

Market Bulletin

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How will the Brexit negotiations conclude?

The prime minister (PM) and UK negotiators have agreed on a Brexit deal with the European Union (EU), and it now needs to be ratified. The UK vote is scheduled for the evening of December 11. But what are the main areas of contention? And should the vote fail, which we think is likely, what happens next?

The proposed deal has two key elements. The Withdrawal Agreement is a legally binding treaty that sets out the terms of the UK's divorce from the EU, including the financial settlement, the rights of citizens, the transition period (to December 2020, or beyond if extended) and a backstop arrangement in case both sides cannot fully agree on a future partnership. The Political Declaration is not legally binding, but contains some broad areas of agreement around which the future partnership will be constructed. The deal now needs to be passed into legislation in the UK, by the European Parliament, and by all 27 EU member states.

Crunch time

There is considerable scepticism about whether this deal will be approved by UK parliament. There are two particular areas of contention.

The first is the backstop. Throughout the negotiation, one of the key areas of difficulty has been that of the Irish border. The UK argued that it wanted to leave the EU but did not want to create a border on the island of Ireland, given the potential for such an arrangement to undo the peace process underpinned by the Good Friday agreement. At the same time, Northern Ireland does not want to be in a separate arrangement from mainland UK.¹ The problem is that the proposed backstop does essentially leave Northern Ireland more firmly rooted in the customs union than the rest of the UK, and requires regulatory checks in the Irish Sea. The Democratic Unionist Party (DUP) in Northern Ireland—which supports Theresa May's minority government—has said that it cannot support this deal. In addition, some members of parliament (MPs) are uncomfortable with the fact that the backstop cannot be revoked by the UK unilaterally. They argue that this limits the EU's incentives to move swiftly towards finalising the future partnership.

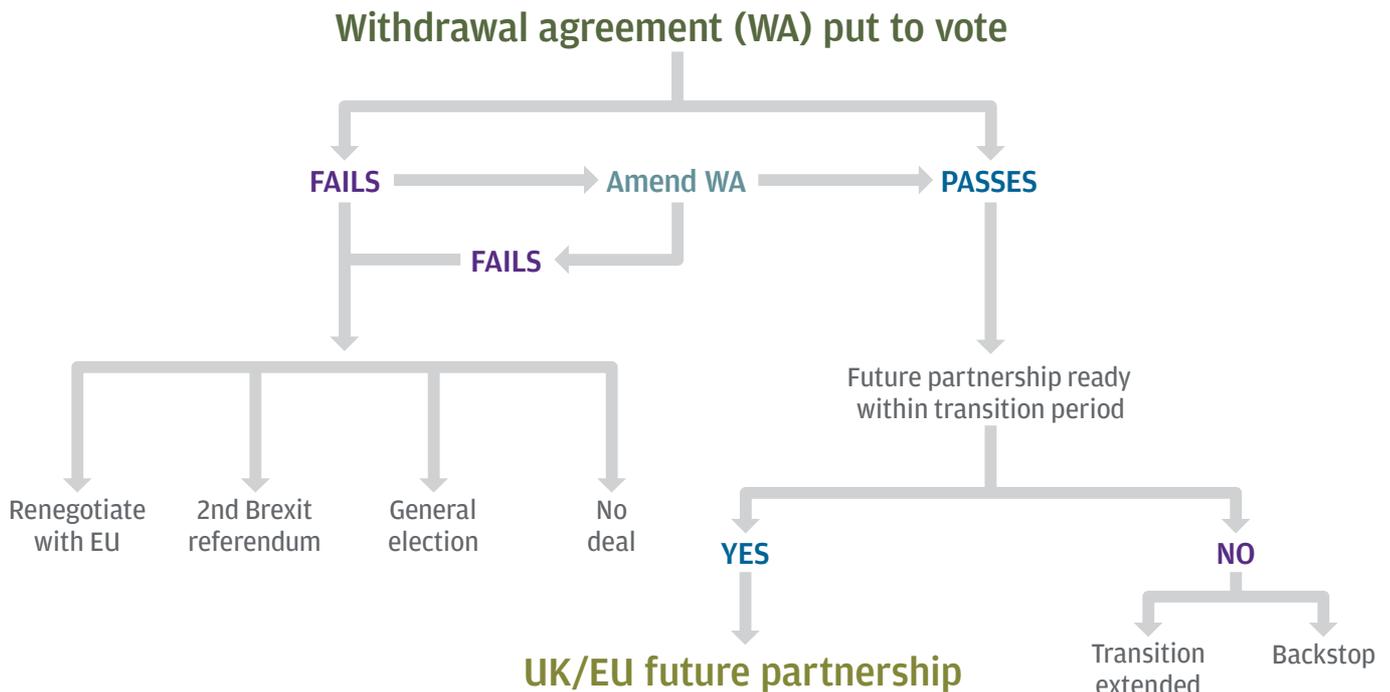
The other key area of opposition is within the Conservative Party. The faction generally known as the Brexiteers are aiming for a cleaner break from Europe—a so called “no-deal” exit. Their view of the current deal is that the cost of having to abide by EU rules and regulations, and the resulting concession of “sovereignty”, outweighs the benefit of having access to the EU's markets (which currently account for 44% of all UK exports).

¹ It is worth noting that while Northern Ireland does not want a separate arrangement, Scotland does because it wants to maintain access to the single market, and so this will reinvigorate the Scottish Independence discussion. So there is a broader question of the stability of the Union of England, Wales, Scotland and Northern Ireland.

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While there is validity to all the concerns, the PM could never have struck a deal that pleased everyone. The UK’s ambitions were internally conflicting. The need to have free flow of trade in Ireland without Northern Ireland being carved off in separate rules, alongside the realities of an extremely integrated UK and EU supply chain, requires the deal to be based around a customs agreement in goods. This means accepting EU standards—and so the UK cannot fully regain sovereignty. (If the UK struck a trade deal with the US to compensate for a lesser relationship with the EU, it would require accepting US standards, which, in agriculture, are currently very different). As such, no deal was ever going to be a “good deal”—one that would please all MPs. This is worth remembering when considering whether an alternative MP would either wish to replace the PM, or have the ability to craft an alternative deal.

If the prime minister fails to get support for the deal on the evening of December 11, there is a complex web of possible outcomes and, given the uncharted territory, the legalities of all the options are not perfectly clear. But below we’ve tried to highlight the four key potential scenarios. We’ll present them starting with those we believe are least likely.

1) No-deal. There was a risk that the PM could be replaced with a Conservative MP less fearful of a no-deal scenario. Were they to face a lack of willingness by the EU either to renegotiate, or to extend the Article 50 process, the UK could have essentially fallen out of the EU on March 29, 2019. However, the Advocate General to the European Court of Justice has now issued an

opinion (not yet passed as a ruling) that the UK could unilaterally revoke Article 50. We are confident that there is no parliamentary majority for no-deal, so believe that there would be a motion of confidence in the government which would prevent such a no-deal scenario from happening. Should we be wrong it is worth noting that the Bank of England estimates that sterling would have to decline 25% in the event of no-deal to cushion the impact on the domestic economy from the new barriers to trade. Whilst we believe there is only a small probability of a no-deal scenario occurring, we attach a higher probability to downside for sterling if the PM either loses a confidence vote from her party, or herself decides to resign.

2) A general election. The Labour Party could put forward and then win a vote of no confidence in the government. The government would then have 14 days to win a vote of confidence by majority in the House of Commons (this may involve them selecting a new leader), or a general election would be held. How the prospect of a Labour government changes the outlook for the Brexit process is unclear given it has not specified exactly which elements of the deal it would change, except that it would prioritise remaining in the customs union.

3) Another referendum. The PM could find it appealing to go back to the British public to ratify her deal. If she received sufficient support for the deal in another referendum, MPs would have to support it to respect the wishes of their constituents. While this sounds simple, the reality is far more

complex. Again, there would need to be a majority in the Commons to commence proceedings. And the design of the question would be similarly contentious. Should it be this deal vs. staying in the EU, or should the option of no-deal be included?

It is worth noting that both a general election and a second referendum would be likely to be lengthy processes and there would have to be an agreed extension to the Article 50 process from both the EU and UK. The EU, at least initially, could appear unwilling.

There appears to be talk of a Norway-style arrangement to act as a holding arrangement. It is not immediately clear what solution this provides, since on top of continuing to accept EU rules as in the current PM's plans, there would likely be continued free movement of people.

How will the market react if the UK appears apparently incapable of passing Plan A, but also coming up with Plan B? Ongoing uncertainty will perhaps be offset by increased optimism that the end result will be the UK staying in the EU or at least remaining clearly in the customs union. So a meaningful shift in market sentiment in either direction isn't entirely obvious if either comes to pass.

4) This deal passes following amendments. Finally, the scenario we see as most likely is one in which the PM returns to the EU at the December 13-14 Council meeting and seeks further concessions—most likely, more detailed specifics about the final deal or achieves a concession on the UK being able to terminate the backstop arrangement. But, as highlighted above, there is no deal that squares the circle of continued access to the EU market and regains full sovereignty.

So why would such minor amendments change the voting intentions of MPs? Our justification is that, when push comes to shove, this will be the least bad option for MPs on both sides of the house. By not supporting the PM, no-deal advocates within the Conservative Party risk losing either an election or another referendum—and potentially ending up with no Brexit at all. Ultimately we expect the PM to garner sufficient support from both sides of the house to pass the deal.

And then what?

If the deal passes the UK would then enter a period of transition from March 2019, in which nothing would change so that businesses could adapt to the new arrangements. The finer details of these new arrangements still need to be hashed out. The ambition is that they will be sufficiently complete by June 2020 so that the new arrangement can take effect in January 2021. However, it seems highly likely that the process will drag on and the period of transition get extended.

Although near-term uncertainty would not be entirely resolved, we believe UK markets would experience a significant relief rally on passage of the Withdrawal Agreement. We would expect sterling to rise significantly. Domestically focused UK stocks would likely benefit, but the rise in the exchange rate could prove challenging for larger cap stocks, which repatriate a large proportion of their earnings from overseas.

The economy would be likely to improve as business confidence lifted investment, and a rise in sterling would push down inflation at just the time when wage growth is rising, supporting consumer spending. Given that the Bank of England believes the economy is already at full capacity, we believe it would raise rates twice during the course of 2019.

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