Market Bulletin

May 24, 2019

Brexit: New UK prime minister, same challenges

The prime minister Theresa May has announced she is stepping down on June 7. Speculation has been mounting and sterling has fallen 3.4% against the dollar in the last three weeks. The market clearly associates the news with an increased likelihood of either a hardline Brexiteer leading the UK towards "no deal" exit from the European Union (EU), or a general election that paves the way for a potentially less market-friendly Labor government. Below we highlight why neither scenario seems likely.

The path to no deal, or a general election

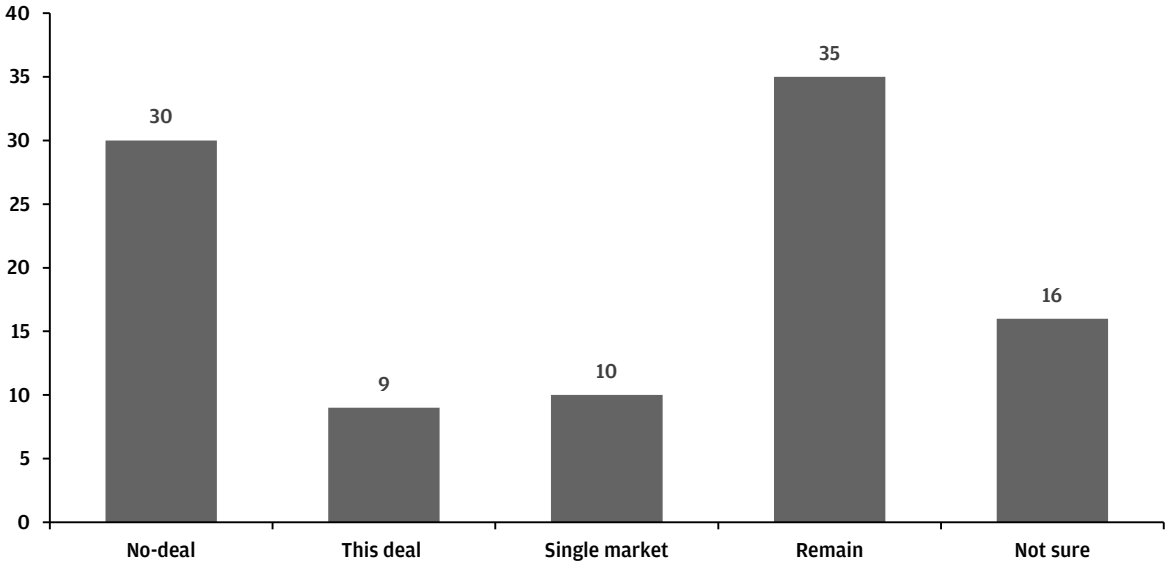
The steps below seem necessary for the UK to leave the EU with no deal.

1. The Tory leadership contest (which could take about two months) results in the appointment of a pro-Brexit Prime Minister.
2. The new leader proposes a harder Brexit to the UK population which receives strong support. The Conservatives rise significantly in the polls providing the new Prime Minister with the confidence to call a general election.
3. The Conservatives win on a landslide big enough to materially change the balance of opinion within the UK Parliament towards support for no deal.
4. On October 31 the UK's current extension with the EU expires and there is no parliamentary majority to prevent no deal happening in the way we have seen from Parliament so far.

The charts on the next page highlight the flaws in this narrative. **Exhibit 1** from a YouGov survey on April 10 shows that 30% of the population are in favor of no deal. A higher proportion are in favor of remaining in the EU.

Karen Ward
Chief Market Strategist for EMEA

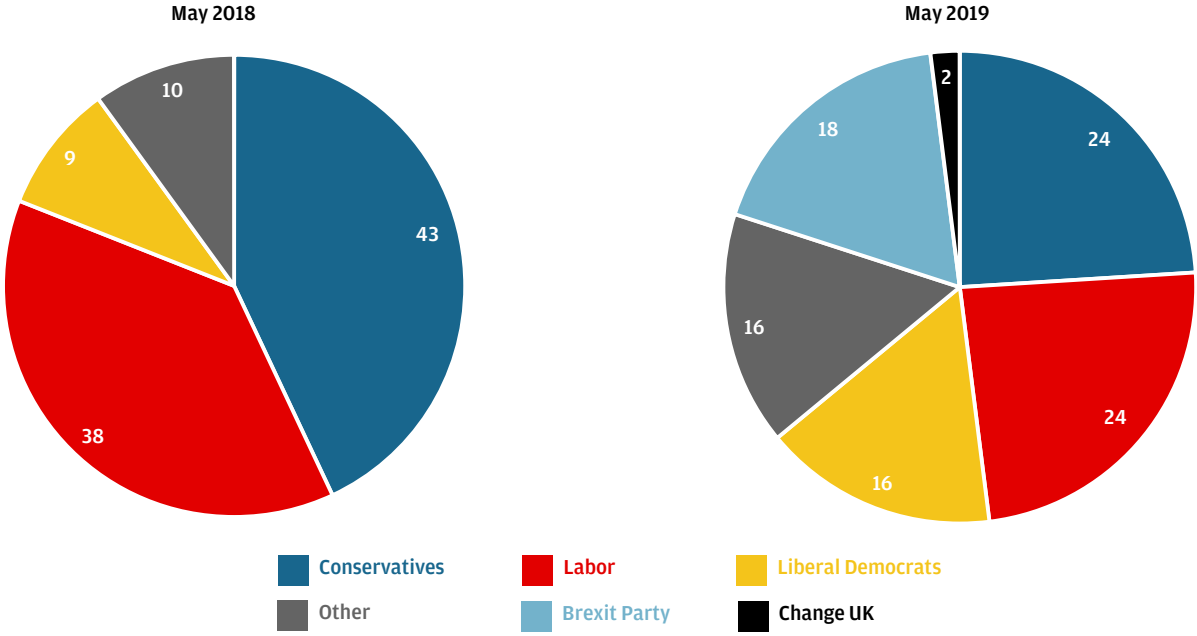
EXHIBIT 1: IF YOU HAD TO CHOOSE ONE OUTCOME OF BREXIT, WHAT WOULD YOU PREFER TO SEE?
% of respondents



Source: YouGov, J.P. Morgan Asset Management. Survey fieldwork was carried out on 10-11 April 2019. Data as of May 24, 2019.

Exhibit 2 compares recent party polls with the polls a year ago. We can see that both the Conservatives and Labor are losing support as those in favor of a hard Brexit are showing their support for the new Brexit Party, while those in favor of a softer Brexit or remain are gravitating towards the Liberal Democrats or Change UK.

EXHIBIT 2: WESTMINSTER VOTING INTERACTIONS
% of respondents



Source: YouGov, J.P. Morgan Asset Management. Data as of May 24, 2019.

These polls could change in the event of a charismatic leader. But in our view they merely represent the deep-rooted Brexit divisions in the UK population that have been evident since June 2016 when 52% voted to leave and 48% of the population voted to remain. Neither side appears to have changed its mind very much (indeed in another recent poll 75% of the population are still sure they voted the right way) but not all those that voted to leave want to leave without a deal.

As a result it seems doubtful that the polls would inspire the new prime minister with the confidence to call an election, so the market looks to be overpricing the chance of a Labor government in the near term under its current configuration.

What about the chance of a new prime minister running down the clock and the UK "crashing out" on October 31? We think this is unlikely for three reasons. First, unless there is a reconfiguration of parliament, MPs will once again prevent it happening. Second, we do not believe that the most likely contenders to be the new prime minister (Boris Johnson and Dominic Raab) would risk taking the country towards no deal without a clear mandate from the population. There are economic risks, at least in the short-term, they may not wish to be responsible for, as well as risks to the Union of Northern Ireland, Scotland, Wales and England (recall that both voted for the Theresa May's deal at the last vote).

Finally, we do not believe the EU will refuse a further extension. Indeed, the EU has demonstrated that it is similarly adverse to no deal. Also, while a large proportion of the UK population support a new referendum, the EU is more likely to hold out to see if, after all this time and fuss, the UK changes its mind and remains in the EU.

In summary, while the latest news provides ample fodder for dramatic headlines, until the UK population materially shifts its position one way or another, it seems unlikely the position of UK parliament will change. The situation will remain that there is not a majority for no deal.

Our core scenario has always been that a compromise that delivers on control of migration and budget contributions, but concedes to accepting EU rules and regulations on goods to protect economic supply chains and prevent a hard border in Ireland, will be the final outcome. Such a deal would be a customs union for goods. However, we have very little conviction at all about how long it will take to get there.

While this is hardly good news for the UK economy or asset markets – the additional risk premium that has built in recent weeks seems unjustified. In the coming months we are likely to find out that a new prime minister hasn't actually changed the outlook at all.

MI-MB_Brexit update

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J.P.Morgan
Asset Management