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Tortoise QuickTake Podcast

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

I'm Graham Allen, Senior Portfolio Manager for Tortoise Credit Strategies. Welcome to the Tortoise Credit podcast. Today we're going to discuss the state of the current BREXIT negotiations and why this is relevant for the EU countries.

Following the surprise vote by the UK public to leave the European Union in June 2016, the two negotiating parties have finally sat down to discuss the terms of the United Kingdom's departure from the European Union. Today we will briefly examine the key issues at stake for both parties and why this is relevant for not only the UK but for the European also the global markets. It should not be forgotten that shortly after the BREXIT decision, the U.S. Treasury 10-year yield dropped to its lowest level ever of 1.36% in July of 2016. Today that yield is approximately 75 basis points higher, so it can be seen that although the UK's departure from the European Union is somewhat local in its scope, it does have the potential to affect the global market narrative.

Why is this? Perhaps the reason why this is not readily apparent is because most of the media discussions are from the perspective of the UK, and what effect a hard or soft BREXIT would have on just the UK economy. This UK is not relevant from a global market perspective. However, if viewed from a more European perspective, the implications of failure or success have important ramifications for the European project as a whole, and therefore the global financial system. In a sense, the UK's departure already represents a partial failure of the European Union itself.

One perspective to delineate more clearly is the widely held view that the UK is at a disadvantage in these talks. While this is a moot point from a political perspective, this is not the case from a financial perspective. It has not helped that this perception has been exploited from within the UK's own political parties, not only by the anti-leave camp, but also by some pro-leavers within the conservative party. In the end however, the financial numbers speak for themselves and they clearly indicate that the UK is in a strong bargaining position.

The UK runs an annual trade deficit with the European Union of approximately $78 billion equivalent per year. Most of that imbalance occurs within the French wine industry and the German car manufacturing sectors. If these negotiations were to end poorly, these particular European industries would be severely hurt when it comes to accessing the UK consumer. This would give rise to severe job losses as well as a significant decline in profitability for both industries. Furthermore there are also a significant number of European businesses and employees based in the UK, which would also suffer if the ability to export from the UK into Europe were restricted by tariffs.

So from a European perspective, there is a real monetary incentive by European businesses to see an amicable resolution to the BREXIT talks.

Secondly the UK is the 4th largest net contributor to the European budget, so from a European perspective it is in their interests to see that those contributions last for as long as possible. An abrupt withdrawal of that contribution which could occur if the UK simply walked away from the table with no agreement would cause a significant and immediate budget shortfall in many areas of spending within the EU. In 2015 the UK's net contribution was a significant $16.6 billion after rebate. So again it is in the European's interest to see an orderly planned reduction in that contribution from the UK to ensure a smooth transition. In short, both parties need an amicable resolution to both the trade agreements going forward as well as departure payments demanded from the UK. To date, both sides have made little progress towards that goal and this is frustrating parties on both sides. The EU accuses the UK of 'ambiguity' in its intentions and the UK has accused the EU of unrealistic expectations of its departure payments.

Now that the negotiations are underway it is reasonable to expect a more pragmatic approach simply because the clock is ticking toward the 2-year deadline and because of the financial implications previously mentioned. There is no question that the level of resistance coming from EU's Brussels negotiators is linked to the desire not to have the UK leave the Union at all. The fear here is that if the UK leaves, and successfully negotiates several new trade deals, other countries may be encouraged to follow suit if the process is a success. It should be noted that leading up to BREXIT, the UK was increasingly less reliant on the EU as an export market. Between 2008 and 2015 the share of the UK's exports shipped to the EU dropped from 60% of the total to approximately 40%. Much of this was due to the poor relative performance of Europe as a whole, again demonstrating the failures of the economic policies of the EuroZone itself. So the animosity of the negotiations so far can be explained by the desire by many in Brussels to make the process as difficult and uncomfortable as possible, and the hardening of the Pro Brexiters in the UK that are determined to see the process through despite the governments weakened bargaining position caused by the recent election results.

In the end however the financial issues will dominate and in fact only this week the French have threatened EU unity and proposed a softened approach to the talks by suggesting compromise. Under the EU timetable negotiators insist that there will be no trade discussions until the terms of the departure have been decided. In other words, the amount of the bill the UK will have to pay to leave, the so called 'divorce bill'. The French are proposing that the two could be negotiated together and are anxious for the deadlock to be broken. It is quite possible that the German Chamber of Commerce will also echo a similar sentiment. In return the UK would maintain EU law and continue to contribute $10 billion a year equivalent into the EU budget for three years.

This development therefore is a clear sign that the reality of both sides' predicament is sinking in, and that a more pragmatic approach is likely to ensue.

To conclude, recent data from the EU has shown a welcomed acceleration of GDP growth across the region. A much needed boost after the eight years of austerity imposed by the stability pact. Hopefully the eventual transition of stimulus from the European Central Bank to individual nation's fiscal programs will ensure the continuation of this much needed economic recovery. A poorly negotiated BREXIT negotiation, or even a premature end, could cause significant disruption of that recovery and plunder the region back into economic malaise, mostly affecting Europe's two largest countries, France and Germany. This would not be good for the global economy. Alternatively, if the UK departs and prospers, it may encourage the breakup of the European Union as a whole and also cause severe global economic disruption if other EU members decide to follow suit. Italy and Greece would be the two most likely candidates, most recently Ireland has been talked about as a possibility.

The best solution therefore is an amicable separation of the two parties, with the UK negotiating separate trade deals in parallel with the talks. At the same time EU businesses would retain access to the UK markets and continue to grow out of recession under a more successful EU framework. Although this outcome seems a stretch for the time being, it does seem that the realities of the situation are finally pushing the BREXIT talks in that direction.

Thank you for listening. We hope you have found this useful.

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@tortoiseinvest.com.