

November 15, 2021

The Special Relationship

Ever since the United Kingdom defeated the Spanish Armada in the 16th century, it has typically kept Europe at arm's length. The victory not only showed that the British could successfully defend itself from invasion, but that it was an important power in Europe. This newfound confidence along with the Commonwealth's growing manufacturing prowess gave it an air of superiority over its continental colleagues. After defeating France in the Napoleonic Wars in 1815, therefore becoming the world's superpower, this sentiment became deeply entrenched into the British psyche.

However, British sentiment took a hit after World War II. As the second war on the continent in forty years, it pushed the U.K. to the brink of collapse. Humbled, the British pursued peaceful coexistence with the rest of Europe as they attempted to rebuild their country. They not only sought collaboration with the rest of Europe but also supported greater integration. That being said, the U.K. has struggled to accept a subordinate role within Europe as it seems to believe it is superior. As recently as December 2020, Education Secretary Gavin Williamson joked that the U.K. was the first developed country to approve the coronavirus vaccine because it "[was a much better country](#)" than others.

Understandably, British hubris has often rubbed other European countries the wrong way. The underlying friction between the two sides came to a head after the European Union rejected the U.K.'s request to be

exempted from the EU's immigration program. This decision not only paved the way for Brexit but may have also set the stage for a potential trade war. In this report, we will examine the history of British-EU relations, discuss the Brexit vote and fallout, and briefly review how the relationship has changed since the U.K. left. As always, we will end with a brief discussion of market ramifications.

U.K. Special Status

Following the end of WWII, the United Kingdom attempted to build closer ties with the rest of Europe. In 1949, the U.K. established military ties with Europe by joining the North Atlantic Treaty Organization (NATO). In 1972, it established deeper trade ties by joining the newly formed European Economic Community (EEC), which has evolved into the European Union. Almost 20 years later, it joined the European Exchange Rate Mechanism (ERM), which, had it remained, would have tied the country to European currency. Despite the steady path toward integration with the EU, the U.K.'s position within the common market was always fraught with uncertainty.

Military Ties

In addition to countering the Soviet threat in Europe, the development of NATO was designed to provide stability. The U.S. agreed to provide the continent with security and in exchange Europe agreed to have a joint foreign policy. Because the United Kingdom played a pivotal part in the postwar rebuild effort, it was able to maintain its Royal Navy. Thus, the U.K. has been a notable contributor to European and global stability. Additionally, as one of the

top contributors to NATO behind only the U.S., the U.K. was able to ensure that it was at the forefront of European foreign policy. Accordingly, its huge role in NATO bolstered its status in Europe, and therefore its membership in NATO has never really been called into question.

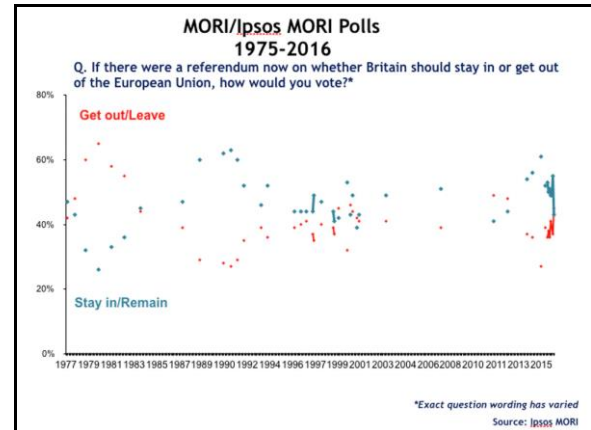
EU Membership

As the continent moved toward integration, the U.K. struggled to decide whether it wanted to be a part of the project. Although it could see the merit of a united Europe, it wasn't comfortable with being treated as equal to its European counterparts. In 1952, the British declined an invitation to join the European Coal and Steel Community (ECSC), only to have a change of heart nine years later. Feeling slighted, members of what became the European Economic Community (EEC) rejected the U.K.'s application in 1961. After waiting an additional 10 years to finally be admitted into the group, it was already plotting its exit. In 1975, it held a referendum about whether it should stay in the EEC. The vote would turn out resoundingly in favor of the U.K. remaining; however, the debate continued to rage on afterwards.

Joining the Eurozone

After the referendum, Eurosceptics remained vocal about their opposition to European integration, but the public still had a favorable view of Europe. Going into the 1990s, support for the EEC was at an all-time high. This changed after the U.K. entered the European exchange rate mechanism (ERM). The ERM was a system of semi-fixed exchange rates between members of the EEC. Each currency was pegged to the German deutschmark. Unfortunately, the U.K. entered the ERM with an overvalued currency which harmed its economy. Over time, traders decided the peg couldn't be defended. Speculative

attacks ensued, which forced Westminster to withdraw from the ERM as the country stated that it could no longer defend the currency's peg. This episode soured the public on the Eurozone and the entire project of European integration.



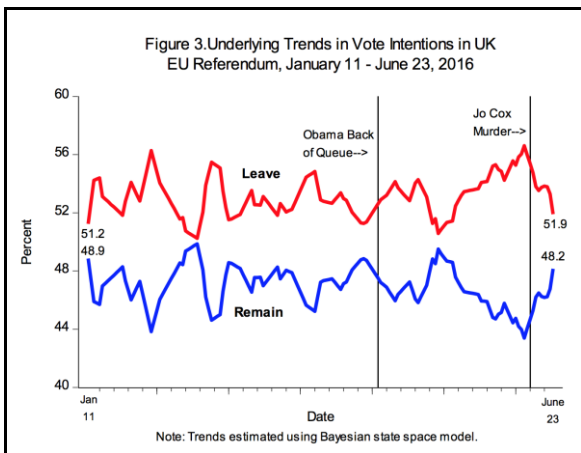
Brexit Vote

Years after the sterling left the ERM, support for European integration began to dip, but a majority still favored remaining in the EEC – now known as the European Union (EU). Nevertheless, politicians and pundits alike began criticizing the EU for its burdensome rules. Sentiment began to swing in favor of leaving when a refugee crisis led to a surge of migration throughout Europe. As part of the open-border policy, all members of the EU had to welcome citizens from across Europe. This led to a backlash in the U.K. as many people did not feel comfortable with the increase in immigration and accused the EU of overstepping its authority.

Calls to limit the flow of immigrants entering the U.K. placed pro-EU politicians in a bind. In 2013, David Cameron vowed that if reelected he would allow an “in-or-out” referendum. The decision helped seal his renomination as prime minister as even members of his own party had become jaded with the EU. However, the decision did not come without risk.

When Cameron declared a referendum, it was based on the premise that he would be able to reach a compromise with the EU. He hoped the U.K. would be allowed to impose temporary restrictions on immigrants entering the country. However, the EU rebuffed most of his proposals as they would have required a rewrite of the governing rules. He was able to get some concessions, but it was not enough to assuage the sceptics. As a result, the U.K. voted to leave the EU in 2016.

The vote came as a surprise for most of the British establishment. Most polls showed that the Remain camp was slightly in the lead in the run-up to the referendum. However, there was growing evidence that the British public were getting tired of outsiders trying to influence their opinion. This is best seen when Barack Obama warned that if Britain were to leave the EU, it would have to wait in the back of the queue to secure a trade deal with the U.S. New data suggests that this warning unintentionally boosted support for the Leave camp.



(Source: London School of Economics)

Brexit Fallout

According to Article 50 of the European Union's Lisbon treaty, the two sides had to come to an agreement within two years of the U.K. formally asking to withdraw from

the EU. Failure to reach an agreement meant that Britain would lose access to the single market, a scenario referred to as a “hard Brexit.” Losing access to the single market would mean that the U.K. could no longer benefit from tariff-free trade within the EU. This outcome was undesirable as it would have major ramifications for British businesses that rely on trade with the EU. Given the fact that the U.K. was a net importer of EU goods, securing a deal was also in the best interest of the group’s members. Hence, neither side wanted a hard Brexit.

The time constraint made coming to an agreement difficult as trade deals are complex. As a result, some of the more delicate issues were often shrouded in ambiguous language to ensure there was an agreement in place prior to the deadline. The primary sticking points in the agreement generally revolved around three issues: financial regulations, fishing rights, and the Northern Ireland border. By including vague language in the agreement, the sides ensured that negotiations could continue even after the U.K. left. After several failed attempts to get a deal passed through the British Parliament, they were finally able to come to an agreement. Although the U.K. technically exited the EU in 2020, its formal transition out of the group wasn't official until 2021.

Since splitting, the U.K. and EU have struggled to maintain a healthy relationship. The two sides have ostensibly acted as if they are rivals. The pandemic also complicated matters. The EU accused the U.K. of hoarding COVID-19 vaccines and threatened to halt shipments of key ingredients needed to produce them. After that issue was resolved, the U.K. teamed up with the U.S. and snatched a submarine deal with Australia away from France. And, most recently, the U.K. began withholding its

fishing licenses from EU member countries due to vessels “not meeting its criteria.” All the while, the U.K. and EU have bickered over the Northern Ireland border arrangement. With leaders on both sides displaying vain and uncompromising behavior, further tensions and trade disputes are likely as the two sides view each other as strategic competitors. If we are correct, a hard Brexit could be unavoidable.

How Will It End?

NATO will likely prevent the two sides from completely severing ties. However, a trade war is probable. Actions by the U.K. and EU over the last year suggest that both sides are looking for vindication. The U.K.

wants to show that it is stronger following Brexit, while the EU is hoping to prove the opposite. As a result, Europe will likely try to build closer ties with remaining members to dissuade any talk of another exit. Meanwhile, the U.K. will attempt to build closer ties with Pacific countries and the U.S. as it seeks to chart its own path. A hard Brexit will likely be bearish for British sterling in the short term as the uncertainty will likely lead to capital flight. This scenario will be beneficial for U.S. safe haven assets.

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