

On the Minds of Investors

August 2019

“Do or die” – is Brexit set to conclude with no deal on 31 October?

The UK's new prime minister, Boris Johnson, has stated that, ‘do or die’, the UK will leave the European Union on 31 October. Yet he also states that there is a ‘one in a million’ chance that the UK will leave without a deal. Sterling markets are confused and rattled.

In this article we consider the following questions:

- What is no deal, and what might it mean for the UK economy and markets?
- Will UK parliament accept no deal and, if not, are we headed for a general election?
- What are the risks to markets in the event of a general election?
- Is all hope of a deal dead?

We argue that no deal is still not priced in to UK markets and, were it to happen, we could see sterling trade as low as 1.10 against the dollar and the UK interest rate cut to 0.25%.

However, to deliver a no-deal Brexit, it still seems likely that Johnson will need to change the configuration of parliament via a general election. We will know a lot more about both parliamentary and government strategy immediately after MPs return from summer recess on 3 September. With the political and economic newsflow likely to get worse in the near term, sterling assets are set to face ongoing challenges.

What is no deal, and what might it mean for the UK economy and markets?

The EU is a club of countries, members of which can trade with minimal barriers, since all countries apply common regulatory and product standards. Goods entering the EU from outside the club face a common tariff rate. The EU also strikes trade deals with other countries or blocs on behalf of all its members. There are 40 such agreements, covering around 90 countries.

If the UK leaves the EU, it still sits in a broader club of 164 countries called the World Trade Organisation (WTO). The terms of trade under the WTO are much less comprehensive and so reverting to WTO terms would mean:

- UK exports to the EU would face tariffs, and vice versa. The WTO prevents discrimination between members, so the tariff on each product must be offered to all WTO members (known as the most-favoured-nation rate). This equates to a weighted average rate of roughly 3.2% applied to UK exports to the EU.
- Customs checks would be required at all border points, including those between Northern Ireland and the Republic of Ireland.
- Neither side would recognise product standards, so regulatory checks would be required for new and existing product lines.

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- The UK financial services sector would lose its passporting rights (its right to service EU clients from any EU country). Broadcasting and transport services rights would also be lost.
- The UK would need to replicate the trade agreements that have been negotiated on its behalf by the EU (the UK has made arrangements to roll over 12 of the 40 so far), but would have the autonomous capacity to negotiate new trade deals independently.

While this would be the default position on 1 November if the UK leaves without a deal, in reality there are likely to be a number of emergency arrangements to ease the process of transition, even if the negotiations ended in a particularly hostile fashion. Either side could, for example, choose to grandfather certain arrangements for a set period of time to create a period of transition for firms to adjust.

The extent to which any such arrangements are put in place is just one element of the uncertainty involved in forecasting such an unprecedented event. In our view, the most detailed and rigorous attempt to analyse the short-run impact of leaving without a deal is that produced by the Bank of England (BoE) on request of the Treasury Select Committee. Taken from this report,¹ the table below details the economic and sterling impact of a ‘disorderly’ no-deal scenario, versus a ‘disruptive’ no-deal scenario in which provisions are made by both sides to ease the transition.

EXHIBIT 1: BANK OF ENGLAND MODELLING OF NO-DEAL BREXIT SCENARIOS

	GDP	Unemployment rate	Inflation	House prices	Commercial property prices	Bank rate (peak)	Sterling dollar FX at trough
Disruptive	-3%	5.75%	4.25%	-14%	-27%	1.75%	1.10
Disorderly	-8%	7.50%	6.50%	-30%	-48%	5.50%	0.93

Source: Bank of England, J.P. Morgan Asset Management. GDP and property prices represent maximum fall from starting point. Unemployment rate and inflation represent peak levels. Data as of 6 August 2019.

Having analysed the assumptions, the ‘disruptive’ scenario looks more plausible than the ‘disorderly’ one, in our view. The most immediate economic impact would be the supply chain disruption as firms face customs processing and EU manufacturers seek to source component parts from EU companies that officially comply with EU regulations. It is worth noting that, in a BoE business intelligence survey, only one fifth of the respondents stated that their businesses were ready for a no-deal Brexit as of July 2019. The sectors most likely to be affected are food & agriculture, chemicals & pharmaceuticals, and transport & transport services.

¹ <https://www.bankofengland.co.uk/-/media/boe/files/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability.pdf?la=en&hash=B5F6EDCDF90DCC10286FC0BC599D94CAB8735DFB>

The fall in sterling and subsequent rise in inflation would squeeze real incomes and put downward pressure on consumer spending. This would be compounded if business confidence declined and firms chose to cut back on staff. The recent weakening in the global backdrop will not help in this regard.

One key uncertainty is the EU’s treatment of UK financial services. While the UK will lose its passporting rights, there may be an agreement to enable the UK to continue providing financial services via some form of ‘equivalence’ (essentially permission to provide some services as long as UK regulators were deemed to set regulations to at least an equivalent standard to those set by the EU). It helps greatly that the BoE is held in such high regard internationally for its regulatory competence.

If an agreement on financial services was not forthcoming then no deal risks a broader European financial contraction, which would exacerbate a downturn on both sides of the channel. There may also be serious challenges for the UK if international investors questioned the ongoing dominance of UK financial services, not least with regards to the sustainability of the UK’s public finances (given 28% of all income tax comes from the top 1% of earners in the UK).

The one element of the BoE analysis detailed in the table that we would dispute is the monetary policy rate. The BoE had argued that a no-deal scenario would do more damage to the supply side of the economy than to demand, and as a result the net effect would be lasting upwards pressure on inflation. More recently, the BoE has conceded that it is more likely to cut rates. We would therefore expect the BoE to cut its policy rate at the November meeting, potentially by 50 basis points to 0.25%. The asset purchase scheme would most likely be restarted in the subsequent months. This might help the bond market absorb the additional government debt issuance (the Office for Budget Responsibility² argues that a no-deal Brexit will require the government to borrow GBP 30 billion more per annum).

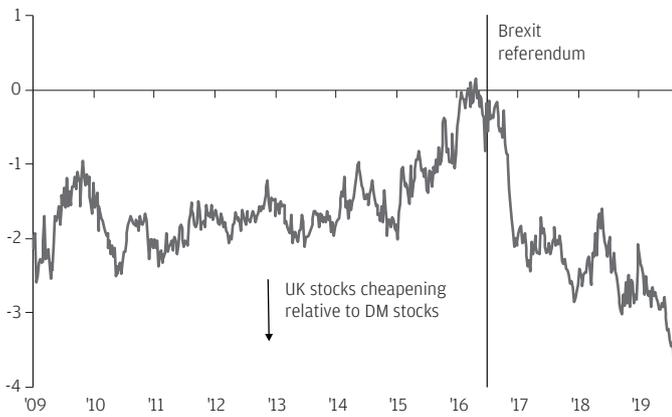
With regards to equity markets, there are many international companies listed on the London Stock Exchange that have significant foreign revenue streams and little exposure to the UK economy. In the event of no deal, the decline in sterling would notably boost the repatriated earnings of these companies, helping larger companies with significant international exposure to outperform smaller, more domestically exposed companies. For reference, in the ten trading days after the referendum in 2016, sterling fell 13% against the dollar. Over the same period, the FTSE 100 index rose 3.1% and the FTSE 250 fell by just over 8%. While the case is clear for large caps to outperform small

² <https://obr.uk/docs/dlm/uploads/Fiscalrisksreport2019.pdf>

caps again if the pound slides following a no-deal exit, it is less clear whether UK large caps would deliver positive returns as they did in the period following the Brexit referendum. If investors decide that UK-listed companies warrant lower valuations following a disorderly Brexit, given the extent of political uncertainty, this de-rating could potentially offset the positive boost to prices from higher repatriated earnings. FTSE 100 valuations have already declined significantly relative to broad developed markets since the referendum, as **Exhibit 2** shows. This suggests that further downside is limited, but we would not rule out another leg lower in the valuations that investors are willing to pay for UK-listed companies in a no-deal scenario.

EXHIBIT 2: GAP BETWEEN FTSE 100 AND MSCI WORLD FORWARD P/E RATIOS

x, difference in multiples



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. The line shows the 12-month forward price-to-earnings ratio of the FTSE 100 minus the 12-month forward price-to-earnings ratio of MSCI World. A zero level represents both indexes trading at the same valuation level, a negative level represents the FTSE 100 trading on a cheaper valuation than MSCI World. Data as of 6 August 2019.

The implications are not limited to the economy and markets. Without a solution for the Irish border, questions could be raised about the reunification of Ireland. And a no-deal exit would provide significant fuel for the debate on Scottish independence, given 62% of the Scottish population voted to remain in the Brexit referendum.

Will UK parliament accept no deal, and if not, are we headed for a general election?

We have seen on multiple occasions in the last year that there is not a majority for no deal in UK parliament. Will parliament seek to block no deal again? And can it?

Current legislation stipulates the UK will leave on 31 October so, for parliament to block no deal, the law needs to be changed. This could happen by MPs tagging amendments to any other laws the government tries to pass. One recent example is the

amendment preventing the government from suspending parliament that was tagged on to a law about Northern Ireland devolution. The government can avert this risk by choosing not to pass any new legislation before 31 October.

So how can parliament intervene? This is where the parliamentary rulebook becomes vague and opaque. We know that the Speaker of the House plays an important role and that he has stated it is “unimaginable” that parliament would be sidelined. While the exact legislative vehicle by which the law could be changed is unclear, we struggle to see a scenario under which the Brexit outcome is acutely at odds with that desired by a majority in UK parliament.

Johnson may in fact welcome such resistance from parliament as an excuse to call a general election. The aim would be both to increase his majority (from the current working majority of just one) and to provide himself with more runway after no deal for the economy to recover before he again has to face the electorate. Under the Fixed-term Parliaments Act, Johnson would need a two-thirds majority in favour to call an election. We suspect that one condition for such support would be an extension of the 31 October deadline, which would be sold as a technical extension to facilitate the election. We would expect the EU to agree to such an extension.

It is also possible that a general election could be forced on the prime minister if the Labour Party halts proceedings by calling a vote of confidence in the government.

As a reminder, the Fixed-term Parliaments Act stipulates that the government has 14 days to restore confidence in the house, by a change of either policy, prime minister or cabinet. If it cannot restore confidence, there is the opportunity for other parties to form a government.

For the vote of confidence process and electoral procedures to take place before 31 October, the vote of confidence would be need to be called in the very early days of the new parliamentary session.

A vote of confidence could be called later in the day but risks leaving the UK without a government over 31 October. However in order to alter the exit date to facilitate the process of a general election, a government of national unity could be formed.

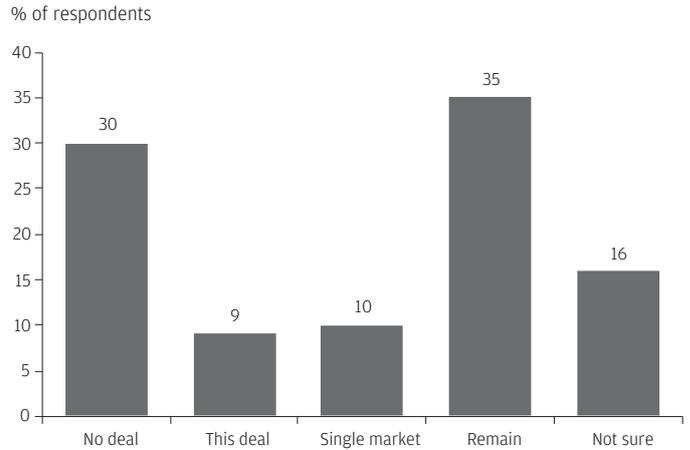
One thing is for sure, the initial days of the new parliamentary session will be busy.

What are the risks to markets in the event of a general election?

The scale and volume of recent pledges to cut taxes and increase spending suggests the prime minister is preparing for a general election.

However, it is far from clear at this stage that the Conservatives will win on a landslide. Consider **Exhibits 3** and **4**. **Exhibit 3** shows that, three years on from the referendum, the UK population remains heavily divided. This survey - taken in May of this year - shows that 30% of the population want no deal. But 35% of the population would still rather remain. This is shifting the landscape of British politics - see **Exhibit 4**. Those seeking no deal are tempted by the newly formed Brexit Party. By contrast, those seeking to remain are swayed by the Liberal Democrats, who believe the UK should get a new vote. These two parties are eating into the support of the Conservatives and the Labour Party alike.

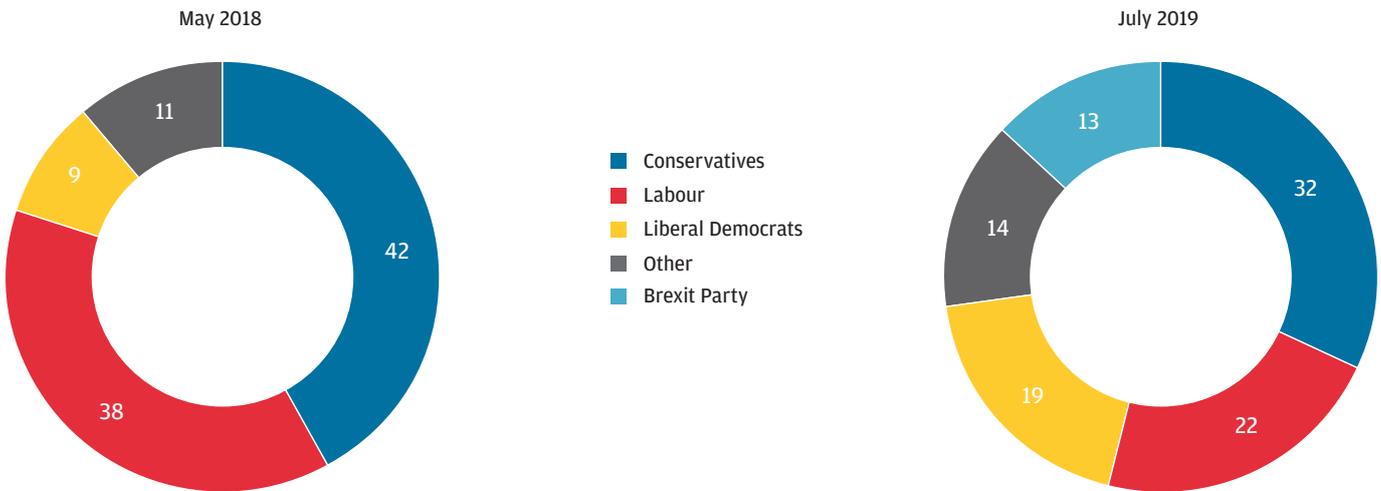
EXHIBIT 3: IF YOU HAD TO CHOOSE ONE OUTCOME OF BREXIT, WHAT WOULD YOU PREFER TO SEE?



Source: YouGov, J.P. Morgan Asset Management. Survey fieldwork was carried out on 10-11 April 2019.

EXHIBIT 4: GENERAL ELECTION VOTING INTENTIONS

% of respondents



Source: YouGov, J.P. Morgan Asset Management. May 2018 survey fieldwork was carried out on 20-21 May 2018. July 2019 survey fieldwork was carried out on 29-30 July 2019.

Johnson faces the difficult balancing act of appealing to the hardline Brexiteers tempted by the Brexit Party, but not losing Conservative remainers tempted by the Liberal Democrats. While the Conservative Party's membership is heavily dominated by no-deal supporters, its broader electoral support is less strongly in favour of no deal. Indeed, in May of this year, a survey of the electorate revealed that, of those that voted Conservative at the 2017 general election, 42% wanted to leave without a deal, 32% wanted to leave with a deal and 23% wanted to remain.

To make matters worse in terms of predictability, the UK has a first-past-the-post electoral system that heavily favours the two

leading parties. Therefore, a voter who has traditionally voted Conservative but is averse to no deal and lives in a constituency where voting for the Liberal Democrats would be seen as a wasted vote might vote Labour purely based on their Brexit preference. The potential for increased turnout from younger cohorts adds another element of uncertainty.

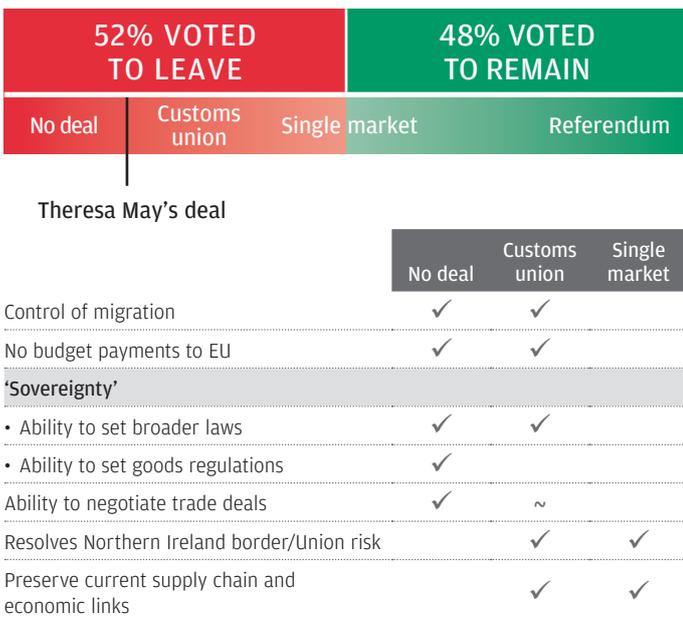
Overall, the outcome of a general election is hard to predict, and for markets creates multiple risks. It may be that no party obtains a majority, and/or we see a significant rise in support for the Liberal Democrats, giving them a much more influential role in the formation of a new government. This would most likely be perceived positively by markets.

Alternatively, the Conservatives could obtain a strong majority and have the mandate and parliamentary capacity to deliver no deal. Though it seems unlikely on current polling, the Labour Party could see increased support if it firms up an anti-Brexit position and manages to absorb the vote swaying to the Liberal Democrats. In this scenario, while the market may welcome Labour’s pro-EU stance, it is likely to be concerned by the less market-friendly policies contained in the current Labour manifesto, such as large-scale renationalisation.

Is all hope of a deal dead?

It is not impossible that the UK and the EU could reach a deal in the coming weeks that could pass through UK parliament. As a reminder, the deal Theresa May negotiated had two parts: a political declaration on a future partnership, which wasn’t legally binding, and a withdrawal agreement, which was legally binding and included a financial settlement. The undoing of the deal was the backstop in the withdrawal agreement, which stipulated that if the two sides couldn’t agree on a future partnership it would default to a customs union for goods with the EU. While this is a clear solution for the Northern Ireland border and overcomes some of the economic challenges, it prevents the UK re-establishing sovereignty in full and limits the UK’s ability to create its own trade agreements (**Exhibit 5** is a reminder of the various on-the-shelf deals on offer and what they deliver).

EXHIBIT 5: BREXIT OPTIONS FACING THE UK



Source: J.P Morgan Asset Management. Data as of 6 August 2019

To increase the likelihood of a deal passing through UK parliament, the backstop could be made time-limited. Alternatively, the political declaration did include a workaround which was a commitment to work on a technical solution to the Irish border that would prevent the need for customs infrastructure and free up the UK to set its own laws and trade deals.

If the EU agreed to adjust the wording on the backstop in order to align it to the text in the political declaration, the deal may pass through UK parliament. The EU is showing no inclination to reopen the withdrawal agreement at this stage, but no deal will be damaging for the economies on both sides. If the current brinkmanship de-escalates and a new deal is agreed, the rebound in sterling could be meaningful, towards 1.40 versus the US dollar.

CONCLUSIONS VERSUS CONVICTION

In order of likelihood, from most likely to least, this is how we see the situation as at 1 November:

- 1) Following resistance from parliament, the prime minister has called an election and accepted a short technical extension to Article 50 to facilitate the process
- 2) The UK and EU have agreed a revised deal
- 3) The UK has left the EU without a deal

However, our conviction in any one scenario is uncomfortably low. We have consistently overestimated the willingness of MPs to put national interests ahead of party politics. With such a binary outlook - sterling at either 1.40 or 1.10 versus the US dollar - it does not make sense to assume large positions in sterling assets in either direction at this stage. ‘Do or die’ may be seen as an acceptable political strategy. It is not a strategy we would deploy with our clients’ hard-earned savings.

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