On the minds of investors

July 24, 2019

UK: New prime minister, same stalemate?

Boris Johnson has won the UK Conservative Party leadership contest, and set to become the next Prime Minister. During his campaign, Johnson has stated that he sees a “no-deal” exit as a potential option. This position has prompted market concerns that the UK economy could face significant economic damage. This has put downward pressure on the British pound (GBP), which has now depreciated against the U.S. dollar by 5.4% since early May.

Our core scenario remains that the UK would leave the European Union (EU) but remain in a customs union for goods. However, much drama could still take place ahead of reaching this endgame. Hence, we can expect more volatility ahead for the UK equity, fixed income and currency markets in months ahead.

We have seen in recent months that the current configuration of the UK parliament has regularly demonstrated that it is not willing to allow the UK to leave the EU without a deal. It is also ready to overrule the prime minister and government to prevent this scenario. That said, there is no consensus on what form Brexit should take either, which was why Theresa May’s deal was rejected three times, leading to her resignation. Hence, this provides some comfort that there is a safety measure preventing the UK breaking away from the EU with no deal by default, but not a path to resolve the deadlock.

A general election or a second referendum probably would not help to solve the stalemate either, as public opinion remains divided on the issue. A YouGov poll conducted in late May shows that 46% of the respondents chooses remaining in the EU as their most preferred outcome, while 32% chooses a no-deal Brexit as their top choice. In another poll in mid-July, 56% of respondents believe the UK is either ‘not very likely’ or ‘not at all likely’ to leave the EU on October 31, versus 27% who think leaving on time is either ‘very likely’, or ‘fairly likely’.

The European Parliamentary elections in May have shown that voters are binding their support to a particular political party with their view on Brexit. This has prompted a decline in support for the Conservative and Labour parties, and a rise for the Brexit Party and pro-remain Liberal Democrats. While it is hard to predict its outcome, it seems safe to say that no single party would gain a majority. A coalition government would help to contain no-deal Brexit risk, but short of providing a sustained solution. A second referendum would be challenging in providing voters a clear set of options in a very complex issue, with different consequences and risks attached to each option.

The EU has repeatedly stated that it won’t reopen negotiation with the UK on the withdrawal agreement. However, considering the potential negative economic impact on Europe, another deadline extension to give the new prime minister more time to form a consensus seems logical. This might require him to work across different parties.

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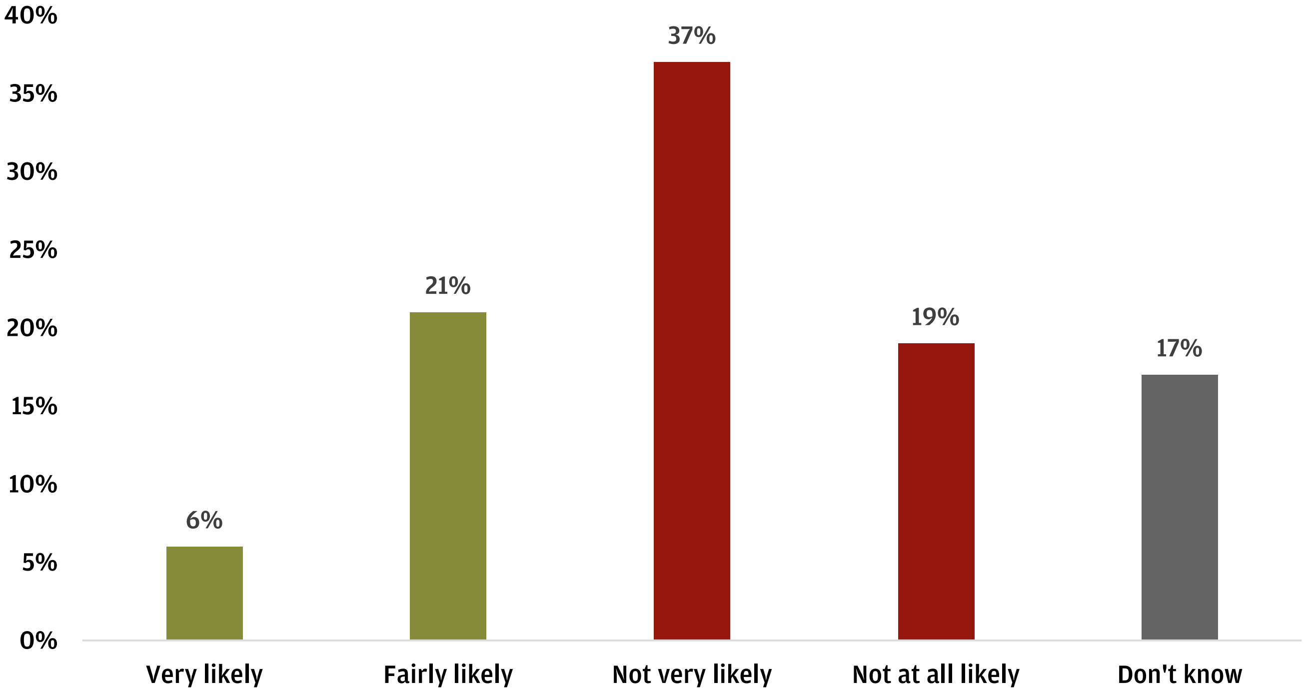
EXHIBIT 1: YOUGOV POLL ON LIKELIHOOD OF THE UK LEAVING THE EU ON OR BEFORE OCTOBER 31ST
PERCENTAGE OF VOTES



Source: YouGov, J.P. Morgan Asset Management. Data most recently available as of 23/07/2019.

Investment implications

With a new prime minister in power, investors would be hoping for a breakthrough to the situation. As the new prime minister, Johnson will face similar challenges to his predecessor given the way in which the nation—and parliament—remain divided over what it wants from Brexit. Uncertainties are likely to linger in months ahead, possibly beyond the Halloween deadline.

For Asian investors, it is important to recognize that political and policy risks and financial assets do not necessarily follow a simple one-for-one relationship. For example, Brexit has been a negative for the GBP and domestically focused companies, while positive for UK government bonds (Gilts) with rising possibility for rate cuts. However, a weaker GBP has boosted repatriated earnings for large-cap international companies. The spillover effect from the UK markets to European and global markets after the 2016 Brexit referendum and this year's parliament rejections of May's deal has been limited. That said, uncertainties from Brexit could add to a list of investors' concerns, including the rise of protectionist policies, falling corporate investment and slower earnings growth.

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