Brexit: High Noon at the Last Chance Saloon

Being at the 'Last Chance Saloon' is essentially having one last chance to find a solution to a problem before it all collapses. 'Last roll of the dice' would be a synonym.

Whist the phrase is common place, what I didn't know was its origin, according to history there was a saloon in the 1800's in what we know as the 'wild west'. It was called the Last chance saloon because this saloon was the last place to drink alcohol before a rider entered Indian Territory where alcohol was prohibited.

It's strange to be writing once again about Brexit and I suppose that's indicative of the relapse in European COVID-19 cases which is a golden lining to what could rapidly see the resurgence of Brexit volatility coming roaring back in both UK and European markets.

From where I am sitting, with EU / UK trade talks reaching a crunch point in the next couple of weeks, the prospect of a Brexit trade deal is well and truly having a drink at the last chance saloon.

What makes the trade deal so interesting is the survival of the UK equity market, fixed income market and the pound are seemingly resting in the balance of the trade deal. Reassuringly the picture on the European side of the channel looks more stable when it comes to a potential fallout from a hard Brexit.

With the UK still importing around 50% of all overseas goods from the EU and exporting over 40% of its total exports to the EU there remains a reassuringly strong balance in favour of the EU. One can see this in terms of stock price performance of European markets vs. UK markets since the vote to leave and the relative strength in the Euro vs. the pound.

As it is in so many economic examples, COVID-19 has dramatically changed the status quo on Brexit. On the EU side there remains high risk of second infection waves, imported or home induced, and this remains fraught with risk not only to human life but to the fragile but positive European stock market recovery. With the fractious relationships between EU nations there remains a lot of political risk in agreeing a bailout package which suits all nations when you have such polarised COVID experiences coming from the likes of Germany and Italy.

The background EU centric risk remains that COVID-19 has arguably seen some of the wealthy northern nations such as France and Germany being slow to agree a support package for the southern nations which has the potential to boost the likes of Italian and Spanish anti EU populism.

Furthermore, the recent EU COVID bailout fund (500 Billion Euros) also has no provisions for a UK hard Brexit and the subsequent drop off in funds and payments from the UK would force the whole EU block to forcibly top up the COVID disaster fund with additional billions.

Throw in negative interest rates and stretched government finances and you have an EU block that can ill afford neither the economic or political impact from a hard Brexit.

So where are we? Negotiations have been progressing at an encouraging pace after the forced lockdowns put paid to the pre COVID progress. Whilst the UK has seemingly been ratcheting back on some of its agreements in the exit deal and the EU commission has been very verbal about this, it would appear the EU has been able to realise the bigger picture and remain at the negotiation table.

From here, if the UK and EU cannot make real progress over the next month then its likely real selling pressure on the pound and UK domestic assets but also in European markets is going to materialise.

UK and EU companies with international assets predominantly residing in the large cap end of the market should remain largely insulated. As we move closer to the December deadline the volatility in EU and UK assets is going to be very closely correlated to progress on trade negotiations with the volatility sensitivity increasing exponentially the closer we get to December without a deal. Again, this volatility will centre on UK assets because of the EU trade imbalance but it will still be seen in some measure in the European market.

In terms of progress towards a deal its actually looking better than it has done in a long time. The EU has now admitted they might be able to find some common ground on equivalency rules for UK companies in the EU. Equivalency between UK and EU companies was by far the largest sticking point for Brussels which seems to be now softening.

This change in rhetoric came in the wake of a high level meeting in Brussels between the EU commission and the UK where both stated "We want to create the most conducive conditions for creating an agreement before the end of 2020" and as such both sides needed to "intensify the negotiation process". I want to stress that this positivity was from BOTH sides, instead of one side saying something positive with the other contradicting it, which up to now has been the norm. This collaboration is a very big move forward.

In light of the above positivity for stocks there is one final piece of the 'Last Chance Saloon' story.

Riders on their way into Indian Territory saw the Saloon's swinging sign reading 'Last Chance Saloon' a true sign of desperation. Riders on their way out of Indian Territory saw the reverse of the sign which read 'First Chance Saloon' a cause for celebration and most definitely a pickup in one's mood.

So, real progress on a trade deal is going to likely spell a turn from 'Last Chance Saloon' to 'First Chance Saloon' and the chance to finally see one of the longest spells of EU / UK pessimism begin to lift. Which, given the backdrop of extreme corporate uncertainty as a result of COVID, is only a benefit to both sides of the channel.

The foundation of TAM's EU investment exposure remains in well diversified and high quality investments to position client portfolios for either a further bout of COVID fear, or a hard Brexit. Both COVID and Brexit necessitate a need to own plenty of very high quality, low debt companies in Europe which have a good spread of domestic and international earnings to insulate companies from any specific geographical shock, and this is exactly where we continue to focus our investment efforts.

TAM continues to watch Brexit as either an opportunity or a threat for our European clients. We stand ready to react accordingly and alter our investment exposure to capitalise on this highly fluid period, in what has been a truly historic year for global markets.