

Brexit Monitor

End of May

Key takeaways

- **Brexit has returned to the headlines, as Theresa May's premiership is coming to an end and cross-party talks have broken down.**
- **A new (pro-Brexit) Prime Minister would not change the arithmetic in the House of Commons. It is difficult to predict what is going to happen, especially looking beyond the near term.**
- **Our base case is that a further Brexit extension beyond 31 October may be needed given the new Prime Minister will need time to settle but this is not a high-conviction call.**
- **The GBP has weakened, which is fair given the uncertainty and that the likelihood of some of the GBP negative scenarios (e.g. no-deal Brexit) has risen.**
- **Near term, we do not expect a convergence towards one of the many Brexit outcomes and, hence, we expect very limited further weakness in the GBP. Rather, from the current level, small changes in the perception of the possibility of a softer Brexit could cause a non-linear reaction in favour of GBP strength.**

New Prime Minister soon, same arithmetic

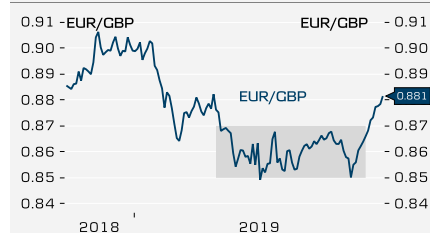
It feels like a long time since April, when the Brexit deadline was delayed by six months to 31 October. Back then we argued that markets would start to focus on other things again, as the imminent fear of the UK crashing out would diminish and the cross-party talks would be unfruitful (see *Brexit Monitor – 'See you in October'*, 11 April). Both predictions were right at the time but now **Brexit is back in the spotlight, as Theresa May's premiership is coming to an end. In that sense, we consider the recent GBP weakness is justified** (EUR/GBP has broken the old 0.85-0.87 range and is now trading at 0.88).

As we argued in April, a bad local election (held on 2 May) and/or bad European elections (voting is today) could be the catalyst for the Conservatives to force out Prime Minister Theresa May. This is very much what is happening right now, after the Conservatives suffered a heavy defeat in the local elections, losing more than 1,300 seats. Polls show that The Conservative Party may come in as number five in today's European Elections and one YouGov poll shows the Conservatives may get as few as 7% of the votes cast.

We do not have much faith in Prime Minister Theresa May's fourth attempt to get her deal through Parliament and it is not unlikely it will be pulled to avoid another humiliating defeat for The Conservative Party.

Instead, the uncertainty is what happens after Theresa May. Near term, she is likely to stay as a caretaker Prime Minister until the party finds a new leader. **The process of finding a new party leader could happen before the UK parliamentary summer recess but, in our view, it is likely that a new leader will not be found before September** (for process see box page 2).

EUR/GBP has broken out of the old 0.85-0.87 range



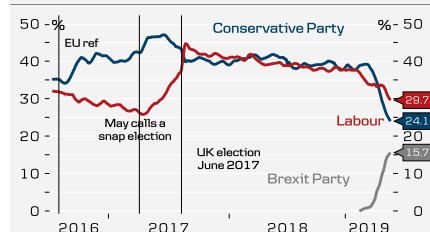
Source: Bloomberg, Macrobond Financial

EUR/GBP scenarios

Brexit scenarios	EUR/GBP forecast
Brexit-deal passes	0.83
Snap election	0.87-0.90
"No deal" Brexit	Towards 1.00
Second referendum	0.82-0.86
- (Brexit is reversed)	Break below 0.80 (0.76-0.80 range)

Source: Danske Bank scenarios

Conservatives are in freefall



Source: British elects, Macrobond Financial

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

The problem for the future new Prime Minister is that the arithmetic in the House of Commons will be unchanged. The main headache has been, and still is, that there is no majority for anything and party loyalty/discipline is low. **A more pro-Brexit Conservative leader would probably increase the chance of a no-deal scenario but the small majority in the House of Commons is likely continue to do as much as it can to avoid this.** One attempt could be to make it illegal for the Prime Minister to pursue a no-deal Brexit. Another could be for the moderate Conservatives to join forces with the opposition to call for a general election.

A general election could solve the deadlock but the Conservatives would risk losing power to Labour or The Brexit Party (the Conservatives are in freefall [see chart on the previous page], having lost more than 15pp support in two months). A new Conservative party leader also risks splitting the party in two if he/she moves the party in a more pro-Brexit direction, complicating things further. **Near term, we do not expect a convergence towards one of the many Brexit outcomes and, hence, expect very limited further weakness in the GBP.**

If we are right that the party does not find a new leader until September and, given the party conference season takes place in September/October, it does not leave much time before the new cliff-edge date of 31 October. In our view, this means **there is still a high probability that the deadline will be pushed somewhat further out**, so the new Prime Minister can settle (potentially giving the UK time to hold a general election if needed). The problem is also that the EU is probably not going to change its current stance that the only way to leave the EU in an orderly way is to pass the Withdrawal Agreement.

Looking at the endgame, uncertainty remains very high right now and, as we highlighted in April, it is difficult to predict what will happen. Therefore, we are still more or less happy with our old ‘game tree’, although the likelihood of no deal has probably increased.

Conservative Party leadership contest – process

The Conservative Party holds a leadership contest if the current leader loses a no-confidence vote or resigns. If the party leader resigns, he/she can remain until the party finds a new leader.

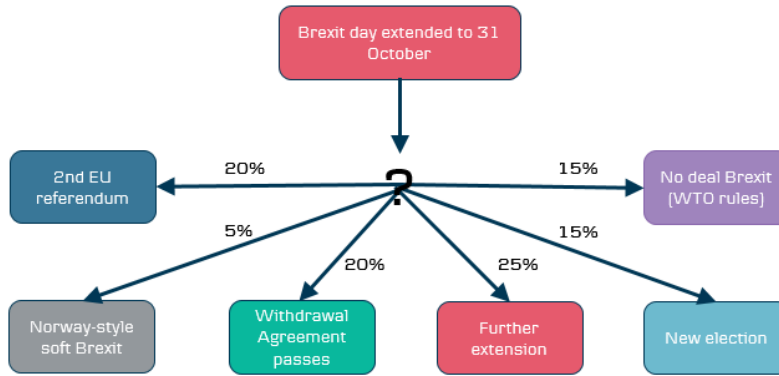
Electing the leader of The Conservative Party consists of two stages. In 2016, the leadership contest was scheduled to take around two months but given Theresa May's competitor Andrea Leadsom withdrew, Theresa May was crowned as party leader. If the process is speeded up, it could take just one month, making it possible to find a new leader before the UK parliamentary summer recess.

First stage: The Conservative members of Parliament select their preferred two candidates. If more than two candidates run, the Conservative Members of Parliament vote on all candidates, removing one candidate each round until two candidates remain.

Second stage: Conservative Party members vote on which of the two candidates chosen by the Conservative Members of Parliament they prefer as party leader (simple majority).

Source: *Parliament UK* <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN01366>

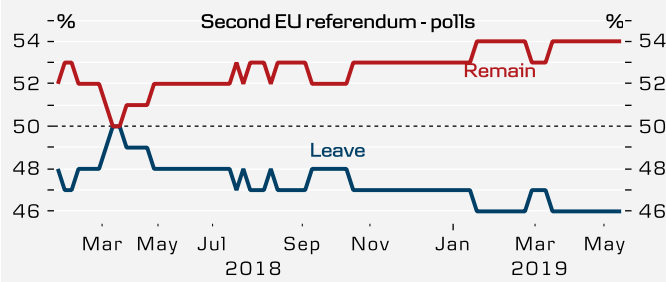
Brexit scenarios



Source: Danske Bank

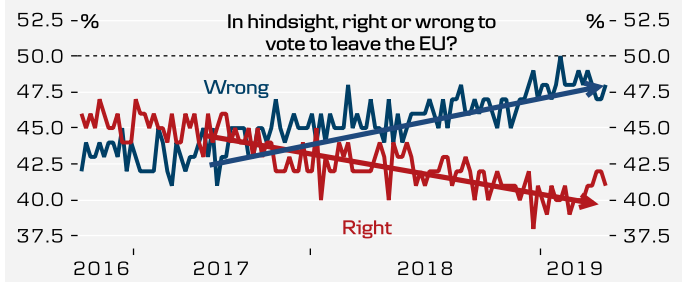
Brexit charts

Small majority now wants to remain in the EU but still close



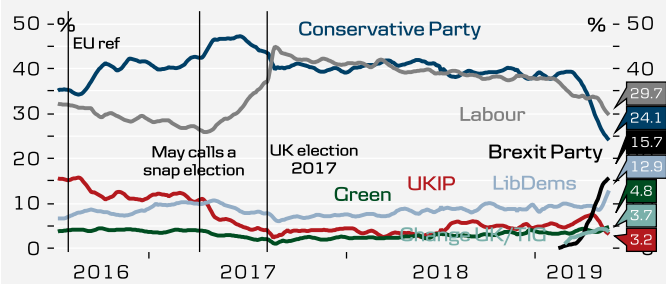
Source: NatCen Social Research, Macrobond Financial

More people think it was wrong to vote to leave the EU



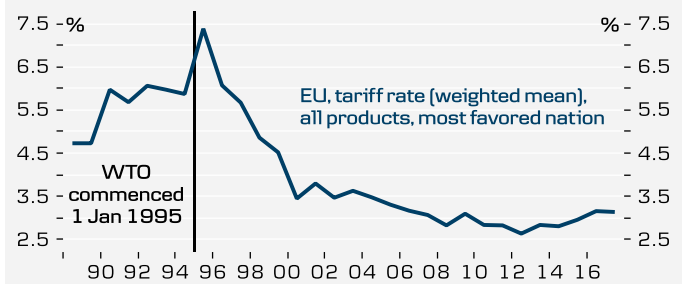
Source: NatCen Social Research, Macrobond Financial

Conservatives in freefall



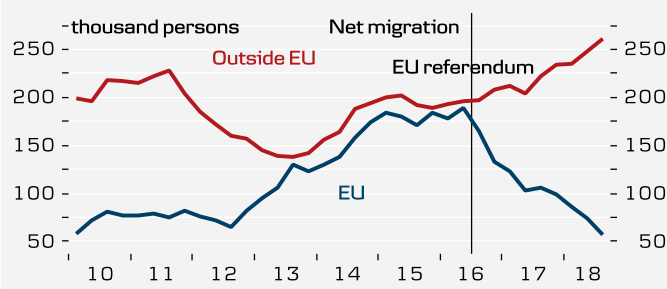
Source: Britain Elects, Macrobond Financial

Tariff rates have declined since WTO came into force



Source: WTO, Macrobond Financial

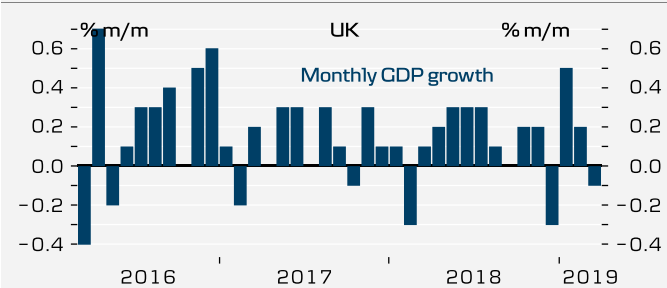
Net migration from the EU to the UK has declined since the EU referendum



Source: ONS, Macrobond Financial

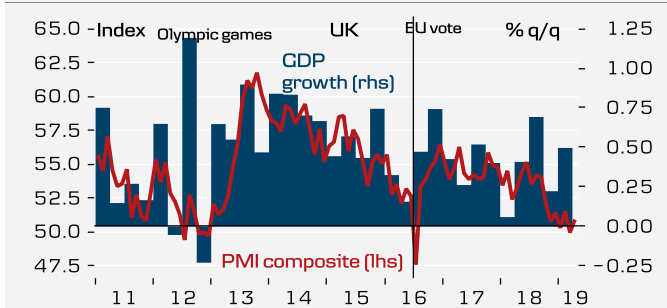
Macro charts

GDP growth in Q1 driven by stockpiling



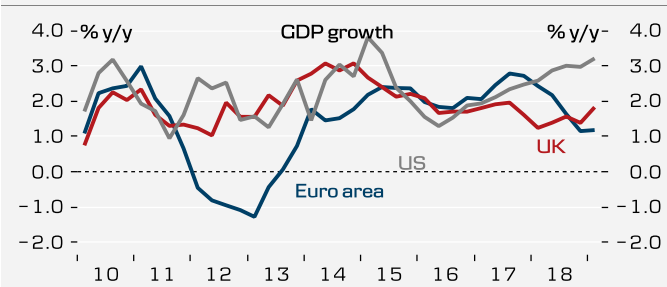
Source: ONS, Macrobond Financial

PMIs suggest weak underlying growth



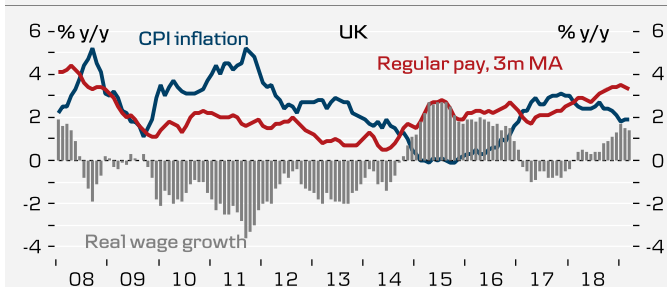
Source: ONS, Markit Economics, Macrobond Financial

GDP growth is stuck at around 1.0-1.5% compared with 2-3% previously



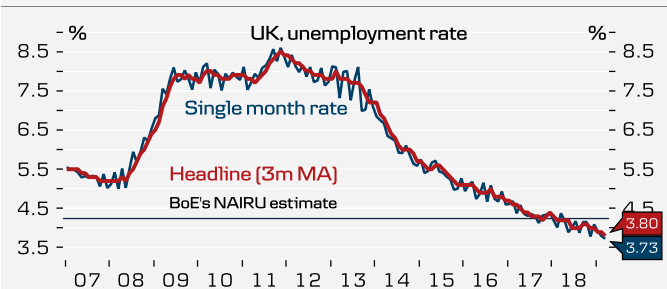
Source: ONS, Eurostat, BEA, Macrobond Financial, Danske Bank calculations

Real wage growth has turned positive again



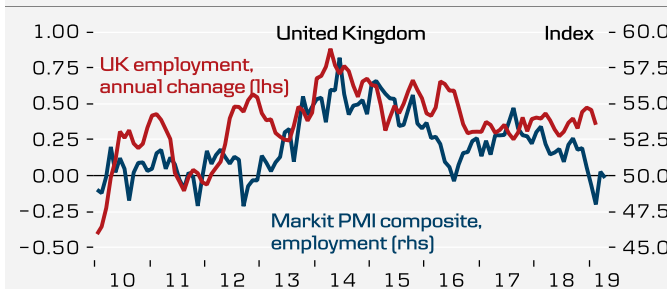
Source: ONS, Macrobond Financial, Danske Bank

Unemployment rate is low



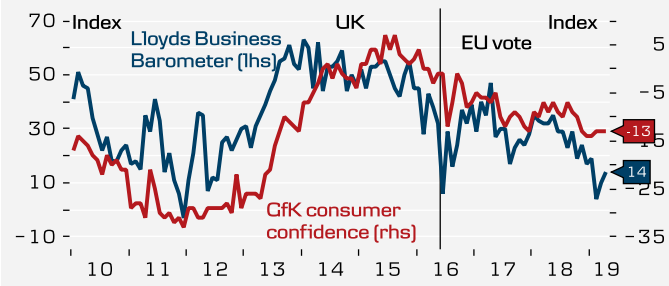
Source: ONS, Bank of England, Macrobond Financial

PMIs signal employment growth is slowing down



Source: ONS, Macrobond Financial

Business confidence hit by Brexit fears



Source: Lloyd, GfK, Macrobond Financial

Companies have stockpiled as part of Brexit preparations



Source: IHS Markit, Macrobond Financial

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 22 May 2019, 17:01 CEST

Report first disseminated: 23 May 2019, 06:00 CEST