



MORNING BRIEFING

November 28, 2018

Brexit Is Hard To Do

See the [collection](#) of the individual charts linked below.

(1) Touring London. (2) The short-term case for Go Global. (3) Around the world, around the luncheon table. (4) Taxi and informed opinion for hire. (5) Can a deal that is not too hard and not too soft get enough votes? (6) The upfront costs are set, while the trade deals are TBD. (7) Brexit with lots of regulatory strings attached. (8) Moving out of the UK. (9) Churchill weighs in.

UK I: The Travellers Club. I'm in London through Thursday. Most of our accounts here tend to invest globally. So they are very interested in the outlooks for both the US and global economies, particularly those of the emerging economies.

I've been telling them that I still lean toward a Stay Home investment strategy, rather than the Go Global alternative ([Fig. 1](#)). However, in the very short term through the end of this year, Go Global might outperform. That's because I expect that Fed Chairman Jerome Powell, in his speech before The Economic Club of New York at 11:30 this morning, will strongly hint that the Fed might pause its rate-hiking during the first half of next year as he and his colleagues reassess their monetary policymaking, as we discussed in last Monday's [Morning Briefing](#) titled "On Your Mark, Get Set, Pause."

If so, the dollar could weaken, which would likely boost commodity prices ([Fig. 2](#)). A pause in the Fed's rate-hiking combined with a weaker dollar would be bullish for emerging market stock prices ([Fig. 3](#)). If the FAANG (Facebook, Amazon, Apple, Netflix and Google's parent Alphabet) stocks remain under pressure in the US, that could also favor Go Global for a while, since they led the S&P 500 Growth index higher this year until they led it lower since September 20 ([Fig. 4](#)). Interestingly, the ratio of the S&P 500 Growth Index to the Value index has been highly correlated with the ratio of the US MSCI stock price index to the All Country World ex-US MSCI since 1995.

One of our accounts graciously hosted a lunch meeting for me yesterday in the library of [The Travellers Club](#), which was founded in 1819 and moved to its present clubhouse in 1832. It counts many foreign ambassadors and high commissioners in London among its members. In the spirit of the club, I asked everyone to go around the table and relate a favorite travel adventure. It was great fun, actually.

Every time I come to visit our London accounts, I hire the same taxi driver to take me to all my meetings. He knows how to negotiate the narrow roads and heavy traffic to get me to my meetings on time. In fact, he knows a lot about everything, since he talks to business people all day long. He has a good book of business with other professionals who use his service to get to their meetings.

On Monday morning, as he was driving me to my first appointment, he brought me up to speed on Brexit. He doesn't think the deal that Prime Minister Theresa May struck with the EU is a good one, and expects her to lose the vote on it in Parliament and to step down from her office. I asked Sandra Ward, our contributing editor, to explore the issue in greater detail, which she does in the following two sections.

UK II: Brexit—Messy Divorce. No one ever said Brexit would be easy. No one ever imagined how hard it could be either. And there's still a chance that it won't happen after all.

Nearly two and a half years after the UK voted to leave the European Union (EU), Brexit inched closer to becoming a reality in the past two weeks. First, Prime Minister Theresa May reached agreement with the EU on terms of exiting the bloc, as detailed in an 11/14 *FT* [explainer](#). After lots of handwringing over whether it would be a “hard” Brexit or a “soft” Brexit, the deal May struck is somewhere in between. In the initial phase, the UK will remain closely aligned with the EU and subject to many of its rules, yet it will have no role in formulating policy and will continue to contribute to its budget.

Chaos ensued as six members of May's government resigned in protest over the draft agreement, including Brexit secretary Dominic Raab, an architect of the plan. This could lead to May's leadership being challenged, the *WSJ* observed in an 11/15 [article](#). Raab is the second Brexit secretary to resign this year: David Davis quit the negotiating post in July after May introduced her Chequers plan. May also lost the support of Northern Ireland's Democratic Unionist Party, the group that props up her minority government. And leading Conservative and hard-Brexit backer Jacob Rees Mogg submitted a letter of “no-confidence” in May, tantamount to instigating a coup against her. A snap general election—or even a second referendum on Brexit—is possible. Or there could very well be a “no-deal” Brexit, in which the deadline comes and goes with no agreement in place.

The pound took a shellacking as a result of the government disarray, falling 1.67% on the day of the resignations—November 15—to post the biggest daily decline since October 2016. It has steadied around 1.27 to the dollar, but it is down 13.6% from its 1.47 closing value prior to the Brexit referendum on June 23, 2016 ([Fig. 5](#)).

Nonetheless, the 27 other EU leaders voted in unison to support the split on Sunday, November 25. European Council President Donald Tusk declared approval of the historic withdrawal in a [tweet](#). EU leaders cautioned that negotiations won't be restarted if the British Parliament fails to approve the agreement, according to an 11/25 [piece](#) in the *NYT*. “This is the deal,” said Jean-Claude Juncker, the president of the European Commission, in the *NYT* report. “The European Union will not change its fundamental position.”

Parliament will vote on Brexit amid a serious economic slowdown across the Eurozone, with growth weighed down by trade tensions; rising political uncertainties, including Brexit; and softening demand, according to an 11/23 IHS Markit [release](#) of its latest purchasing managers' survey ([Fig. 6](#) and [Fig. 7](#)).

And Bank of England Governor Mark Carney warned that a no-deal scenario could plunge the UK economy into a recession on a par with that caused by the oil crisis in 1973, the year the UK joined the EU, Reuters reported in an 11/20 [article](#).

Let's examine what's next in this tortuous endeavor and how it's impacting the UK:

(1) *The vote.* A vote in the House of Commons is expected to be held on the 585-page legally binding withdrawal treaty before members break for the Christmas holiday. Parliament will also be voting on a non-legally-binding statement declaring goals for a future partnership between the UK and the EU on a wide swath of interests including trade, law enforcement, foreign policy, and security and defense. EU officials have been told to expect a Parliamentary vote before the next meeting of the European Council scheduled for December 13, an 11/25 [article](#) in the *Independent* noted.

(2) *The deal.* The UK is set to withdraw from the EU as of March 29, deal or no deal. (Fun fact: Meghan

Markle, bride of Prince Harry, was once a briefcase model on the game show, *Deal or No Deal*.) If the deal passes, the UK would continue to follow the rules and regulations of the EU until at least December 2020 under a transition period agreed to in the current plan. It will have no decision-making or rule-making power. The UK will continue to pay existing dues under the current long-term budget, estimated at €41.4 billion, and continue to contribute to the EU budget during the transition period. The transition period can be extended, only once and for a limited time, if the decision is made July 2020, according to an 11/15 [piece](#) in EUobserver outlining the key points of the Brexit agreement.

(3) *The backstop*. The agreement includes a controversial “backstop” provision to prevent a hard border from being established between Northern Ireland and the Republic of Ireland to avoid the potential threat of a return to sectarian conflict. It will also be the new post-Brexit border for the UK and EU. If the parties can’t agree on a future trade agreement before the end of the post-Brexit transition period, it could trigger the creation of a UK-EU customs territory, explained an 11/15 [report](#) in *The Guardian*. In the territory, no custom checks and no customs duties would be levied between Northern Ireland, a province of the UK, and the Republic of Ireland, an EU member, and minimal checks would occur between the UK and Northern Ireland on all goods except fishery products. Goods will be covered under the agreement, but not services.

(4) *The sticking point*. The UK would be required to apply EU rules in the customs territory to prevent UK businesses from getting an unfair advantage. Also, the UK would not be able to leave the arrangement unilaterally. This arrangement is what the hardline Brexiters can’t abide, describing it as a “trap,” a point made in an 11/11 BBC [article](#).

(5) *No deal*. If there is no deal, the consequences of withdrawal would be immediate, and the free movement of people and goods between the UK and the Continent would be disrupted, as an 11/27 piece on [iNews](#) outlines. The UK would be forced to follow the World Trade Organization’s rules on trade and be on the hook for the EU’s external tariffs. Prices on goods in the UK would rise. British-made goods might be subject to new certification and regulations by the EU. Manufacturers could move plants to the EU to avoid delays. Work and residency rules for expatriates would be thrown into question. Travel between the EU and UK could be disrupted. And the border issue between Northern Ireland and the Republic of Ireland could be a potential problem.

UK III: Brexit—Expensive Divorce. Breaking up is hard to do. Usually, there is a steep price to pay. This particularly messy divorce is no different, except for the scale of it. Below, we consider some of the costs of disruption:

(1) *The business of Brexit*. Companies have had to prepare for all outcomes, including the worst-case scenario of a no-deal, by stockpiling goods, relocating manufacturing plants, and making acquisitions in EU countries to ensure access to markets. Some have moved or laid off staff, while others have abandoned plans to build new plants. An excellent tool to assess the extreme measures that businesses are taking to stave off supply disruptions and cope with potential regulatory issues is Bloomberg’s [Brexit Impact Tracker](#).

Here you will see that many insurers are moving their headquarters to Luxembourg, and major drug makers are stockpiling as much as six months of drug inventories. AstraZeneca is spending \$51.0 million to duplicate its UK-based testing facilities for drug distribution. On the darker side, Smurfit Kappa Group jettisoned plans for a \$63.9 million plant in the UK that was projected to employ 50 people, and Telefonica will postpone an IPO of its UK O2 unit because of the uncertainty.

(2) *Weak pound, poorer consumers*. Some businesses are beginning to see a drop in demand as weakness in the pound impacts consumer spending. Airline operators Virgin Atlantic Airways, Jet2, and

Ryanair Holdings have noted that demand is being negatively affected because of the slide in sterling, Bloomberg reported in an 11/27 [article](#). There is the added concern about potential flight disruptions from a no-deal Brexit.

Weakness in the pound partly reflects concerns about the impacts on business and investment as Jeremy Corbyn's Labour Party gains popularity. Corbyn has advocated for nationalizing rail, water, and energy companies in addition to raising taxes.

While a weaker pound has provided some support for multinational companies, and can be a boon to attracting tourism, many sectors are feeling the pain as the outlook for domestic earnings darkens and political risks heighten, according to an 11/15 [piece](#) in the *FT*. The stocks of financial services firms, homebuilders, leisure companies, and utilities have suffered. The FTSE 100 is off more than 8.4% ytd as of Monday's close, and down 11.0% since its mid-May high of 7036 ([Fig. 8](#)). Yet Deutsche Bank strategist Oliver Harvey told the *FT* that a no-deal Brexit is "significantly underpriced" by the market.

(3) *Hit to GDP*. The International Monetary Fund puts the price to the UK of a no-Brexit deal at 6% of GDP, or about four years of economic growth, an 11/14 Reuters [report](#) observed ([Fig. 9](#)).

(4) *\$1 Trillion in Outflows*. Outflows from UK equity funds surged to \$19.4 billion in the week when May presented the withdrawal plan to the cabinet, the highest level since the 2007-08 financial crisis, according to an 11/25 [report](#) in the *Irish Times*. More than \$1 trillion has flowed out of UK equity funds since the 2016 Brexit referendum, as investors have withdrawn money every week in the aftermath. In the year prior to the Brexit vote, UK equity funds attracted \$127 billion in inflows.

(5) *Valuation*. The MSCI UK share price index is off 8.5% ytd in local currency, compared with a drop of 9.1% for the EMU and a loss of 0.1% in the US. MSCI UK's forward P/E of 11.8 is at levels last seen five years ago ([Fig. 10](#)). NERI (our Net Earnings Revision Index) has been negative through much of the year and is at levels last touched in late 2015 ([Fig. 11](#)). Consensus earnings forecasts for companies in the UK MSCI index imply 7.8% growth in 2019, down from 10.3% estimated in 2018 and compared with earnings growth of 24.9% registered in 2017.

As Winston Churchill noted, "Fear is a reaction. Courage is a decision." We shall see how courageous the UK is in the coming weeks.

CALENDARS

US. Wed: Real GDP & PCE 3.5%/3.7%, GDP Price Index 1.7%, Corporate Profits, Richmond Fed Manufacturing Index 15, Merchandise Trade Balance Advance Estimate -\$76.8b, New Home Sales 575k, MBA Mortgage Applications, EIA Petroleum Status Report, Powell. **Thurs:** Personal Income & Consumption 0.4%/0.4%, Headline & Core PCED 2.1%/1.9% y/y, Jobless Claims 220k, Pending Home Sales 0.0%, EIA Natural Gas Report, FOMC Minutes, Mester, Evans. (Econoday estimates)

Global. Wed: Japan Retail Trade 0.5% m/m/2.7% y/y, BOE Financial Stability Report & Stress Test Results, Banxico Inflation Report. **Thurs:** Germany Unemployment Change & Unemployment Rate - 10k/5.1%, Germany CPI 0.2% m/m/2.4% y/y, France GDP 0.4% q/q/1.5% y/y, Japan Industrial Production 1.2% m/m/2.5% y/y, Japan Jobless Rate 2.3%, Japan CPI Headline, Core, and Core-Core 1.1%/1.0%/0.6% y/y. (DailyFX estimates)

STRATEGY INDICATORS

AC World ex-US MSCI ([link](#)): This index is down 13.0% ytd in dollar terms after rising 24.1% in 2017

and 1.7% in 2016. In local-currency terms, the index is down 8.9% ytd compared to gains of 15.3% and 4.1% for all of 2017 and 2016, respectively. The US-dollar price index is down 18.7% since its cyclical high on January 26; it has been in a correction since mid-June and entered a bear market with a 20.3% decline on October 26. The local-currency price index is down 12.9% from its record high on January 26 after being down as much as 14.6% on October 26. Local-currency forward revenues edged down 0.1% m/m, but had risen 15.0% from a five-year low in March 2016 to record highs since May for the first time since October 2014. Local-currency forward earnings fell 0.8% m/m, but has performed better since its six-year low in March 2016—rising as much as 35.3% to its first record highs since September 2008 beginning seven months ago in April. Revenues are expected to rise 6.9% in 2018 and 4.8% in 2019 following an 8.7% gain in 2017, and earnings are expected to rise 8.8% (2018) and 8.4% (2019) after surging 21.8% (2017). The industry analysts' sales forecasts imply short-term 12-month forward revenue growth (STRG) of 5.1%, down from 5.5% a month ago. Their STRG forecast compares to a seven-year high of 6.8% in March 2017 and is up from a cyclical low of 2.3% in March 2016. Their short-term 12-month forward earnings growth (STEG) forecast of 8.3% is down from 9.2% a month earlier, and compares to a four-year-high forecast of 14.1% in March 2017 and a seven-year low forecast of 6.3% in January 2016. The profit margin estimate implied by analysts' earnings and revenue estimates rises to 8.0% in 2018 and to 8.3% in 2019 from an actual 7.8% in 2017. The forward profit margin forecast of 8.2% is down from a nine-year high of 8.3% in October. The Net Earnings Revision Index (NERI) for the AC World ex-US MSCI was negative in November for an eighth straight month following six positive readings, and dropped to a 40-month low of -6.7% from -3.5% in October. That compares to a 76-month high of 2.7% in May 2017 and a 51-month low of -11.3% in March 2016. The forward P/E of 12.0 is up from a five-year low of 11.7 at the end of October, and compares to a recent 31-month high of 14.8 in January, a six-year high of 15.3 in April 2015, and a cyclical bottom of 12.3 in January 2016. The index's current 13% discount to the World MSCI P/E remains near its record-low 15% discount during September and October.

EMU MSCI ([link](#)): The EMU's MSCI price index has dropped 14.1% ytd in dollar terms after rising 25.3% in 2017 and falling 1.2% in 2016. In euro terms, the price index is down just 9.1% ytd following gains of 10.2% in 2017 and 1.8% in 2016. The US-dollar price index is down 20.4% since its cyclical high on January 25; it has been in a correction since late May and a bear market since late October—hitting bottom on November 20 with a 21.5% decline. However, its local-currency price index is down only 13.4% from its record high on January 23 after being down as much as 15.1% on November 20. Euro-based forward revenues rose 0.3% m/m to its highest level since May 2013 and 6.2% above its six-year low in May 2016, but remains 5.0% below its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016, and edged down 0.1% m/m from its highest level since November 2008. Although it has improved 24.8% from its 23-month low in June 2016, it remains 15.8% below its record high in January 2008. Analysts expect revenues to rise 3.1% in 2018 and 3.9% in 2019 after a 5.0% gain in 2017, and think earnings will rise 4.8% (2018) and 10.1% (2019) following a 13.7% increase in 2017. Forecasted STRG of 3.8% is unchanged m/m, which compares to a six-year high of 5.0% in April 2017 and a cyclical low of 2.0% in May 2016. Forecasted STEG of 9.8% is up m/m from 9.6%, which compares to a 78-month high forecast of 21.0% during February 2017 and a seven-year low of 5.7% in April 2016. STEG had been higher than LTEG (currently 10.2%) from July 2016 to May 2017, but is trailing now. The forward profit margin was steady m/m at a nine-year high of 7.9%, which is up from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.5% in 2018 and 7.9% in 2019 from 7.3% in 2017. NERI was negative in November for a second month (following three straight positive months through September), dropping to a 28-month low of -6.2% from -2.6% in October. That compares to an 11-year high of 8.1% in May 2017 and a 24-month low of -13.2% in April 2016. The P/E of 12.3 is up from a five-year low of 11.9 in early November, but down from a nine-month high of 14.9 in January. That compares to a 13-year high of 16.4 in April 2015 and a 30-month low of 12.2 in February 2016. The current valuation represents an 11% discount to the World MSCI's P/E now, up from 14% a week earlier. That compares to a record-low 25% discount

during 2011 and is well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI ([link](#)): The EM MSCI price index is down 15.7% ytd in US dollar terms after surging 34.3% in 2017 and rising 8.6% in 2016. In local-currency terms, EM has slipped 11.1% ytd compared to gains of 27.8% (2017) and 7.1% (2016). The index's US-dollar price index is down 23.1% since its cyclical high on January 25; it has been in a correction since early February and entered a bear market in late October. On October 29, the US-dollar price index had been down as much as 26.6% from its cyclical high. Its local-currency price index has been in a correction since June 19, and is now down 17.8% from its record high on January 26 after being down as much as 20.9% on October 29. Local-currency forward revenues rose 0.1% m/m and is up 19.2% from a four-year low in June 2016; it's now back at a record high after stalling for five months from its first record since November 2014. Local-currency forward earnings fell 1.8% m/m, but has fared substantially better with a 37.8% gain from its six-year low in April 2016. However, it has dropped 2.0% from its record high in early October, which was its first since January 2014. Revenues are expected to rise 11.2% in 2018 and 7.5% in 2019, down from a 12.2% gain in 2017. That's expected to lead to earnings gains of 13.2% in 2018 and 10.2% in 2019, following a 22.2% surge in 2017. Forecasted STRG was down to 8.0% in November from 8.5% in October and down from a four-year high of 9.6% in January 2017. STEG fell to a 29-month low of 10.3% in November from 11.9% in October, and is down from a cyclical peak of 17.5% in March 2017 and below LTEG (15.9%) again. The implied profit margin is expected to improve to 6.9% in 2018 and 7.1% in 2019 from 6.8% in 2017. The forward profit margin edged down 0.1ppt m/m to 7.1%, and is down from a six-year high of 7.4% in May. It remains 3.2ppts below its 10.3% record high in December 2007 and compares to a record low of 6.0% in February 2016. NERI was negative for a tenth month in November as it fell to a 31-month low of -7.6% from -4.4%. NERI had been positive for only three months through January after 80 months of negative readings through October 2017, and compares to an 83-month low of -10.2% in March 2016. Emerging Markets' forward P/E of 10.4 is up from a 56-month low of 10.0 at the end of October and compares to an eight-year high of 13.1 in January. The index is trading at a 24% discount to the World MSCI P/E, up from a four-year low 27% discount in late October, and compares to a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions ([link](#)): Analysts' recent earnings revisions through November are now suggesting rising pessimism about profits across most of the world, with most of the NERI readings falling to their lowest levels since mid-2016. The AC World MSCI's NERI was negative for a second month following 20 straight positive readings through September, and fell to a 30-month low of -5.1% from -1.0% in October. That's down from a 93-month high of 7.1% in February. EM Eastern Europe is now in the lead among all regions, and was the only region to remain positive in November and to improve m/m. The US was negative for the first time in 19 months, as its NERI tumbled to a 19-month low of -1.0% from 5.4% in October, and is down from a corporate-tax-rate-cut-boosted record high of 21.8% in March. Outside of EM Eastern Europe, NERI for the remaining regional EM indexes was negative for a 10th straight month. November's scores among the regional MSCIs: EM Eastern Europe (4.2% in November, up from 2.4% in October), United States (-1.0 [19-month low], 5.4), EM Latin America (-3.5 [14-month low], -2.4), AC World (-5.1 [30-month low], -1.0), EAFE (-6.0 [28-month low], -2.7), Europe (-6.0 [30-month low], -2.7), EMU (-6.2 [28-month low], -2.7), Europe ex-UK (-6.2 [28-month low], -2.0), AC World ex-US (-6.7 [30-month low], -3.5), Emerging Markets (-7.6 [31-month low], -4.4), and EM Asia (-8.2 [31-month low], -4.6).

MSCI Countries Net Earnings Revisions ([link](#)): NERI was positive for 5/44 MSCI countries in November, the lowest count since April 2016 and down from 12 in October. NERI improved m/m in November for 10/44 countries, the lowest count since April and down from 18/44 countries improving in October. Among the countries with improving NERI in November, the Czech Republic was at a record high, followed by Egypt (21-month high), Hungary (10), Indonesia (8), the Philippines (8), and Poland (8). On the flip side, Argentina's NERI was at a record low (with data going back to October 1992),

followed by those of the United Kingdom (33-month low), China (31), Germany (31), Hong Kong (31), Korea (31), and Spain (31). The 18-month positive NERI streak for the Czech Republic is the best among countries, followed by the positive streaks of Russia (14), Austria (6), and Hungary (3). South Africa's NERI has been negative for 54 straight months, followed by the negative streaks of New Zealand (30-months), Mexico (25), Pakistan (24), Denmark (16), and Germany (16). NERI turned positive in November for Egypt for the first time in six months. Eight countries slipped back into negative territory this month; among them, Canada was negative for the first time in 14 months, followed by Finland (first time in eight months), Sweden (8), and France (5). The highest NERI readings in November: the Czech Republic (17.5% [record high]), Russia (12.6), Hungary (8.5), Egypt (7.1), and Austria (6.7). The weakest NERIs occurred this month in Argentina (-16.2 [record low]), Ireland (-13.8), South Africa (-13.1), Germany (-12.4), and Korea (-10.6).

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): The Consumer Confidence Index (CCI) fell for the first time in five months, though remains at historically strong levels. "Overall, consumers are still quite confident that economic growth will continue at a solid pace into early 2019," says The Conference Board's Lynn Franco. "However, if expectations soften further in the coming months, the pace of growth is likely to begin moderating." November's CCI slipped to 135.7 after increasing from 127.1 in June to 137.9 in October—not far from the all-time high of 144.7 reached during 2000. The expectations gauge dipped to 111.0 this month—within striking distance of last month's 115.1—which was its best reading since September 2000. Meanwhile, the present situation component climbed for the sixth time in seven months, from 157.5 in April to 172.7 this month—just shy of August's 172.8 reading, which was the highest since the end of 2000. The current jobs outlook remained very favorable this month: Jobs plentiful (to 46.6% from 45.4%) jumped to its highest reading since January 2001, while jobs hard to get (12.2 from 13.4) fell to within a tick of August's cyclical low of 12.1%. The six-month jobs outlook also remained very favorable, with the percentage reporting more jobs (22.8 from 22.3) edging up a bit, while those expecting fewer jobs (11.1 from 10.6) did the same—though held near July 2000 lows. The spread between the two was unchanged at 11.7ppts—the highest percentage since the 1980s.

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