Markets take Brexit bumps in their stride

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Markets appeared relatively unshaken by the resignations of David Davis and Boris Johnson on Monday. European bourses were broadly up and the FTSE 100 gained 0.9% despite a tumultuous day for the UK government.

The resignations came after the Cabinet agreed a negotiating position with the EU on Friday which Johnson and Davis felt they could not support.

Markets were largely unshaken by the resignations because the stated negotiating position indicates that the UK government is heading towards a soft Brexit, and that is very much the preferred outcome for stock markets. It would also likely lead to a modest rise in the pound.

However, when Johnson announced his resignation, we did see an immediate rise in bond prices and a simultaneous fall in the price of utility stocks. This is unusual because both asset classes are usually seen as safe havens and move in tandem with each other. It could well be, however, that markets saw Johnson's departure as raising the chances of a Labour government at some stage, with the consequent threat of nationalisation of those companies and uncertainty over the compensation shareholders would receive.

To summarise, the most important features of the agreed position are that:

- There would be a meaningful degree of regulatory harmonisation with the EU in order to facilitate frictionless trade.
- That would mean the UK could technically conduct an independent free-trade policy (with other harmonious nations, or by persuading them to become aligned with the EU, or by subsequently moving away from the EU rules and potentially suffering some EU frictions as a result).

In practice this restricts the UK quite meaningfully. The cabinet also agreed that while free movement of people would have to end, a mobility framework would need to be established.

Despite the shortcomings of this position, and the high-profile resignations, we suspect that the Tory party will support the plan because the alternatives i.e. no deal at all, or extending Article 50, are so politically unpalatable.

Additionally, David Davis's replacement, Dominic Raab will give Theresa May the credibility of having given the Brexit wing of the party the opportunity to engage with (and therefore support) her negotiating position.

Since a soft Brexit is by far the stock market's preferred approach, and would also see a modest appreciation in the pound, it is no surprise to see sterling edge higher as this saga unfolds. But if we see a backlash towards the current negotiating stance we could see sterling weaken once again.

The most negative scenario for investors remains a "no deal" situation which would have a detrimental impact on sterling and we would see retailers severely underperform, as costs would rise due to the weaker pound yet their revenues would be little changed. Large companies such as many FTSE 100 stocks could actually perform quite well in these circumstances because they earn so much of their revenue in other currencies.

The resignation of a minister could be seen as a precursor to a leadership challenge, which in turn could lead to calls for a new general election (although this would be by no means certain).

Again, this would be very negative for the pound, not least because the financial markets would not look kindly on a Labour government under the party's current leadership. We don't expect Mrs May to face a confidence vote during 2018 though, as she would likely win it and then dissenters would be restricted by party rules from challenging her again for a year. The more logical time would be in the new year when the negotiations have been concluded.

So in the meantime, if we look through the politics, the economy is performing remarkably well. Recent data has confirmed our suspicions that the first quarter's disappointing economic growth was a weather-related aberration. Employment remains robust notwithstanding concerns that businesses have over Brexit. For the immediate future the pound is likely to be more interested in interest rates than Brexit and will be bolstered further by today's reasonable figures for the new monthly GDP series. However, in the final quarter of this year, we expect Brexit – and the leadership challenge that may well follow – to come back into focus.

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Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.