STATE STREET GLOBAL ADVISORS

Outsourced CIO

Staying on Course as Brexit Storm Rages

One of the great aspects of working with the OCIO team is listening to the dynamic conversations that go on in our investment forums around real time market events and how they impact the opportunity set we have to add value for our clients.

In talking with one of our OCIO portfolio managers this week, Geoffrey Preston in the market positioning team, I asked him to explain the scenario framework the team was employing following recent events in Parliament.

Geoffrey—Theresa May's deal was defeated by a wide margin on Tuesday, January 15th, but she survived a "no confidence" vote the following day. So what happens next is the critical question.

I'd say the four main options are:

1. "Harder" Brexit, removing/limiting Irish backstop provision,
2. "Softer" Brexit, perhaps mirroring something like Norway,
3. No Brexit via withdrawal of Article 50, new election, or 2nd referendum, or
4. "Crash out" – no agreement with EU and an abrupt departure.

May needs to bring her "Plan B" to Parliament by January 21st. Brexit is still scheduled to occur at the end March 2019.

Natasha—So what is the team's view on the outcome?

Geoffrey—The team increasingly views an abrupt departure or "crash out" scenario as less probable. There is a clear consensus in Parliament to leave the EU with a deal. The struggle has been to form a consensus on what that deal looks like. The EU has voiced it will not remove the Irish backstop provision. Therefore, shifting towards a "harder" Brexit to appease the Boris Johnson types will have its challenges. Another path for May could be to form a cross-party coalition with "softer" terms, i.e. accepting the free movement of people and permanently staying in the customs union. The EU would most likely accept those changes to the existing agreement. Article 50 may need to be extended by 3–6 months depending on how quickly May can form a coalition and negotiate with the EU. Reversing Brexit would require a 2nd referendum or new elections which would further delay the process.

The key takeaway is with a "crash out" scenario becoming less probable, Sterling should have a higher floor in the near term. If May is able to find a majority on a Brexit deal and get the Europeans to agree, then the uncertainty that has plagued Sterling will be lifted and the currency should move higher.

Natasha Dayaramani
Chief Portfolio Strategist
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Geoffrey Preston
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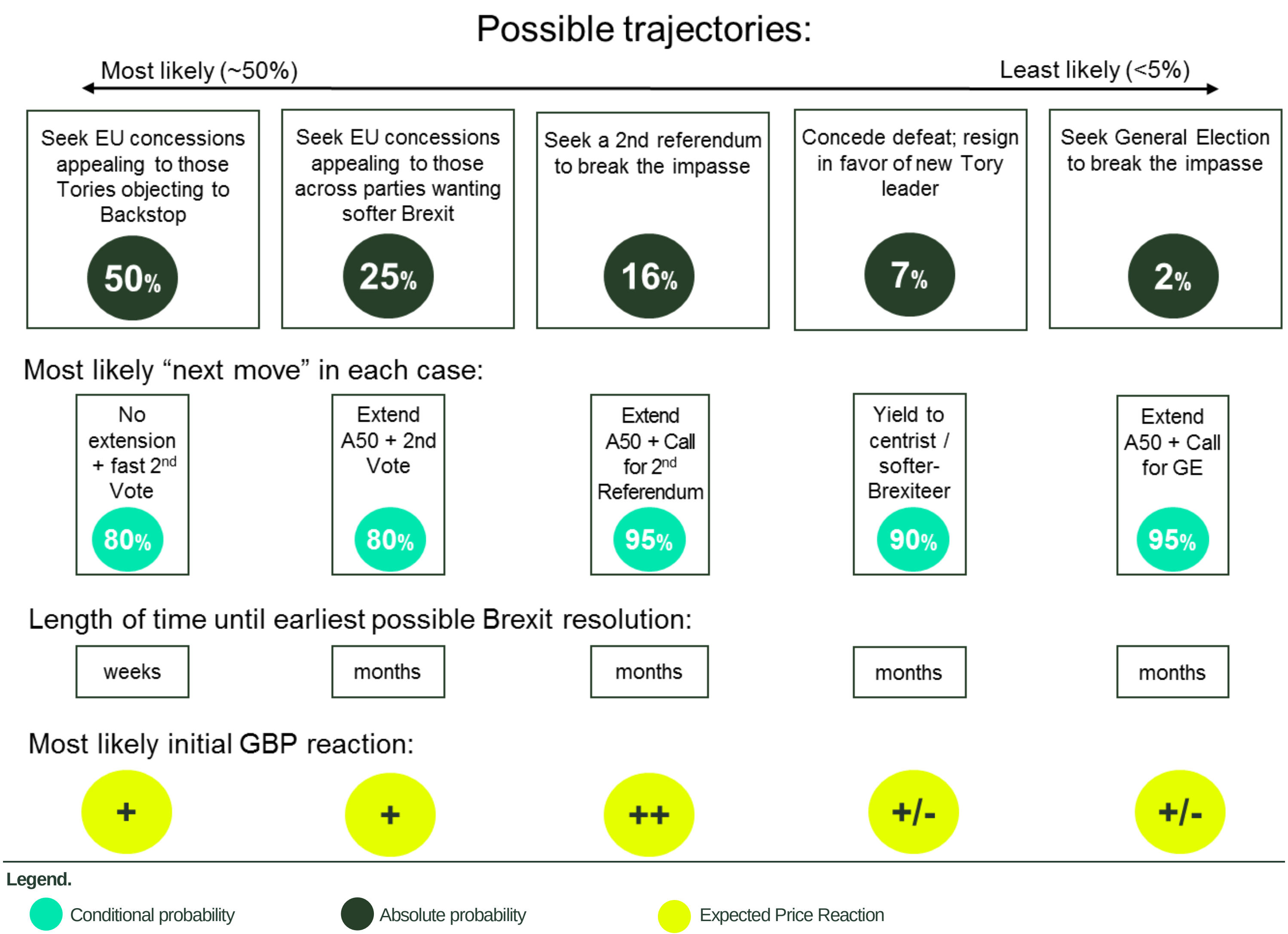
Figure. **OCIO Team's Brexit Scenario Framework following May's Victory in the No-Confidence Vote**



Source: State Street Global Advisors. As of January 16, 2019

The BoE will have the flexibility to raise short term rates, assuming economic conditions warrant, shrinking interest rate differentials. Sterling remains significantly undervalued with long term fair value somewhere north of 1.40 on GBP/USD. The combination of stronger Sterling and a weaker Dollar could grind us there.

Further can-kicking could keep GBP range bound around current levels. However, if a 2nd referendum or election indicates that Brexit could be undone, that – in isolation – would be a nice tailwind. It is hard to understand what the possibility of a Jeremy Corbyn government would mean long term. We would need to reassess as that scenario unfolded.

Natasha—How does this affect our client portfolios and would this differ for a US versus UK scheme?

Geoffrey—Given our view that "crash out" has become less probable, we have been reducing or removing downside hedges on Sterling. For UK-based clients, for the same reason, we have been adding upside Sterling protection.

Marketing communication

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