Eurozone Equity Markets Face Political Headwinds

Eurozone equity markets have had a difficult year thus far, losing some 13.2% as of November 28, as measured by the iShares MSCI Eurozone ETF, EZU. While a slowing economy and a 6% weakening of the euro offer a partial explanation of the US-dollar return from these markets, a number of political uncertainties appear to have been more important causes.

These uncertainties include the outcome of the Brexit process, Italy's budget conflict with the European Union (EU), trade war concerns, and the recent political turmoil in France and on the Zone's eastern border, with the dangerous escalation of tensions between Russia and Ukraine. As the year end approaches, these headwinds to investor market sentiment have not eased.

With time running very short, there remains great uncertainty about Brexit. The EU governments have agreed to the draft agreement between the EU and the UK that provides the terms of the UK's withdrawal from the EU and have indicated that they are not open to making any changes in it. Prime Minister May now has the very difficult task of seeking the approval of the UK House of Commons (one of the two houses of Parliament), which will vote on the subject on December 11. May now finds it necessary to argue against her past statements that no deal is better than a bad deal. She has emphasized that this is the best deal the UK can obtain and would be much better than exiting without a deal next March. However, there is great opposition to the deal from both May's Conservative Party and from opposition-party MPs, including those strongly intent on leaving the EU, on the one hand, and those strongly preferring to remain in the EU, on the other. The deal, as structured, falls in the middle ground, not fully satisfactory to anyone; but a no-deal break would clearly be very damaging to both the UK and the EU. The Bank of England just released their analysis which indicates a no deal Brexit (a "disorderly Brexit") would lead to a recession worse than the financial crisis. That possibility may lead some to reluctantly vote for the deal or to abstain. Nonetheless, it appears likely the Commons vote will be negative, if the vote is on the current text. It now appears there will be amendments to that text before the vote. What then will follow is highly uncertain.

Rejection by the House of Commons would leave the government with 21 days to put forward a further revised plan, which would go to a second vote in Commons. Any changes in the original draft agreement would require reopening negotiations with the EU. One amendment suggested as a solution adds a sunset provision to the so-called backstop provision in order to remove the possibility that the UK would be locked into the backstop customs union indefinitely. The most-mentioned proposal for a more extensive renegotiation of the deal is the "Norway option," which would involve the UK's joining the European Free Trade Association. But that option has a number of drawbacks: the UK would still have to make payments to the EU, would still have to find a solution to the Irish border issue, and would not gain control over migration.

A Commons' rejection on December 11 could also very well trigger a challenge to Prime Minister May's leadership, which could lead to a new Tory Prime Minister. There might also be a general election, which could possibly bring in a Labour government. Labour has had unclear views as to which way to move on Brexit but clearly intends to pursue policies strongly opposed by business. The likely second vote in Commons, either on the current deal again or on a revised arrangement, if affirmative, would then see the measure taken up by the European Parliament. A simple majority there would lead to consideration by the European Council, where approval requires the affirmative votes of 20 countries representing at least 65% of the population.

Should the second vote in the UK Parliament be negative or the agreement be rejected by the EU, the UK would likely exit the EU with no deal on March 29, 2019. But that outcome is not the only possibility. The EU could agree to extend the time limit and continue negotiations despite having said they would not do so. The UK could decide to hold a second referendum on Brexit, a step more likely should the Labour Party come into power following a general election. Another possibility would be a new referendum after the UK exits the EU. A positive vote on rejoining the EU would require agreement by the EU, which would be possible if an exit deal had finally been approved but very unlikely for many years in the case of a no-deal BREXIT. In view of all the various possible outcomes, uncertainty is weighing heavily on investor sentiment.

The budget stand-off between the new Italian government and the EU has escalated. The EU has announced that Italy's proposed budget is in "particularly serious non-compliance" with previous commitments and EU regulations. This pronouncement signals the likely beginning of the EU's formal enforcement process, which can lead to large financial penalties. There are reports that the Italian government is beginning to yield a bit on its budget, which may provide some room for Brussels to reach an agreement that avoids the most severe outcome.

The Bank of Italy has issued a warning that the rising bond yields caused by the government's expansive spending plans could threaten the stability of Italy's banks and insurers as well as add billions to the interest on Italy's debt. Moody's has cut Italy's local and foreign currency ratings to Baa3 from Baa2. Foreign investors are shedding Italian bonds, while Italian retail investors do not appear eager to increase their participation in the government's debt raising. The high interest rates and developing strains on the banks certainly will not help the Italian economy, the Eurozone's third largest, to reverse the slowdown that has developed over the course of this year.

Trade uncertainties have had an impact on economies around the globe, hampering global economic growth. For the Eurozone economies, the uncertainties include those related to Brexit, to the US–EU trade conflicts, and to the widespread effects of the US–China trade war that have already emerged. The IHS Market Eurozone PMI for October, which showed that the Eurozone's economic growth had slowed to its lowest pace in over two years, cited "an export-led slowdown, linked to growing trade tensions and tariffs." The IHS Markit Flash Eurozone PMI for November then indicated that growth had dropped further to near a four-year low. It cites a further fall in new export orders across manufacturing and services. The drop in exports was the largest seen in the four-year history of this indicator.

The political difficulties of French President Macron do not yet appear to have seriously affected the French economy, which continues to grow at above-trend rates. His business-friendly economic reforms are a plus there. Spain's economy also is recording firmer gains in activity. In contrast, the growth of the German economy, the Eurozone's largest, slumped to a five-month low in October, and Italy's growth turned negative in October for the first time since 2014.

Relative equity market performances year-to-date reflect these differences in economic activity. The iShares MSCI Germany ETF, EWG, is down 17.5%; and the iShares MSCI Italy ETF, EWI, is down 15.9%; while the iShares MSCI France ETF, EWQ, is down only 9.4%; and the iShares MSCI Spain ETF, EWP, is down 11.5%. A sustained recovery in the Eurozone markets would be possible should trade tensions ease. A final agreement between the UK and the EU on the terms of the UK's withdrawal from the EU would also provide a substantial boost for these markets. In the current highly uncertain situation, caution and close monitoring of developments are warranted.

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Sources: BBC.com, Financial Times, Bloomberg, New York Times, The Economist

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BREXIT Breakthrough Followed by Threat of Breakdown

On November 13, British Prime Minister Theresa May and her Brexit negotiating team reached agreement with the European Union (EU) negotiators on a draft withdrawal treaty. The next day, after a very difficult five-hour meeting, May secured the agreement of her cabinet. Following the cabinet meeting, she told reporters “The choice before us is clear: This deal, which delivers on the vote of the referendum, which brings back control of our money, laws and borders, ends free movement, protects jobs, security and our Union; or leave with no deal, or no Brexit at all.” She reportedly told her cabinet that the deal, while not perfect, was as good as the UK can get.

It was evident the deal was not good enough for some of her cabinet members, and resignations were likely. Still, the country was shocked today (November 15) by the resignation of May's Brexit secretary, Dominic Raab, her chief Brexit negotiator, who could not support the deal. Several other secretaries have resigned, and more may follow. A deep political crisis is developing for May, for the country, and also for the EU.

The deal may be the best the UK could have obtained at this point, considering that, as the *Financial Times* said today in an editorial, "The UK has a weak negotiating hand, and the May government has played it poorly." The 585-page draft agreement had to address many issues. The most difficult has proved to be the Irish border. Recall that Northern Ireland is part of the UK and along with the rest of the UK will be exiting the EU next March, while the Republic of Ireland is an independent nation that will remain in the EU. A very important element in the Irish peace process has been the elimination of a visible border with checkpoints. Both the UK and the EU are committed to avoiding the restoration of such a border. In addition, the UK and particularly Northern Ireland are opposed to creating any border between Northern Ireland and England.

The draft agreement involves a so-called "backstop arrangement," which is a common customs arrangement for the UK and the EU, a “single customs territory” (which would eliminate the need for border checks), together with some provisions specific to Northern Ireland, requiring alignment to some other EU rules and standards. This arrangement is supposed to be a temporary solution. There would be a transition period ending in December 2020, during which there would be negotiations on a permanent arrangement. The transition period could be extended until an agreement is reached on an arrangement that negates the need for border checks. During this period, the UK would continue to follow all EU rules and therefore would remain under the jurisdiction of the European Court of Justice. It appears that the UK probably would be unable to negotiate trade agreements with other countries during this period.

Dominic Raab’s resignation letter summarized the main reservations of the pro-Brexit MPs. He believes the proposed regulatory regime for Northern Ireland, which includes provisions not required of the rest of the UK, “presents a very real threat to the integrity of the United Kingdom.” He also opposes what could become an “indefinite backstop arrangement where the EU holds a veto over our ability to exit.” He also underlines the evident fact that the proposed deal falls short of the Tory party’s promises in its election manifesto. Indeed, as the *Financial Times* notes in its editorial, the draft withdrawal agreement exposes the “harsh realities of UK’s position.” Under the agreement the UK will weaken its many ties with its most important trade partner while having “less say over the rules that govern its economy.” Unfortunately, the alternative of a no-deal Brexit would be much more disruptive to the UK and also to the EU.

The immediate threat to May is the real possibility of a challenge to her premiership, led by pro-Brexit hardline Tory MPs in the European Research Group. They have been encouraging cabinet members to resign and say they have in hand the 48 requests from Tory MPs that would be needed to call for a vote of no confidence. Should these requests be tabled, it would take a majority of the Conservative law makers, at least 148, to force a leadership change. Whatever their reservations about the draft agreement, the Tory party members would have to consider the implications of rejecting May and thereby the terms of this agreement. Doing so would mean that the prospect of a no-deal Brexit in which the UK is ejected from the EU with no transition period becomes highly likely and would increase the likelihood of a new election and the threat of a Labour government.

Should May survive the leadership challenge, the next essential step will be to seek the agreement of Parliament sometime before Christmas. The intense political debate within the UK now begins. She does not have a majority and has had to rely on the Northern Ireland Democratic Unionist Party (DUP) for key votes. Arlene Foster of the DUP has indicated they will not support May on the Brexit vote. Nor will a number of the Eurosceptic Tory MPs. The Labour Party has indicated that it is opposed to the deal, although a number of Labour MPs have supported May's Brexit efforts to date. The Liberal Democrats have issued a statement indicating their opposition to the deal. While the Tory party whips express confidence, the prospects for getting this deal through Parliament are not looking good. Success may depend on whether members recognize the highly disruptive implications for the UK of a no-deal Brexit.

The European negotiators, like their British counterparts, had to make significant concessions in order to reach the agreement on the draft exit treaty. An EU summit to seek agreement from the 27 remaining EU states will be held on November 25, assuming the UK parliament approves the deal. EU approval appears to be likely. Donald Tusk, the president of the European Council, said today that "We have always said that Brexit is a lose-lose situation, and these negotiations were always about damage control." Difficult negotiations to produce the final text of the withdrawal agreement and a political declaration outlining the future relationship between the UK and the EU will need to proceed. Time is very short, as the UK is due to leave the EU on March 29, 2019.

For investors, Parliamentary agreement of the proposed deal would reduce but not eliminate uncertainty. Financial markets in both the UK and the EU would likely respond positively, and the pound and the euro would likely strengthen somewhat. However, the long-term future relationship of the UK with the EU would remain in limbo. The incentive for financial firms in particular to move operations to the EU would remain. Rejection of the deal would increase the odds of a no-deal Brexit significantly and would be strongly negative for markets.

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Sources: BBC.com, Financial Times, Bloomberg, New York Times, The Economist

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