August 2019

Brexit Update

Many paths to No Deal

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Following the election of Boris Johnson to Conservative leader, we flagged that the risks were rising on Brexit. We have now updated our scenarios for the short and medium term. The summary view is below. The PDF attached, containing the multi-step risk analysis, political analysis and economic impact assessment, is a five-minute read.

This view is produced in conjunction with Paul McGhee, Head of Brexit Strategy. Many thanks to asset class experts from FX strategy, government bonds, credit and equities for their contributions on the asset class impacts.

Summary View

- We think an extension to facilitate a general election is the most likely outcome by 31 October, despite the government's decision to suspend Parliament for five weeks. However, an extension merely delays but does not solve the Brexit challenge.
- We estimate a 25% probability of general election before 31 October. This reflects the government's narrow majority of one seat, the potential that Johnson wishes to build on strong polling and to secure the mandate decisively in advance of 31 October 31.
- However, we also think the risk of a No Deal on 31 October is 25% given claims by Johnson's advisors that they would call an election for after 31 October and the risk that the anti-No Deal coalition fails to act decisively.
- Our multi-step scenario analysis highlights that the probability that there is a No Deal Brexit at some point is 50%. This reflects the political bifurcation that has taken place on Brexit, the new more hard-line Brexit government and the dwindling time remaining to secure a deal.
- As a result, we have revised down our UK economic forecasts to incorporate No Deal. We now expect the economy to contract by slightly more than 1% in 2020 driven by a big fall in business investment. Consumption will also be squeezed by falling real incomes in the context of rising inflation (which climbs above 4%) and a pick-up in unemployment. This helps to offset some of the negative impact of the Brexit shock, but not enough to avert recession.
- In terms of policy response, we expect that the Bank of England (BoE) eases policy back to the effective lower bound in response to this demand shock, while fiscal policy is eased substantially with the current fiscal rules abandoned.
- The expected impact of a No Deal on UK assets is detailed below.
  - Gilt Yields: fall 20-30bps
  - Sterling Trade Weighted: fall 5-10%
  - IG Credit Spread: 30-40bps higher, led by banks and insurers unless BoE policy is unexpectedly accommodative
  - Equities: FTSE 350 down c.7%; FTSE 100 outperforms 250 with major rotation out of domestics, financials
- It is worth noting that No Deal Brexit may not be a long-term equilibrium and the ultimate UK-EU relationship could be anything from the wide array of basic trading agreements right up to re-entering the EU, depending on how the politics plays out after the initial shock.

There are three key assumptions to be tested in coming weeks.

What does Johnson want?

- There is huge debate about whether Johnson actively wants a No Deal. He may know a compromise deal will never pass parliament and simply doesn't want the UK to be bound by the strictures of stronger alignment. Alternatively, he is bluffing in order to attempt to force the hands of the EU in negotiations. The issue with this is that investors cannot truly know his intentions and whether he is looking long term or short term; indeed, even his close colleagues may not really know.
- However, we do know that the rise of the Brexit party was a key change for the Conservative party. Having lost support to the Brexit party under May, Johnson's hard-line approach has won back support. That dynamic means that Johnson is extremely hemmed in by the ERG/Brexit party. With a single-seat majority, his wiggle room is extremely limited.

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- His life would be easier with a government with a larger majority and a more explicit mandate for his hard-line approach. So in some ways, a snap election before Brexit day that he wins could strengthen his hand. However, 2017 was a tough lesson for Conservatives on the risk of triggering snap elections. Additionally, if Johnson does actually want a No Deal, his team have repeatedly noted a willingness to hold elections following Brexit.

Can opposition parties mobilise effectively?

- While in the past, the Remain alliance from Labour, Conservative, Lib Dems, SNP and Green party have failed to come together to permanently remove the No Deal risk, the government's provocative action of proroguing parliament may be the shot in the arm needed to force action. Indeed, a parliamentary Remain coalition has already met to begin to agree to use legislative means to force an extension. Indeed, recent signalling from Corbyn to find a compromise has been positive.

- However, how they choose to act will be crucial. Parliament may directly influence Johnson through legislation ruling out or delaying Brexit or by taking the government down through a vote of no confidence. The former has the benefit for remain-leaning Conservatives of not having to vote against their own party. Plus, if Johnson announces that the election will take place after 31 October – which, as PM, he has the power to do so – then the purpose of bringing down the government will be moot.

- Legislation is the more palatable option, but the reality of drafting and passing legislation in opposition of the government is challenging. The short time period is problematic here: drafting and passing legislation through the House of Commons and House of Lords takes time. We think that the coalition can do this, but MPs will need to act quickly and be very well coordinated in the limited time remaining.

Will EU leaders compromise on the backstop?

- If Johnson's maximum pressure approach is not circumvented by parliament, will EU leaders cave on the crucial Irish backstop issue? If Johnson is successful in removing the parliamentary threat, it really forces the EU to think about how critical the backstop is. EU leaders had until recently been steadfast on not altering the withdrawal agreement. However, recent weeks have seen key leaders signal some willingness to consider reopening the Withdrawal Agreement if a viable alternative to the Irish backstop consistent with EU law is found. Equally, however, EU leaders remain sceptical that the alternatives are viable.

- So, there is reason for caution here: the path to a compromise remains very thin and parliament's willingness to trust the administration to deliver a compromise is at an all-time low. It may indeed be that one or both of the UK and EU are signalling positively so that they can plausibly say they tried all avenues to secure a withdrawal agreement, but ultimately do not expect success.

- Ireland is pivotal to the EU view. The Irish backstop is the key defining issue in the process, so it will be crucial to watch the interaction between the UK PM Johnson and Irish Taoiseach Varadkar for any signs of compromise emerging in the near term.

So what does this all mean for the market outlook?

- When we go through the many paths that Brexit may go down, the cumulative risk of No Deal is 50% in the medium term. This reflects the fact that an extension or general election also carries some risk of No Deal; for example, through victory for a new hard-line Brexit government or from a second referendum (see Chart 1). It is worth highlighting that some outcomes in our multi-step analysis lead to a loop of extension, election and negotiation with no determinate end state.

- Our medium-term scenarios refer to the initial relationship, or lack thereof, that emerges in the medium term. We would expect that even following a No Deal, the two sides will try to hammer out a trading relationship of some kind over the longer term or that a Remain government emerges that seeks a close relationship or even referendum (see Chart 2). So, it is worth recalling that No Deal may not be a long-term equilibrium and the ultimate relationship could be anything from the wide array of basic trading agreements right up to re-entering the EU depending on how the politics plays out.

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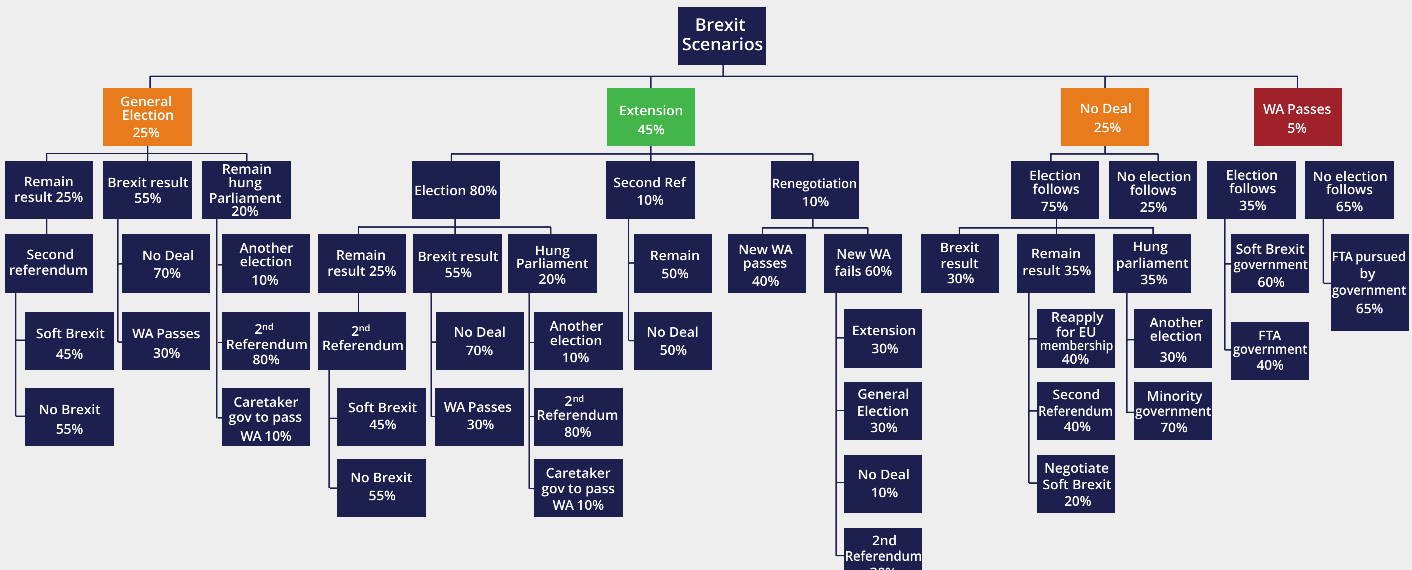
Chart 1: Brexit is a multi-stage game



Source: ASIRI (as of August 2019)

Table 1: UK heading to the polls directly or through extension

Next Step Scenarios	Waymarks	Market Impact	Indicative likelihood
1. Extension beyond 31 October	• Opposition MPs produce clear, joined up communication pre-parliament return • Opposition coalition mobilise in parliament through commons votes rather than confidence vote	• Gilt Yields: rise 5-10bps • Sterling Trade Weighted: up 5-10% • IG Credit Spread: 10bps lower • Equities: FTSE 350 broadly flat, modest rotation to domestics.	45%
2. No Deal Brexit 31 October	• Remain MPs do not coalesce around single solution • Conservative Remainers signal stronger party loyalty than Brexit focus • Normalisation of No Deal Brexit in media • Withdrawal agreement negotiations break down • Johnson prorogues parliament	• Gilt Yields : fall 20-30bps • Sterling Trade Weighted: fall 5-10% • IG Credit Spread: 30-40bps higher, led by banks and insurers unless BoE policy is unexpectedly accommodative • Equities: FTSE 350 down c.7%; FTSE 100 outperforms 250 with major rotation out of domestics, financials	25%
3. General election before 31 October	• Conservative Remainers leave the party amid fears of No Deal risk • Anti-No Deal MPs fail to organise legislation • Media/public backlash against proroguing parliament • Dominic Cummings importance recedes	• Range for Gilt Yields : unchanged • Sterling Trade Weighted: 0-5% lower • Range for IG Credit Spread: 30-35bps higher • Equities: UK domestic de-rate 5%	25%
4. New Withdrawal Agreement passes by 31 October	• EU messaging on alternatives continues to become more positive • Negotiations increase between both sides • Pressure increases as prorogued parliament fails to act • Legal experts coalesce around alternative solution	• Range for Gilt Yields : rise 10-20bps • Sterling Trade Weighted: 10-15% higher • IG Credit Spread: 10-15bps lower • Equities: FTSE 350 broadly flat; significant rotation to domestics	5%

Source: ASIRI(as of Q2 2019)

How is this embedded in economic forecasts?

As a result of the probability mapping, we are incorporating No Deal as the baseline for our economic forecasts until such time as the political environment changes.

There are a number of channels through which No Deal Brexit will affect the UK economy. First, increased barriers to trade through higher tariffs and non-tariff barriers with both the EU and the rest of the world. This includes: rules of origin checks; changes in product standards; and other border frictions and delays, which together raise the cost of importing and exporting and impair cross-border supply chains.

Second, a decline in productivity and potential growth due to: a fall in investment; less exposure to trade competition in certain sectors; value destruction of some of the existing capital stock; less flexible labour markets; and fewer skilled and unskilled workers compared to the baseline. Third, shocks to other macro variables including: the exchange rate; financial conditions more generally; business and consumer sentiment; and policy variables.

Overall we expect the economy to contract by slightly more than 1% in 2020 driven by big fall in business investment. Consumption will also be squeezed by falling real incomes in the context of rising inflation (which climbs above 4%) and a pick-up in unemployment. The Bank of England eases policy back to the effective lower bound in response to this demand shock, while fiscal policy is eased substantially with the current fiscal rules abandoned.

This helps to offset some of the negative impact of the Brexit shock, but not enough to avert recession. Long run potential growth is around 0.5ppts lower due to much weaker investment, capital destruction, and a less open economy.

Table 2: More paths to No Deal than any single other outcome

Medium term Scenarios	Waymarks	Market Impact	Indicative likelihood
1. No Deal Brexit	• Parliament unable to take back control • Conservative Remainers signal stronger party loyalty than Brexit focus • Johnson prorogues parliament • No alternative backstop solution emerges • EU refuses to extend Article 50	• Gilt Yields : fall 20-30bps • Sterling Trade Weighted: fall 5-10% • IG Credit Spread: 30-40bps higher, led by banks and insurers unless BoE policy is unexpectedly accommodative • Equities: FTSE 350 down c.7%; FTSE 100 outperforms 250 with major rotation out of domestics, financials.	50%
2. No Brexit	• Conservative Remainers leave the party amid fears of No Deal risk • Media turns against aggressive government approach re: proroguing • General election sees remain parties garner strong majority • Second referendum offers Brexit or No Brexit	• Gilt Yields: rise 20-30bps • Sterling Trade Weighted: rise 20% • IG Credit Spread: 30-40bps lower • Equities: FTSE 350 modestly up, very strong rotation to domestics	40%
3. Negotiated Brexit	• Opposition coalition mobilise in parliament through commons votes rather than confidence vote • Media turns against aggressive government approach re: proroguing • Legal experts coalesce around alternative to backstop • General election sees hung parliament • Second referendum offers Brexit or No Brexit	• Gilt Yields: rise 10-20bps • Sterling Trade Weighted: rise 10-15% • IG Credit Spread: 5-10 bps higher • Equities: FTSE 350 broadly flat, significant rotation to domestics	10%

Source: ASIRI (as of Q2 2019)

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