UK Prime Minister Theresa May has invoked Article 50 of the EU's Lisbon Treaty, formally commencing the country’s two-year withdrawal process from the EU. Barring unanimous agreement by the European Council, which includes all 27 remaining EU members, to extend the negotiating period, the UK will cease to be a member of the EU by March 30, 2019.

Negotiations on the future agreements governing the relationship between the remaining 27 EU members (EU 27) and the UK will commence in the coming months. The EU 27 are expected to hold a special summit beginning on April 29 to agree on their approach. Further delays could be caused by the outcome of the French presidential election. It is broadly anticipated that Marine Le Pen of the Front National (FN) party will be one of the candidates in the second round of voting on May 7 (assuming no outright winner emerges from the first round on April 23). A Le Pen victory would likely complicate EU 27 discussions further given her intention to renegotiate and hold a referendum on France’s continued membership of the EU. Any negotiation delay is negative for the UK as it shortens the time available to reach agreement in multiple highly complex areas. The UK is the weaker partner in these discussions as the potential impact of the UK exiting the EU without replacement agreements is significantly more negative for the UK than for the EU 27.

Certain aspects of the discussions are highly contentious, such as immigration policy, EU budget contributions, and trade agreements in goods and services. One imagines the EU 27 has no desire to make the divorce process easy, for fear of incentivizing one of the less enthusiastic remaining members to follow the UK’s path. German Chancellor Angela Merkel has made it clear that she will not allow the UK to cherry-pick among the EU’s four freedoms, namely free movement of people, capital, services and goods. May has signaled her desire to control immigration from the EU 27. Thus, before negotiations start it seems a foregone conclusion that the UK will not be able to maintain its current EU trade agreements outside of the EU. If the UK continues to insist on complete control of immigration from the EU 27, then the EU 27 may find it difficult to grant the UK preferential access to the EU customs union and trade agreements.
The divorce will not be without controversy. Rumors suggest an EU request of up to EUR 60 billion to fund EU liabilities. While that figure is likely an opening gambit from the EU that will be negotiated downwards, it includes future spending commitments the UK agreed to while still an EU member, and pension pledges made to UK employees at EU institutions. The Vote Leave campaign emphasized that sizable funds currently paid to the EU budget each year would be saved if the UK voted to exit. While that assertion was vigorously challenged by the Remain side during the campaign, any suggestion that the UK would foot a bill for leaving the EU would be very poorly received domestically, particularly if it were not accompanied by a quid pro quo of an attractive trade agreement. From the perspective of the EU 27, however, a reduction in the UK’s contribution to projects that have already been sanctioned would likely require higher contributions from the remaining member states. This would be politically difficult and equally unpopular domestically among the remaining EU 27.

The lead EU negotiator, Michel Barnier, has indicated that negotiations on trade and other aspects will not commence until an agreement has been reached on the divorce and the free movement of people. Given the potentially fractious nature of these discussions and ensuing delays, this could result in the UK exiting the EU without a formal trade agreement in place, or even without transition agreements that may need to last at least five years or more. Unsurprisingly, the UK wishes to pursue parallel negotiation streams, with trade negotiations progressing alongside other discussions.

The chief UK negotiator, David Davis, has prompted alarm in recent weeks by suggesting that the government did not have sufficiently detailed projections of the economic impact of leaving the EU without a formal trade agreement, reverting to trade under the Most Favored Nation status of the World Trade Organization. Nonetheless, he acknowledged that certain industries could face tariffs of 30%-40% on exports to the EU under those circumstances, and that financial firms would lose their ability to passport services to the EU. May has stated, “No deal is better than a bad deal,” a startlingly blithe approach in the absence of a comprehensive assessment of the impact and the likely implications for the UK economy. Other potential impacts include the UK exiting the U.S./EU open skies deal, and the re-imposition of border controls between Northern Ireland and the Republic of Ireland, the only land border the UK would share with the EU 27. May has sought to allay fears of a hard border across Ireland, but it’s unclear how that scenario could be avoided.
ADDITIONAL CONSIDERATIONS

The Brexit referendum exposed significant fault lines in how the member countries within the UK viewed the EU, with both Scotland and Northern Ireland voting to remain. Scotland voted by a margin of 62% to 38% to remain, while in Northern Ireland the margin was 56% to 44%.

Nicola Sturgeon, leader of the Scottish National Party (SNP) has called for a second Scottish independence referendum to be held before the UK’s formal exit in late March 2019. The SNP-dominated Scottish Parliament has supported that request, and Sturgeon will now formally write to May to request the power to hold a referendum be transferred to the Scottish Parliament at Holyrood under a Section 30 order. May is unlikely to agree to the referendum on the SNP’s timetable, if at all. Indications are that if she were to consent, the referendum would take place after the formal separation from the EU.

Recent elections in Northern Ireland resulted in significant gains for nationalist parties, with unionist parties losing an overall majority for the first time. While largely driven by allegations of economic mismanagement by the previous Unionist first minister related to a renewable energy initiative, the impending EU exit also played a significant role in the campaigns. Northern Ireland has the only UK land border with the EU 27. The re-imposition of border controls is especially problematic due to the potential impact on the peace process in Northern Ireland.

UK economic activity has held up surprisingly well since the referendum. However, below the surface the UK economy is in relatively poor shape, especially compared to the other G7 economies. Most of the recent economic growth has been driven solely by high consumer spending and less consumer savings. Despite a devaluation of sterling of over 15%, the UK’s current account deficit has not dramatically changed from its historically high deficit pre-referendum. Among the G7, Mellon Capital’s proprietary leading economic indicators show the UK with the lowest overall level and the only economy that is forecast to deteriorate over the next 12 months. The latest Bank of England statement indicated a potential reduction in monetary accommodation. Inflation is on an upward trajectory, in part due to the recent higher economic growth but also due to the impact of the weaker pound.

As negotiations unfold, we anticipate the largest market response may occur through sterling, with the balance tilted towards a more negative
outcome, and sterling testing the 1.20 level against the U.S. dollar. We are short the British pound in portfolios, based on macroeconomic dynamics and relative interest differentials. We are also short UK gilts due to the unattractive term premium relative to other markets. As inflation rises, we anticipate that UK gilts should suffer. Conversely, however, we are positive on UK large-cap stocks, as the weaker currency benefits multinationals through a positive translation impact for earnings generated outside the UK.

Negotiations of this magnitude are typically slow and ponderous. To provide context to the scale of the complexities of the trade agreement negotiations alone, discussions on the recent Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada started in 2009 and concluded in August 2014. Given the noises emanating from the EU 27 and UK negotiators so far, this could prove to be a very long process.