Market Bulletin

15 November 2018

Brexit: Getting there

There has been significant progress in the Brexit negotiations in the last 48 hours. A withdrawal deal has been agreed between the UK and European Union (EU). Whilst the prime minister (PM), Theresa May, appeared to have the backing of her cabinet last night, Dominic Raab, the Secretary of State for Exiting the EU has just resigned which will create concerns about a leadership challenge and the deal when it reaches Parliament. We continue to believe that no UK politician can secure a better deal simply because there is no other solution to the Irish Border. Despite posturing, we expect the PM to conclude the negotiation and the deal to pass through Parliament by the end of the year.

What is "the deal"?

The deal constitutes three parts: the divorce bill, a period of transition to December 2020 (or possibly beyond) in which nothing changes so firms have time to adapt, and the broadest heads of terms on the future long-term economic relationship between the UK and the EU.

The sticking point throughout has been how to manage the UK's ambition of having no border on the island of Ireland nor a border in the Irish Sea, but at the same time separating itself from the European single market and customs union to enable it to set its own rules and trade agreements.

The simple fact is that there is no solution to the Irish border question, except that Great Britain and Northern Ireland stay in the customs agreement for goods. That is the stated ambition for the final relationship. Given the priority in the UK parliament of maintaining the union between Great Britain and Northern Ireland and to respect the Irish peace process, we have always expected the deal to land in this way (see *On the Minds of Investors - How will the Brexit negotiations conclude?* [1]). The ambition - and compromise to certain members of the Conservative Party - will be that the UK pursues a technological solution that, at some point in the future, allows for an invisible Irish border and opens up some options for the UK in establishing other trade relationships.

There is also enough in the wording to suggest that UK financial services will be able to continue trading in the EU in much the same way today under an equivalence framework. Importantly, these rights cannot be removed in an abrupt or arbitrary manner.

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[1] *On the Minds of Investors - How will the Brexit negotiations conclude?*, Karen Ward, J.P. Morgan Asset Management, October 2018.

There is a 'backstop solution' which would come in to force at the end of the transition period in December 2020 if a broad trade deal encompassing the customs union cannot be achieved. This does see some special arrangements for Northern Ireland. The PM will need to reassure the DUP that this is such an extremely remote possibility in order to have their backing.

What's next?

The PM has presented the deal to her cabinet. Whilst she appeared to have the backing of her cabinet last night, Dominic Raab, the Secretary of State for Exiting the EU has just resigned which will create concerns about a leadership challenge and the deal when it reaches Parliament. We continue to believe that no UK politician can secure a better deal simply because there is no other solution to the Irish Border. We believe the PM will win any leadership contest.

There is then likely to be another round of meetings in Brussels to sign off on 25 November and then the bill needs to be put to the UK parliament. This is the bit investors have been most nervous about.

The specifics are that the government will lay a statement in the Houses of Parliament saying that a deal has been reached and then will submit a motion to the House of Commons and schedule a time for a debate and vote. This could be as little as five days after laying the statement.

It may not be voted through first time. It may take a number of amendments to appease backbenchers (such as specifics on the ambition for a technological Irish border solution and how that could alter the deal in the future). So there may still be back and forth as footnotes and finer details are added to appease all sides. This process may still generate considerable market volatility.

But it is important to remember that even if members of the Conservative Party do not 'like' the deal, voting against the PM raises the risk of political deadlock that can only be resolved through either another Brexit referendum (with the options this deal or stay in EU), or a general election. That would be a significant risk for backbenchers to take. We think the bill will pass and most likely in the first week of December.

All 27 remaining EU member states also need to pass legislation (hence the need to get the deal wrapped up well ahead of 29 March) but we see limited reason for concern about that ratification process.

The UK formally leaves the EU on 29 March but during the period of transition (running up to December 2020 or beyond) nothing changes. The transition period was designed to allow businesses time to adapt to the new relationship. Negotiators will continue to work during the period of transition on the full aspects of the final partnership with the ambition of having all the details filled in six months ahead of the transition period ending.

What impact will it have on markets?

Whilst political headlines are likely to generate a lot of volatility in the coming days on passage of the bill, sterling is likely to rally. This may adversely affect the FTSE 100 given the high proportion of FTSE earnings that are repatriated. Going in to next year we expect business investment to experience a relief rally and higher sterling to depress inflation and lift real wages so consumer spending would also accelerate. Given the Bank of England (BoE) believes that the economy is already at capacity, we think it will raise interest rates at a faster pace than the market currently expects (we see at least two 25 basis point increases next year). When the BoE confirms this more hawkish playbook, we expect sterling to rally further.

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