

Brexit Update: The Sword of Damocles

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July 26, 2019

Together we'll go far



- **Boris Johnson is the new prime minister of the United Kingdom.**
 - Several Conservative MPs have already resigned, and more could follow. Johnson's speech tomorrow will be in focus, while he has already cleaned house and appointed new cabinet ministers, many of whom are hardline Brexiteers.
- **We now see a higher risk of a no-deal exit.**
 - The chances of a **general election** and **another delay** to the October 31 deadline have also risen, in our view.
- **We also now see no outcomes with a probability higher than 50%.**
 - “Deal” remains the base case, but not by much. A general election or another delay would further diminish the chances of “deal,” in our view.
- **Parliament will be on recess from July 25-September 3.**
 - In the meantime, Johnson's team will likely seek to renegotiate the withdrawal agreement with the E.U. We do not expect much success, at least at first.
- **This will set up for a tense backdrop come early autumn.**
 - Expect Johnson to push for a no-deal exit—even if “no-deal” is averted, GBP could still come under renewed pressure heading into September.

1. The U.K. leaves the E.U. with a deal in place (“deal”)

- *Our estimated probability: 40% (previously 50%)*

2. The U.K. does not leave the E.U. (“no Brexit”)

- *Our estimated probability: 30%*

3. The U.K. leaves the E.U. with no deal (“no deal”)

- *Our estimated probability: 30% (previously 20%)*

- **The most important change is a higher risk of a no-deal exit.**
 - We take Boris Johnson's no-deal threats seriously.
 - Despite Parliament's best efforts, no-deal is still the legal default if no alternative path forward is agreed upon (see next slide).
- **“Deal” is still the base case, but the probability is now below 50%.**
 - Johnson has a better chance of securing concessions or changes to the backstop than Theresa May, in our view, because his no-deal threat is more credible.
 - That said, the parliamentary timetable is tight, and while Johnson may have a *better* chance for E.U. concessions, that does not mean he has a *high* chance.
 - The threat of another delay could convince more Brexiteer MPs to vote for a deal this time around in hopes of avoiding the “no Brexit” outcome.
- **The risk of Brexit being cancelled entirely is still very much possible.**
 - The risk of a general election has risen given the government's razor thin majority. A new election could pave the way for 2nd referendum.
 - Several E.U. officials have signaled a willingness to grant another extension to the U.K., which could offer time for a general election/2nd referendum.

Q. I thought U.K. Parliament voted to block a no-deal Brexit?

A. Not technically. They narrowly approved a vote which makes it harder for the prime minister to prevent parliament from sitting. That was one of the options Johnson has considered to push for no-deal.

Q. O.K., so how do we get to a no-deal Brexit?

A. The better question is how do we *not* get to a no-deal Brexit. No-deal is the default outcome on October 31 **unless** (a) parliament approves a deal, (b) the U.K. gets an extension or (c) the U.K. revokes Article 50. If none of those things occurs by October 31, the U.K. will leave the E.U. with no deal.

Q. How could parliament try to stop a no-deal Brexit?

A. Parliament could try to force a confidence vote in the new government if the prime minister is pushing for a no-deal exit—if the government loses, a general election would likely follow. However, it seems unlikely an election could be wrapped up by October 31—thus, another extension would likely be required, which would require unanimous approval from the other 27 E.U. member states (more on this later).

- Q. Would there be any impact on other economies or currencies?
- A. The Eurozone economy is likely to feel some economic pain in a no-deal scenario—with growth already weak at just around 1%, a no-deal Brexit risks tipping the Eurozone economy into recession. Expect more downward pressure on global bond yields, global trade volumes and global growth more broadly. Still, relatively low U.S. exposure to the U.K. economy suggests the U.S. economy can skirt recession following a no-deal Brexit—USD should strengthen broadly.
- Q. What will a no-deal Brexit actually look like in practice?
- A. In short, nobody knows. Parliament published a [white paper](#) on the possible economic ramifications, but it lacked definitive answers. For example, U.K.-E.U. trade in goods will likely be dictated by WTO rules, implying tariffs will be collected. However, that would presumably require a hard border between Northern Ireland and Ireland with customs checks, and that is one of the most controversial aspects of the current Brexit negotiations and may be a non-starter for Ireland. Our view is that, if the U.K. leaves the E.U. without a deal, the two sides would probably have to come to the negotiating table to ensure that trade continues to function. Uncertainty would still reign, however, and the talks would likely be acrimonious, suggesting GBP is unlikely to recover meaningfully for some time and indeed could head even lower in the short term.

- Speculation of a snap election is growing as Boris Johnson has taken power. How do we get to a snap election? One of two ways:
 - 1. Motion of no confidence:** if the government loses a confidence vote and no group of MPs is able to form a government that garners the confidence of parliament within 14 days, a general election is automatically triggered.
 - 2. 2/3 of MPs vote** in favor of a motion for a snap election.
- We think **(1) is more likely** than (2). Jeremy Corbyn said he may table a motion of no confidence, but not until after parliament returns from recess on September 3.
 - Corbyn (and others) may refrain from calling a motion of no confidence unless it is seen as the only way to block a no-deal Brexit, which may mean any no confidence motion would be delayed until mid to late October.
 - Recent resignations from Conservative MPs raise the chances that a no confidence motion would succeed in toppling the government.
- It is also possible that **Johnson could propose a snap election**, but that motion would **still need to be approved by 2/3 of MPs**.
- According to the House of Commons Library, the likely **earliest date for a general election to take place is October 24**, one week before the October 31 deadline ([link](#)). That suggests an extension would be needed in this scenario.

- **Our current forecast calls for two 25 bps rate hikes from the Bank of England (BoE) next year (Q2 and Q4).**
 - We are sticking with that view for now, although to be clear, that view is predicated on a smooth resolution to Brexit by late 2019 or early 2020, which is becoming less likely by the day.
 - *Our conviction in this BoE outlook is only moderate.*
- **Risks are tilted toward no moves from the BoE over the next year or so.**
 - Another delay to the October 31 deadline would make this “permahold” scenario more likely, although rate hikes next year would still be possible if a Brexit deal is approved early in 2020—not out of the question.
- **The BoE would very likely cut rates in a no-deal scenario**
 - Rates could quickly return to zero if there is a no-deal Brexit, and the BoE could also restart its asset purchases.

- July 25-Sept. 3: U.K. Parliamentary recess
- Sept. 29-Oct. 3: U.K. Conservative Party conference
- Oct. 17-18: E.U. leaders' summit
- Oct. 31: New Article 50 deadline AND expiration of current European Commission term

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