Tortoise QuickTake
Sustainable Energy Podcast

Tortoise

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provide a timely update on trending topics in the market.

Hi, this is Jean-Hugues de Lamaze, London-based Senior Portfolio Manager with the Tortoise Ecofin Platform.

The point of our message today is to give you an update on what we believe is the possible impact of how Brexit talks are progressing on a few weeks ahead of the 29 March 2019 deadline. This is based on our observations and hypothesis. However it must be stressed that we are not political commentators so this is simply our opinion, rather than fact, and should in no circumstances be used as the basis of any investment decisions.

U.K. Prime Minister Theresa May is actually in Brussels today to try to seal a last minute deal with the EU authorities. At such a late stage in the process, we think it is worth asking ourselves the following question: What if the financial markets were to be proved overly optimistic about the outcome of Brexit talks?

Clearly there remains a good chance that a deal will be signed at the very last minute next month between the U.K. and the EU. But we are surprised to see how confident the public opinion and financial markets seem to be about such a scenario. In a recent paper, published on 28 January 2019, JP Morgan was attributing a mere 5% chance to a no-deal scenario on 29 March. A few days before, on 21 January, Goldman Sachs' strategists attributed "subjective odds of 10%" to the no-deal scenario." The firm has since then raised the probability to 15%, which remains very low. Overall, it seems that financial markets are attributing an approximately 80% chance to scenarios which investors could consider positive, ie either a last minute deal, or an extension of the negotiation period, or the launch of a second Brexit referendum which could reverse the outcome of the June 2016 one.

We are actually surprised and concerned that the probability of a no-deal Hard Brexit scenario is largely ignored by equity markets.

Even if Theresa May managed to sign a deal with the EU for an orderly Brexit, she may struggle to get it approved by the Parliament. The Prime Minister suffered a blow this morning as three Tory MPs have resigned from the party to join an independent group formed last week by dissatisfied Labour MPs. Last week also, Theresa May's motion to back her current negotiation strategy was rejected by 303 votes to 258. So these recent series of events show that the Prime Minister's stated confidence that she would gain support to a last minute revised deal may be overly optimistic. This clearly increases the risks of a Hard Brexit, even by default.

We think that the risk that the EU and the U.K. cannot find an agreement by 29 March is probably much more significant than the market assumes, potentially as high as a 50% possibility.

So what happens on 29 March 2019 if no U.K./EU deal has been reached? We believe that risks are skewed to the downside.

Two main scenarios:

First scenario: No extension to the 2-year negotiation period which was triggered in March 2017 by the exercise of Article 50 of the EU treaty:

If the U.K. Parliament rejects any extension of the talks, we enter into proper Hard Brexit, i.e. EU treaties stop being applied to the U.K. from day one. This would be highly unknown territory, with a significant risk of supply/chain disruptions and of the U.K. economy going into recession.

- ⇨ The main stock market implications could be the following:

- Sterling could drop, by as much as 10-15%, going towards parity with the EUR; admittedly though, that risk could be limited by the fact that the British currency has already fallen by over 10% since the June 2016 referendum against both the USD and EUR;
- U.K. gilts could fall with a steepening yield curve due to an inflationary context;
- Sovereign risk could increase for the whole U.K./EU zone;
- USD-exposed names could get a boost on the equity markets, but;
- U.K. utilities may be hit by the risk of new general elections, with the threat of Jeremy Corbyn, the leader of the Labour opposition party, to gain power and implement his public services nationalisation programme.

A second scenario: The extension of the Article 50 negotiation period, which would have to be at the U.K.'s request: Negotiations could then continue for another few weeks or months. But the extension is unlikely to be for more than three months. Beyond three months, the U.K. could have to organise European parliamentary elections before the start of the new EU Parliament session due to start on 2 July 2019.

The U.K. would have to justify the request for extension, by either the intention to organise a new Brexit referendum or general elections.

=> Stock market implications could be the following:

- Uncertainty could persist
- Sterling currency could see a short-lived relief rally;
- And then two possibilities:
  - Either Theresa May's weakened political position forces her into general elections: this could be a worst case scenario for equity markets, in our view, given how unclear the current polls are, showing 35/40% for each of the Tory and Labour parties. The so-called "Corbyn risk" could dominate, with threats of nationalisation of UK water, power and rail networks. This could be bad for U.K. equities overall.
  - Or, second possibility, the Parliament votes for a 2nd referendum: this could represent a boost to equity markets in our view as chances of a Remain scenario could be enhanced. Note that current polls actually show 56% in favour of the Remain camp against 44% for Brexit (versus 52/48 Brexit lead in the June 2016 vote). This could still be pretty tight and uncertain.

So in conclusion, we see that:

- Only five weeks away from the 29 March deadline, equity markets still attribute a very high probability to an orderly Brexit scenario;
- Risks are clearly skewed to the downside if such scenario is proved wrong;
- A Hard Brexit could heavily destabilise U.K. and EU economies;
- It could also introduce major political uncertainty in the U.K. with a risk of general elections, with the main opposition party suggesting stringent nationalisations as part of its programme;
- Only a second referendum could then leave the door open to a still possible full reversal of the Brexit process.

That's it for today, hope you found those comments useful.

Have a nice day!

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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