BREXTENSION

By Jeff Weniger, CFA®, Asset Allocation Strategist

Just what is the probability of Hard Brexit, the scenario that sees Britain crashing out of the European Union without a deal? The probability of it happening by March 29, the deadline for the two-year negotiation saga, is low, especially after the House of Commons' late-January vote to send Prime Minister Theresa May back to Brussels for another round of negotiations with European Union counterparts. However, we think the market needs to appreciate another contingency: Brextension. This is the scenario of kicking the can down the road, driven by flighty markets and fear of the unknown.

Yes, MP Yvette Cooper's plan to extend Article 50, the Lisbon Treaty clause that puts the deal deadline at March 29, failed in Parliament. But Labour put that on the table when there was still two months to go. Let the clock tick some more. Brextension looms.

As regional economic data stumbles this winter, it is important to realize that the slowdown in Britain isn't that bad compared to the eurozone. Sure, U.K. Prime Minister Theresa May is facing softness in London real estate (though national home prices are still up compared to last year) and the pound's decline has been relentless, off 17 cents to $1.32 from the rate that prevailed at the summer 2016 referendum. But the U.K. has thus far largely defied the gloom-mongering of hard-nosed Remainers. A big risk of Brexit was supposed to be the mass exodus of financial professionals from London's Square Mile to supposedly more banker-friendly climes in Frankfurt and Paris. It seems to have been more of a trickle than a flow.

A look at the data makes it clear that the EU is hardly in a position to allow Hard Brexit.

The Markit/CIPS U.K. Manufacturing PMI[1] beat Street estimates in its latest print, just as it did in November, coming in at 54.2 versus a consensus estimate of 53.5.[2] For context, that is near the robust Markit US Manufacturing PMI, which was 54.9 in January.

By comparison, France flirted with manufacturing contraction in December, though expansion reappeared in January.

Meanwhile, Germany's reading of 41.9 is threatening to corroborate the scary dip into negative GDP territory in Q3[3]. To be fair, it is somewhat widespread in officialdom that total output was stagnant because of one-time auto manufacturing production issues stemming from implementation of "Dieselgate" regulations.[4] Nevertheless, global stock markets on edge aren't going to let anything slide.

That was manufacturing. How about services, which captures finance industry activity? Here is where Theresa May might have some concerns. The Markit/CIPS U.K. gauge of this measure came in at 51.2 in December, flirting with contraction territory below 50.

[1] Purchasing Managers' Index (PMI): An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction, while 50 indicates no change.
[2] As of December 2018. Sources: Bloomberg, WisdomTree. Data for the U.S. and Germany are as of 01/19.
[3] Gross domestic product (GDP): The sum total of all goods and services produced across an economy.
[4] German auto manufacturers and engineering in general has been caught in an embarrassing cloud from revelations that the major players illegally gamed their computers to falsely indicate that carbon emissions were within with regulatory standards. This may be the biggest scandal to hit corporate Germany in recent years, exceeded only by the global financial crisis.

German services look better at 53.1, down from this autumn's 56.0 reading registered around the stock market's peak.

The French economic and political scene is also a problem. Services PMI there was 47.5 in January, confirming manufacturing's woes. With 10 dead from the "yellow vest" gas tax protests, French negotiators are hoping upon hope for economic positives. They can hardly tow a hard line on the British if the clock starts ticking to March 29.

Though the Franco-German alliance is typically the focus, let not Italy and Spain be ignored. The Italian composite index of manufacturing and services PMIs is right on the expansion/contraction line, at 50.0. The country is dealing with scrutiny into its troubled banks, reflected in the blowing out of the state's sovereign yields in 2018. Add in the "strange bedfellows" coalition government of the leftist Five Star Movement protest party and the anti-immigrant League, trying to figure out how to keep promises of tax cuts, pension age reductions and guaranteed income minimums while somehow keeping the budget deficit-to-GDP ratio in the 2% range.

Spain is a bright spot, continuing its remarkable post-crisis recovery with a composite PMI of 53.4. But the other three of the four major eurozone economies—Germany, France and Italy—have some very real economic question marks that may just exceed those of Britain as 2019 gets rolling.

Both British and EU negotiators probably had their Christmas dinners ruined, after the VIX volatility index[5] shot sky high and the stock market cratered on the holiday's eve. Both sides of this negotiation have heels on the cliff's edge.

Cue Brextension.

RULES MEANT TO BE BROKEN

Article 50 of the Lisbon Treaty, the EU Constitution, was triggered by Theresa May in 2017, setting a two-year timeline to come to terms with the EU. That is where the March 29 deadline comes from: the clock strikes midnight. Yes, the PM is steadfast in her determination to get a deal done. But having survived a confidence vote in December, and with her "deal" summarily rejected by a 432-202 result in Parliament in mid-January, she may not be prime minister for much longer.

We fool ourselves at our peril if we believe that the 2016 Brexit vote is a new rejection of Common Europe, aligned with the embrace of populism that hit running stride with the rise of politicians such as Donald Trump, Hungary's Viktor Orban, and even never-electeds like France's Marine Le Pen. In fact, there have been numerous instances of the "European question" being put to a plebiscite, with the results ignored because they went against Brussels' wishes.

Investors would be remiss to forget events that are becoming hazy in memory but did nevertheless occur during most of our adult lives.

62% of Dutch voters said "No" to the European Constitution in 2005, two years before the onset of the banking collapse and a decade before the populists gripped fascination. The Dutch were no anomaly; the French said "No" to that question that same year. Yes, those votes were different from Brexit; those countries weren't being asked if they wanted to leave the EU. But the plebiscite was allowed to indicate if they were keen on the way things were going with the EU, the Project, Common Europe, whatever it is that each voter wanted to voice an opinion about. The answer: No.

But the EU simply ignored them. Which is why investors may want to consider a concept we call the "Ireland-Norway" model for a Brexit outcome.

[5] CBOE Volatility Index® (VIX®): a key measure of market expectations of near-term volatility conveyed by S&P 500 Index stock index option prices. It is the premier benchmark for U.S. stock market volatility.

NORWAY MODEL? NO, TRY THE IRELAND-NORWAY MODEL

First, let's cover the much-discussed "Norway" theory. This is the angle whereby Britain could join a little-known economic bloc that also includes Lichtenstein and Iceland, countries that are EU-friendly but not in the club. They enjoy free movement of labor and goods to and from the EU—classic Common Market stuff—without the headache of grand-plan Europe: continental militaries, socialization of foreign nations' debt mistakes, having Berlin and Paris call the shots, never-ending buck-passing on the migrant crisis, etc.

But the Norway model presupposes the U.K. and the EU agree to a deal in time. A deal? We are still on the heels of May's no confidence scare and parliamentary embarrassment , with the Tories split into factions. Hardline Brexiters can grab their own microphones now too, courtesy of the evolution in media from the papers to the web. Consider someone like MP Jacob Rees-Mogg, of the once-obscure euroskeptic tradition, using the great equalizer, Twitter, to fight the party's civil war in the public square.

Meantime, pairing up with Hard Brexiters is the sliver of Northern Irish Democratic Unionist Party (DUP) MPs who were vehemently opposed to May's deal with the EU. There could be enough MPs between the more conservative factions of the Tories and the DUP to keep negotiations spinning indefinitely.

Northern Ireland plays an outsized role in Brexit. The issue, in brief, is the so-called "backstop," which addresses a much-feared recreation of a real border with Ireland. It's been a quarter century since the Catholics and Protestants finally put closure to The Troubles. Brexit-induced economic frictions in the region is not what anyone needs in that corner of the world, nor images of armed guards.

With little that everyone can agree on, Britain stumbles forward to March 29 with any new deal probably dead on arrival. A no-deal Hard Brexit is an outcome that neither the Continent nor the British at large desire, given the onset of considerable economic unknowns.

The curious reader may wonder why I stopped at the 2005 Dutch and French votes in citing the EU's history of simply ignoring votes on the European question. Extra credit to those who also remember the Irish case, because that is the one that most closely resembles Brexit's "what next?" whispers. Ireland also voted, but unlike in 2005, they went to the polls at the worst possible time for defenders of the status quo: 2008. That summer, with Irish bank stocks already sliced in half and the Celtic Tiger dead under collapsed home prices, voters were asked to ratify the Treaty of Lisbon, the European Constitution. Again, the answer was No.

But Brussels and Dublin weren't keen on that result, so they put on a massive PR campaign and made the Irish vote again. This time they fell in line.

Which is why Brextension is not only possible but maybe probable, because the weak are negotiating with the weak. There may not be enough time between now and March 29 for all parties—Remainers, Hard Brexiters, EU citizens working in Britain, Soft Brexiters, concerned Northern Irish, French politicians battling economic fallout from the yellow vest riots, Germans trying to keep the experiment together and legions more—to sit at the table and break bread.

A lesson that may be "learned" by the British comes in the form of a second referendum or a pushback on the Brexit deadline.

Don't forget that Article 50 of the Lisbon Treaty only places a two-year deadline under the Constitution as it is currently written.

The EU has no qualms about changing the rules. But when will they do it? Likely at the eleventh hour. This is Brextension, a re-vote, taking place after March 29. And if it is going to be after the deadline, what's the urgency? Don't be surprised if a second referendum comes in the summer months.

This is the Ireland Model, or Norway-Ireland – no one really knows – and if it comes to pass, bitterness could linger for generations, not only among died-in-the-wool Brexiters, but maybe among a considerable portion of the population that is simply "euroskeptic lite." This group may never accept EU membership.

Should the regional economic slowdown turn into something harsh in 2019–2020, make no mistake: euroskeptics like Italy's Matteo Salvini, marginalized French politician Marine Le Pen and U.S. president Donald Trump will be watching.

Below are considerations for U.K. equity bulls and bears.

FOR THE BULLS

Investors of a contrarian bent note that U.K. equities are one of the most shunned asset classes. According to Bank of America Merrill Lynch's December fund manager survey, the degree by which investors are underweight the country's equities is the second highest on record.

Additionally, owners of U.K. equities can consider that sterling has not only taken a considerable tumble in the two-plus years since the Brexit vote, but also over the last decade. GBP traded north of $2 for a spell in 2008 and was as high as $1.72 as recently as 2014. At $1.32, a lot of damage is already behind it.

Because investors have been staying away from the country, the MSCI United Kingdom Index is now offering a dividend yield[6] just short of 5%, while the country's 12x forward P/E ratio[7] is about four points lower than the S&P 500 Index.

Finally, a positive of Brextension. Should both parties push negotiations back to some later date or give the British our Ireland model of voting-until-you-vote-the-way-we-want-you-to-vote, the stock market could cheer the elimination of the March 29 wall by bidding up GBP and U.K. equities.

FOR THE BEARS

Bears argue that money managers are decidedly underweight U.K. equities for good reason: "Little Britain," alone in the region, would officially join the ranks of the middle powers.

6 Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.
7 Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Additionally, with sterling, it could be argued persuasively that its multiyear collapse from north of $2 was called for, as the GBP of yesteryear was trading considerably higher than purchasing power parity when compared to USD. WisdomTree runs metrics on GBP in our dynamically-hedged suite of ETFs, and those metrics aren't too keen on the currency, with both momentum and short rate indicators flashing warning signs relative to USD.

Broad U.K. equity valuations can also be taken with a grain of salt because of the construct of London's stock market. Traditionally heavy in financials, energy and basic materials, the U.K. will always appear less expensive relative to other markets whenever tech stock valuations are elevated, because the country is light in that sector.

Finally, it could be argued that Brextension is negative in that March 29 could become June 30, then September 30, then December 31, in a never-ending debacle. To the extent that British equities have struggled since summer 2016, it was Brexit, Brexit, Brexit that was a major driver of the underperformance. Maybe the Band-Aid does need to be ripped off, and Brextension would disallow that.

WISDOMTREE'S U.K. EXPOSURES

Fortunately, WisdomTree has been around long enough to have something for everyone. Figure 1 shows the country/region exposures of nine of our broad developed international ETFs. High U.K. allocations are on the left, and lower allocations are on the right.

FIGURE 1: Broad International ETF Country Weights

	Largest U.K. Exposure ←							→ Smallest U.K. Exposure	
Ticker	**IQDG**	**IHDG**	**DTH**	**DOO**	**DOL**	**DWM**	**DWMF**	**DLS**	**DIM**
Name	WisdomTree International Quality Dividend Growth Fund	WisdomTree International Hedged Quality Dividend Growth Fund	WisdomTree International High Dividend Fund	WisdomTree International Dividend ex-Financials Fund	WisdomTree International Large Cap Dividend Fund	WisdomTree International Equity Fund	WisdomTree International Multifactor Fund	WisdomTree International Small Cap Dividend Fund	WisdomTree International Mid Cap Dividend Fund
U.K.	20.0%	19.8%	17.5%	17.4%	16.9%	15.5%	15.4%	14.2%	11.9%
Eurozone	21.8%	21.9%	34.7%	37.7%	36.4%	33.6%	25.2%	19.0%	30.9%
Non-EZ Europe	26.6%	26.7%	18.3%	17.3%	17.1%	16.0%	10.1%	14.3%	12.6%
Asia	22.6%	22.7%	17.2%	16.7%	21.5%	25.1%	36.8%	32.7%	31.0%
Antipodes	7.8%	7.8%	10.1%	9.1%	6.6%	7.9%	10.1%	14.4%	10.0%
U.S.	0.0%	0.0%	0.1%	0.7%	0.6%	0.3%	0.5%	1.0%	0.5%
Other	1.2%	1.1%	2.0%	1.1%	0.9%	1.6%	1.9%	4.3%	3.0%
Cash	0.1%	0.0%	0.1%	0.2%	0.1%	0.1%	0.0%	0.2%	0.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Sources: WisdomTree, Bloomberg, through 12/20/18. Subject to change. Weights may not add to 100% due to rounding.

For investors that have dedicated line items in their asset allocations for Europe specifically, figure 2 shows our five broad European ETFs. Again, heavy Britain on the left, light on the right.

FIGURE 2: Dedicated Europe ETF Country Weights

	Largest U.K. Exposure ←				→ Smallest U.K. Exposure
Ticker	**EUDG**	**DFE**	**HEDJ**	**EDOM**	**EUSC**
Name	WisdomTree Europe Quality Dividend Growth Fund	WisdomTree Europe Small Cap Dividend Fund	WisdomTree Europe Hedged Equity Fund	WisdomTree Europe Domestic Economy Fund	WisdomTree Europe Hedged Small Cap Equity Fund
U.K.	30.4%	24.5%	5.3%	0.5%	0.0%
Eurozone	28.4%	41.4%	89.5%	94.4%	89.2%
Non-EZ Europe	40.6%	33.1%	5.1%	5.1%	10.3%
Asia	0.0%	0.0%	0.0%	0.0%	0.0%
Antipodes	0.0%	0.0%	0.0%	0.0%	0.0%
U.S.	0.4%	0.4%	0.0%	0.0%	0.0%
Other	0.2%	0.5%	0.0%	0.0%	0.0%
Cash	0.1%	0.2%	0.1%	0.1%	0.5%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Sources: WisdomTree, Bloomberg, through 12/20/18. Note: "U.K." in the eurozone-focused HEDJ is allocated to Anglo-Dutch Unilever, which is listed in both London and Amsterdam. Subject to change. Weights may not add to 100% due to rounding.
Unless otherwise stated, all data as of 01/25/19.