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COMMENTARY

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Spooked by Brexit? The Markets Don't Seem Too Scared

As trick-or-treaters don their costumes on this side of the pond, the U.K. could be surveying a frightful prospect on its side: Brexit. More than three years after a referendum decided the country would leave the E.U., the British face yet another deadline in what seems to be an endless game of kick the can. The latest date to leave the E.U., Oct. 31 at 11 p.m., was set by the union after former Prime Minister Theresa May failed to gain the necessary votes on a negotiated deal for a "soft" Brexit.

Parliament recently passed a law to avoid a no-deal (or "hard") Brexit, so if current Prime Minister Boris Johnson can't negotiate an agreement by Oct. 19, another extension request may be in order. Of course, the E.U. may not honor it but Johnson may have other tricks up his sleeve, as he has voiced determination to stick to the Oct. 31 deadline with or without a deal. Given all this uncertainty, jockeying, and fluidity, how are the markets reacting and what can investors expect down the road?

<u>Valuations take Brexit into account</u>
Since the June 2016 referendum, Brexit deadlines have come and gone with little clarity about the future for the U.K. Although much discussion has surrounded the issues, the markets have generally been somewhat complacent in response to recent developments while the British pound has trended lower. Some of the most dire scenarios—those associated with a hard Brexit—appear to have been priced into current relatively low equity valuations for the European region.

European economies are being impacted by Brexit concerns as well as an unresolved trade war, and data is reflecting pressure in the region. The Eurozone Composite PMI, an indicator of trends in manufacturing and services, fell to 50.4 in September from a reading of 51.9 in August. Additionally, the services index alone reached an eight-month low of 52.0 in September. Such forward-looking data reports indicate that uncertainties should continue to exert pressure.

<u>Some trading partners exhibit weakness</u>
The E.U. is an important trading partner of the U.K., with member states serving as the destination for about 46% of British-produced goods and services. Major exports include vehicles, services (such as advertising, engineering, accounting, and research and development), financial services, travel services, and pharmaceuticals. Should a hard Brexit take place, expectations are for a weaker pound, which could make these exports more affordable for Europeans. However, cheaper British goods may not be enough to buoy demand.

Germany, which represents a market for about 8.7% of U.K. exports and the largest economy in the E.U., has been showing signs of weakness. The country exhibited a decline in GDP in the second quarter, and should the third quarter follow in negative territory, the country would officially be in a recession. Further, Germany exports twice as many goods to the U.K. as it imports, further exposing this market to uncertainty and risk from Brexit. Although the U.K.'s other large E.U. trading partners—the Netherlands, France, and

Italy—are in better economic shape than Germany, it is unlikely that they can make up for Germany's lost purchasing power.

Impacts on the U.S.

The U.S. is also an important trading partner for the U.K., but the Brexit overhang is weighing down the pound and making U.S. exports less competitive in price. The U.K. represents the fourth-largest export destination for American goods and services, as reported by the U.S. Chamber of Commerce, with major exports including aircraft, machinery, fuels, agriculture, and financial services. As Brexit is expected to pressure the pound further, demand for American goods from this region will likely falter. Additionally, the weaker pound is expected to have a negative impact on the tourism industry in the U.S., which has become a relatively expensive travel destination for the British.

Overall, however, the direction of the U.S. economy and markets should not feel significant impacts from Brexit. The U.S. has extended its economic expansion beyond 10 years, despite some signs of weaker growth ahead. The strong dollar, a slowdown in global trade, and ever-present trade wars are contributing to a contraction in manufacturing activity. Talk of a recession by some may be premature though, as the services economy, consumer spending, and labor market all remain on solid footing.

In the U.S., equities will likely continue to exhibit some spikes in volatility if economic indicators disappoint or if trade wars escalate. At the same time, bond yields should continue to move lower unless growth resumes at a healthier pace, the Fed changes its dovish stance, or inflation rears its head.

Maintain a balanced perspective

The media, politicians, and the public may have a field day discussing and analyzing the horrors and ramifications of Brexit, but the markets appear to have already accounted for any bad news, and valuations in the E.U. are relatively low. As the end of the year approaches, investors may want to pause and reconsider their long-term objectives and how their portfolios are structured to withstand market fluctuations in Europe and beyond. Ensuring a portfolio is well-diversified and structured to absorb as much risk as is comfortable to achieve the desired returns is one way to keep the Brexit monster at bay.

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