignty. Yet, von der Leyen did hint that the ECJ might only need to be involved "where it matters", signalling some softening of the EU position – but even that may not be enough. It therefore highlights the key issue: *how trade disputes are to be settled with neither side's sovereignty impinged*.

Bottom line

Certainly, the key differences really appear to be fundamental questions around the idea of sovereignty. The British insistence on removing the ECJ from the deal, while the EU law requires it, should be an integral part. The British need to control their waters versus an EU need for access. Boris Johnson is pushing for a quick deal and is insistent on the December 31st deadline. The EU is appearing to push back on the deal timeline but appears to accept the end of 2021 limit (there has been less "it's not possible" comment), and the negotiations still look feasible through at least September and even as late as October. On balance, the fundamental issue appears unresolvable until someone blinks. A watered-down deal – which will mean more paperwork but possibly not tariffs or harsh quotas – is most likely to buy time to fully "cross the t's and dot the i's" on a wider agreement.

The question for investors remains how to protect against a seemingly obvious binary outcome – deal or no deal? The impact of Brexit will impact two aspects of portfolios in the main: a) the currency exposure and b) the UK domestic vs. international exposure.

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However, the opposite may well be true going forward. Sterling is trading at historically low levels (£1 = ca. $1.29) and is undervalued versus the US dollar on most measures of purchasing power parity, a proxy for "fair value". A move back towards historical averages (£1 = ca. $1.60), or "fair value" (ca. $1.45), presents a risk. **Some best-case resolution to the UK's ongoing "Brexit" negotiations – a "deal" – could catalyse such a rise. Should that occur, a sharp rise in the value of Sterling cannot be ruled out.** While evidence suggests that attempting to divine geopolitical outcomes, or subsequent market moves, is largely a fruitless pursuit, the KHIC believes that a "deal" presents an unusual, idiosyncratic risk to globally oriented, Sterling-referenced portfolios which is worth mitigating. As a result, in those strategies, we continue to protect, or "hedge", part of our US equity positions, and all gold holdings, helping us mitigate a large rise in the value of Sterling.

At present, we are comfortable with our levels of non-UK exposure both in terms of currency as well as securities.

CA26/MAR 2020

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