May's Brexit plan rejected by MPs

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Theresa May's carefully negotiated deal with the EU has been rejected by parliament. In this Insight, we look at what it might mean for the markets and investments.

The prime minister's pleas to parliament to approve the deal negotiated with the EU have fallen on deaf ears and Theresa May has failed to win over the majority she needed. Yesterday, MPs rejected the prime minister's plan by 432 votes to 202, the largest defeat for a sitting government in history.

There is now a little over two months for the government to get a revised deal from the EU and gain parliamentary consent before 29 March 2019. Otherwise, the UK will leave the EU without a deal, an outcome that hundreds of MPs have openly objected to.

What happens next?

The party leaders announced two alternative ways forward. The prime minister announced cross-party talks to see what agreement can pass the House. However, before they can proceed a further day will be taken up by a vote of no confidence in the government, which was called by the leader of the opposition. Whilst this may sound dramatic, the government is widely expected to survive it. The crucial support of the DUP had been promised before Mr Corbyn's announcement, and reiterated since. It is possible that Conservative MPs would rebel against their own government to prevent a hard Brexit, but they are not expected to do so at this stage.

This is the first no confidence vote under the new procedure laid down by the Fixed Term Parliaments Act, which would then give the government 14 days to regain parliament's confidence.

By rejecting the deal, Parliament has expressed its will to "take back control" of Brexit. Now, since the passage of an amendment supported by MPs from both sides of the House last week, Mrs May will have to present an alternative Brexit plan within three sitting days, so no later than the 21 January[1]. This may give Parliament an opportunity to direct the government on how it should proceed.

What the prime minister's plan B might look like, nobody knows at this point. Given the huge divisions that exist between MPs, and the complexities of parliamentary protocol, together with the views of the EU, no one can be sure quite what another stab at the plan may be.

A number of alternative options have been aired but none appear to have the support of a majority of MPs, at least in the short term, therefore creating a potential for more turbulence.

With no clear majority for any alternative plan at present, "no deal" appears to be the default option.

Are we facing a "no-deal" Brexit?

Although the legislative default for failing to agree a deal by 29 March 2019 is a no-deal Brexit (unless we agree to unilaterally withdraw Article 50 or agree an extension with the EU), it is clear from last week's amendments that there is little appetite amongst MPs for that outcome, under which we would default to World Trade Organization (WTO) rules.

1 Financial Times: May makes last ditch Brexit move ahead of key vote, 9 January 2019.

Does this mean a no-deal Brexit has been averted? It's less likely, but the difficult task of winning parliamentary approval for a new deal means "no deal" remains a possibility.

The first obstacle to winning approval for a deal is that the government needs to retain control of the House in the face of today's no confidence vote.

The second obstacle is that there may be no parliamentary majority for any other option. Other options that are being touted include a deal akin to Norway's arrangements, a Canadian style trade deal or a second referendum. Support for them may be flushed out by the cross-party talks or when the prime minister announces her next steps which is assumed to be on Monday.

The third obstacle, is that parliament could direct the government to pursue an arrangement which can't be achieved, either in time, or at all.

Until an agreement is voted as law ahead of 29 March 2019, a no-deal Brexit can't be discounted. However, the ability of the government to unilaterally withdraw Article 50 up until the 29 March does make this risk considerably less likely and the chances of an extension of the negotiating period seem to be growing.

What does this mean for the markets?

Despite falling in advance of the vote, the pound regained its losses almost immediately afterwards. This may seem a perplexing response to a result which makes the outlook much less certain. However, the reality is that it has changed very little. The vote was not expected to pass and a confidence vote was a possibility, but the government is expected to survive so little has changed.

There was very little reaction from the stock market either.

What happens next will affect how we react to events in the short-term. If Mrs May can craft an agreement which satisfies a majority in parliament the pound is very likely to rally, which will help the UK to outperform other markets. A decision to hold a second referendum may also offer strength which we can sell into, even if the likely result of such a referendum is extremely uncertain.

Alternatively, if the UK looks likely to leave the EU without a deal we would expect to see a strong sterling sell-off. While this will reflect a loss of confidence in UK PLC, it won't necessarily be bad news for the stock market. Approximately three quarters of the FTSE 100's revenues come from overseas earnings. When sterling weakens, revenues from overseas markets are worth more once converted back into sterling. As we saw after the 2016 referendum, this could be good news for overseas earners such as beverage and food producing companies.

That said, given the unprecedented nature of current events there is also the possibility that Brexit uncertainty might outweigh the currency effects in the large-cap index. Should this result in a severe short-term correction we will view this as an opportunity to pick up high-quality companies at cheaper valuations. Rather than being a reason to flee the market it is likely to present buying opportunities.

What should I do now?

Although it is natural to worry about the impact of Brexit on investments, any negative impact will most likely be felt on other assets: house prices in some regions are very likely to be susceptible to a disorderly Brexit; interest rates would be most likely to decline under that scenario; and the probable fall in the pound would mean an effective loss of value for most sterling-denominated assets. The exception is many UK shares of international companies which would still give holders their share of revenues generated in stronger currencies. Equities, as has been amply demonstrated over the past few months, are certainly a risky asset class; however, they may provide a degree of protection in the case of a disruptive Brexit.

Taking a longer view it is important to keep Brexit in perspective. We need to look beyond the current uncertainty; beyond March 2019; beyond the transition period, to the future.

The decision to quit the EU has demonstrably caused international investors to avoid UK assets, amidst concerns that a "hard Brexit" will damage the economy's health. Towards the end of last year, we saw new economic assessments of Brexit from, amongst others, the government and the Bank of England. These assessments looked at a range of scenarios and in every case the UK economy is expected to fare worse under Brexit than had Britain voted to stay in the EU. Government economists have calculated that Britain will be 3.9% worse off in 15 years' time if a deal similar to Mrs May's is finally accepted. A no-deal could deliver a 9.3% hit in 15 years' time[2].

We believe a hit to growth is probable, particularly as small and medium-sized businesses don't have the resources to be able to plan for contingencies. Such an impact could tighten financial conditions despite the banking sector having spent a lot on its own readiness. Our business is relatively unaffected by Brexit and yet we have still devoted a lot of resource to ensuring we are resilient in the different scenarios. A severe economic contraction is possible and wouldn't be pleasant as unemployment would rise, the housing market would suffer and inflation would jump. The governor of the

2 FT.com: Theresa May concedes any Brexit will leave UK worse off, 28 November 2018.

Bank of England has stressed that it is possible that interest rates could rise in such a scenario although we strongly suspect they would be more likely to fall – even in the face of higher import inflation. That has been the view taken by the bank in the past when faced with an economic shock that causes sterling to fall, even as it has pushed inflation considerably above target.

The reality is that the UK stock market at large does not reflect the whole of the UK economy. What's more, the gloomiest current forecasts are based on what we know now, but a lot could happen in the next few months that could alter them significantly. Weaker economic growth in the near future, in this period of extreme uncertainty, doesn't necessarily presage a long-run contraction. Yet, even if the UK economy does fare worse under Brexit, our working scenario, that doesn't mean that there won't be plenty of attractive investment opportunities abroad for us to exploit.

We believe that against a background of so much uncertainty, positioning portfolios on the basis that any particular scenario will arise, is risky. The better approach is to be ready to react to, and make the most of, the turbulence the ongoing process will undoubtedly create. Remaining invested and alert to new opportunities remains the best way to proceed.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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