PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
15 November 2018

# UK - BREXIT UPDATE

## THERESA MAY'S CABINET APPROVES THE DIVORCE DEAL. MORE CHALLENGES AHEAD.

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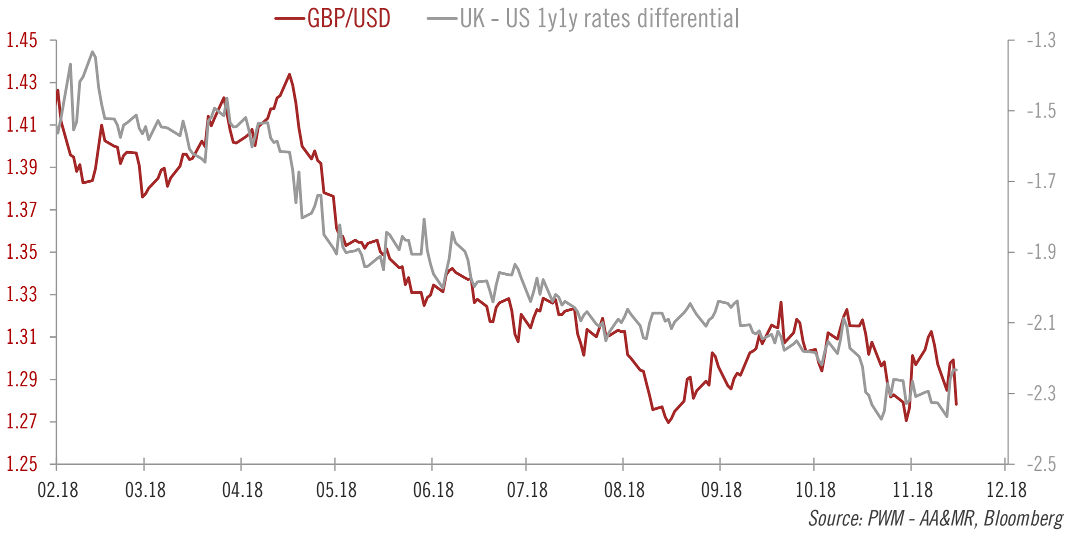
## SUMMARY


- Theresa May's cabinet has approved her divorce deal with the European Union (EU). A few cabinet secretaries have resigned, including Brexit Secretary Dominic Raab because the deal keeps the UK in a transitory 'customs union' with the EU, which in his view continues to give the EU too much influence on UK affairs.
- The next step is formal approval of the deal by EU leaders at a 25 November summit.
- The biggest challenge facing May's deal is UK parliamentary approval by mid December as the 'hard Brexiteers' within the Conservative party oppose it. The Labour party also rejects the deal and wants new elections instead, even though a small group of Labour members of parliament (MP) could dissent and vote their approval.
- In the near term, Theresa May could face a no-confidence motion, ensuring political uncertainty remains elevated.
- The tail risk of a no-deal Brexit on 29 March remains high, although there could still be room for some alternatives, including extension of the March deadline—for instance if new elections were called. There could also be a second parliamentary vote, potentially tied to the promise of a second referendum on the EU. Although there is considerable uncertainty, our base case scenario is for the British parliament ultimately to approve May's divorce deal (or at least an amended version of it).
- New elections could add to economic uncertainty, especially as the pro-business credentials of some Labour leaders are in doubt.
- We remain cautious on sterling (GBP) relative to the US dollar (USD) in the short term given the high political uncertainty. Our three-month forecast is for a GBP/USD rate of USD1.27.


CHART 1: GBP/USD DROPS AFTER THERESA MAY'S CABINET APPROVES THE EU DIVORCE DEAL




*Source: PWM - AA&MR, Bloomberg*

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## Some background – A contentious interpretation of the Brexit referendum

Since the 2016 Brexit referendum, the Conservative party has struggled with the practicalities of leaving the European Union. While prime minister Theresa May (who voted 'Remain' in 2016) has asserted that "Brexit means Brexit", she has remained somewhat vague about the process, attempting to adapt Brexit to changing political dynamics in the UK.

May has actually taken a pretty pragmatic approach to negotiations with the EU, balancing domestic political imperatives with the needs of the UK economy and businesses, for which a sudden exit from the EU ("no deal" or "cliff edge" Brexit) would be very detrimental. May has repeatedly asserted that the Brexit vote must not result in the UK becoming "poorer".

The loss of the Conservatives' parliamentary majority in the snap June 2017 elections has complicated Brexit negotiations. Furthermore, not only has the Brexit issue divided both the Conservative and the Labour parties, it has led to the resurgence of deep-seated issues of regional autonomy, especially as both Northern Ireland and Scotland voted decisively against leaving the EU.

## At least there is a divorce deal

Theresa May's cabinet on 14 November reached a 'divorce deal' that does nothing to resolve the UK's future trade relationship with the EU – though it includes an extendible transition period of 21 months after the UK's official departure from the EU on 29 March 2019, during which current trade arrangements with the EU will remain in force.

There is a vague "political declaration" that the UK will remain in a "free-trade area", with "deep co-operation on goods" in the future. This is a coded way of saying that the exact nature of the UK's future relationship with the EU will be left to another government (i.e., after future elections).

This transition period, which will last at least up to December 2020, is supposed to allow time for the UK to negotiate its future trading relationship with the EU. The options include maintaining close trade relations with the EU, similar to those enjoyed by countries like Norway, or forming a less close relationship, comparable to Canada's.

Along with establishing the ins and outs of the transition period, the divorce deal just agreed covers the size of the divorce bill payment the UK must pay (GBP39 bn), the status of European residents in the UK, and, importantly, the very contentious issue of the Northern Ireland backstop (a provision to prevent a hard border being re-established between the province and the Republic of Ireland in case talks with the EU fail).

The divorce deal addresses the backstop issue by keeping the entire UK in a customs union for goods. But Northern Ireland is to have a deeper relationship with the EU, continuing to apply its regulatory standards so as to ensure a frictionless border between Northern Ireland and the Republic of Ireland.

## What next? All eyes are on the UK parliament vote in mid-December

Following the resignation of the Brexit Secretary Dominic Raab, as well as Work and Pensions Secretary Esther McVey, the immediate question is whether more high-ranking

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government officials will follow suit. This could end up weakening May's position, although she has already overcome many other important obstacles in recent months. Dominic Raab's position has been offered to Environment Secretary Michael Gove, according to *The Telegraph,* although he is reportedly wavering about staying in government.

Some pro-Brexit Conservative MPs are also calling for a no-confidence vote in May (although her hand would be strengthened should she win any such vote, since one can only be called once per year). There is still a question as to whether there would be enough time before March to start the procedure of replacing Theresa May. The party base would need to be consulted. This would take several weeks, eating into precious time needed to renegotiate the withdrawal deal with the EU.

A meeting of EU heads of state has been scheduled for 25 November, a few days before several of them are due fly to the G20 meeting in Buenos Aires (which starts on 30 November).

Presuming May survives until then, the make or break moment will be the UK parliament vote on the divorce deal scheduled for mid December (the exact date has still to be determined).

Should the UK parliament approve the deal, it will still have to be ratified formally by EU countries (although this should not prove too hard).

### What if the UK parliament fails to approve May's divorce deal?

Part of the problem with the current deal is the length of time between now and the 29 March deadline for the UK's departure from the EU. There could be temptation in some quarters to try to renegotiate the deal in the meantime (even though the Europeans insist the divorce deal they reached with the British is their best offer).

More positively, the end-March deadline affords breathing room to find alternative options should the divorce deal be rejected by the British parliament. Nonetheless, knowing they still have time may mean hesitant MPs feel under no pressure to approve the deal in December. But Theresa May is betting that reluctant MPs will end up accepting the divorce deal as better than the alternative of a 'cliff-edge departure' on 29 March. She could also argue that failure to approve it could well lead to new elections, a prospect that scares many Tory MPs.

Theresa May has kept the preparations to a 'no deal' outcome to a minimum, perhaps deliberately, so that this alternative is seen as a 'no go'.

Would parliament rejection of the divorce deal in mid-December lead automatically to a cliff-edge departure on 29 March? Probably not, as we think there are other alternatives to this worst case scenario.

One is an extension of the 29 March deadline, say for one year (in this case the UK would probably not be involved in the European Parliament elections next May).

An extension could especially be on the cards if new elections were called. However, new elections could also bring a new wave of uncertainty. The Labour Party's centre of gravity has moved considerably to the left in recent years, and the party's position on

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Brexit remains very ambiguous. Meanwhile, the pro-business voices within the party have tended to take a backseat, and there is a risk the UK business community could take fright at some of the current party proposals.

Another idea could be to submit an amended divorce deal to a second parliamentary vote, probably by end January. This is the most likely alternative, in our view. But even if an amended divorce deal is passed by parliament in London, the EU is likely to be reluctant to reopen negotiations, arguing that time was too short to seek ratification for the deal in all the remaining EU countries.

It is also possible that the potential market volatility after an initial failed vote in December could put additional pressure on MPs to rethink their vote and ultimately side with May. The latter has underlined that her deal is the only alternative to the two extreme outcomes of either no exit from EU or a hard Brexit. This argument could resonate even more if market volatility picks up markedly.

A variant to this (the odds are low, but rising, in our view) would see the UK parliament approve an amended divorce bill in January that includes a clause calling for a new referendum within next two years to validate parliament's vote. This could break the current logjam in parliament by garnering support from Labour and LibDem MPs who have been calling for a rejection of the divorce deal on the grounds that the UK people should be allowed to vote again on Brexit's terms.

A third option is that the UK government and parliament remains paralysed by their divisions. This would set the stage for a 'cliff edge' departure on 29 March. The high uncertainty, the frictions at ports and borders, and the likely market volatility that would ensue would have serious economic consequences.

### FX outlook: Sterling should rebound—assuming all goes according to plan

The sterling/dollar (GBP/USD) exchange rate is being driven both by the short-term interest rate differential and by the political uncertainty caused by Brexit. As the 29 March Brexit deadline comes closer, the political factor is becoming more potent, especially as the Bank of England's stance on monetary policy will depend on the nature of the transition after 29 March (therefore determining the rate differential with the US).

As stated above, May faces acute challenges in winning parliamentary approval for the draft deal to take the UK out of the EU, and political uncertainties could remain high right up until 29 March 2019. Our central scenario still is that the UK parliament will eventually back May's divorce deal (although it could take a second vote), and that the UK will avoid a cliff edge departure.

This should prove supportive of sterling. That being said, even in this scenario, many political uncertainties (including the UK's future relationship with the EU) will remain, possibly limiting the Bank of England's ability to raise rates more than once in 2019. Based on our core scenario, our three-month forecast for sterling is USD1.27, with potential downside risk in the very short term. We forecast that sterling will recover to USD1.35 on a six-month basis and USD1.37 on a 12-month basis.

In the worst case scenario of a no-deal Brexit, sterling could decline precipitously, potentially below USD1.20.

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