Brexit's in the Bag: Now What?

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- Three-plus years of Brexit uncertainty has had the impact of depressing investment and increasing economic volatility in the EU.
- Government policy is geared toward encouraging growth in Europe.
- We remain optimistic that economic growth in the EU will begin to recover from the lows of 2019.

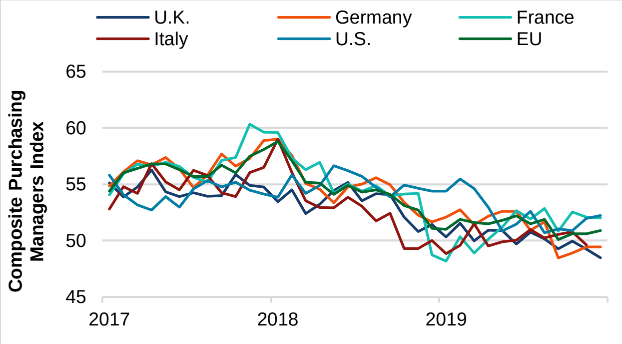
At the end of January, the U.K. officially left the EU, giving way to an 11-month transition period during which the UK and EU will negotiate the terms of their future relationship. Although nothing between them changed economically on February 1, 2020, the day after the official divorce, everything conceivably can change on January 1, 2021, when the transition period is set to expire.

Gross domestic product (GDP) in the EU grew by just 1.1% in the fourth quarter of 2019 compared to a year ago, the area's weakest figure in six years. That performance lags economic growth in the U.S. (2.3%), Japan (1.7%) and Canada (1.7%); Germany (0.5%) and Italy (0.0%) fared even worse over this period.

While other global economies have also decelerated, three-plus years of Brexit uncertainty has had the impact of depressing investment and increasing economic volatility in the area. Questions surrounding the eventual terms of trade have forced some businesses to hold off adding employees or expanding.

Other data—such as the purchasing managers' composite indexes, including manufacturing and services—also suggest a deterioration in EU economic activity over the last two years.

Exhibit 1: Purchasing Managers Indexes



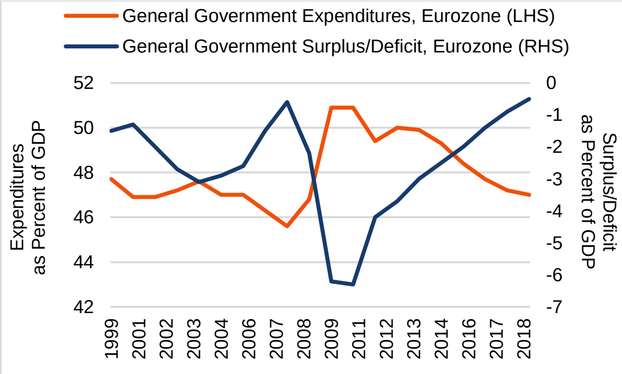
Reading greater than 50 reflects expansion, while a reading less than 50 reflects contraction.

Source: FactSet, SEI
Data as of 12/31/2019

Government policy is geared toward encouraging growth in Europe, although there is constant debate regarding the efficacy of negative interest rates. It remains to be seen in what direction newly appointed European Central Bank (ECB) President Christine Lagarde takes the central bank.

Exhibit 2 shows the trend in eurozone general government expenditures and its annual deficit/surplus as a percentage of area-wide GDP since 1999. Despite the euro area's slow economic growth, government spending as a percent of GDP amounted to 47% in 2018, down from a 2010 peak of 51%. The eurozone-wide aggregate deficit, meanwhile, contracted from a hefty 6.3% to just 0.5% over the same period. If Lagarde's call for government spending is supported, perhaps there's hope that fiscal policy will shift from a steady headwind to a tailwind for eurozone growth.

Exhibit 2: Lagarde Looking to Grow Government Spending



Source: Eurostat, SEI
Data as of 12/31/2018

Our Outlook

We remain optimistic that European growth will begin to recover from the lows of 2019 and expect a respectable reacceleration in growth among the more industrialised emerging markets. This should benefit Europe, particularly Germany. Just a few months ago, a disorderly Brexit seemed a possibility. That threat seems to have passed. Apart from Brexit, the lessening of trade tensions and improvement in China's economic growth should also provide export-dependent Europe with a moderate boost in 2020.

We expect rationality to prevail, but a no-deal Brexit remains a residual risk. As the transition deadline nears at the end of 2020, European markets could experience renewed volatility if the negotiations appear to be foundering on irreconcilable differences. In the near-term, equity investors may still react positively as signs of improved global economic growth accumulate.

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