

BREXIT UPDATE - PM MAY SEEKS NEW DIRECTION

THERESA MAY REACHES OUT TO FIND ALL-PARTY AGREEMENT ON BREXIT

Authors

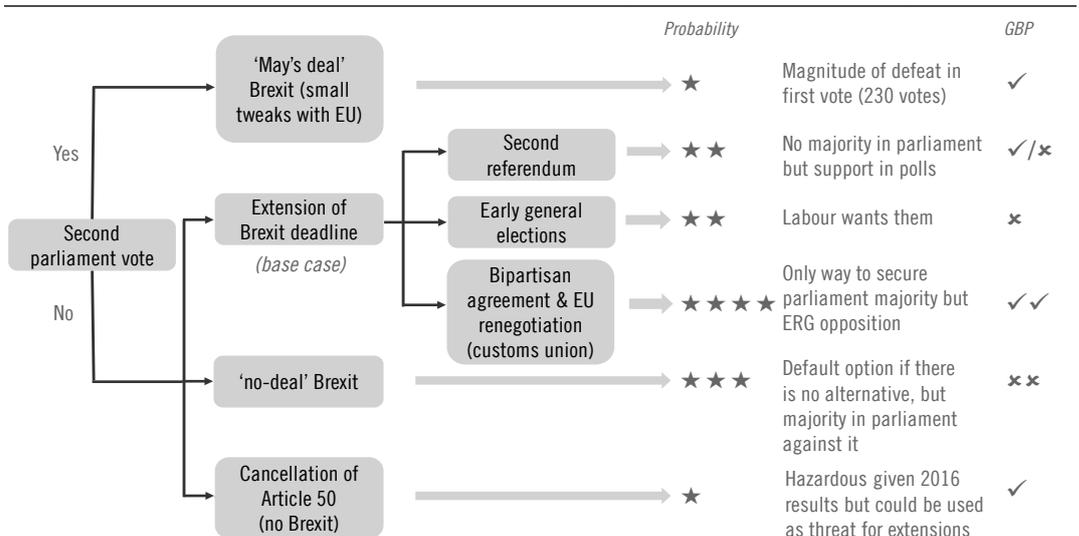
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SUMMARY

- > This week, the British Parliament rejected Theresa May’s divorce deal *en masse*. At the same time, she has kept enough support to stay in power, as a motion of no confidence was rejected.
- > How the Brexit process unfolds from now remains highly uncertain. The recent turn of events means there is an increasing probability of the UK seeking an extension of the 29 March deadline (now our base case) as Theresa May reaches out to opposition members of parliament (MPs) to find an agreement. Possibly revolving around a customs union with the EU, interparty agreement could lead to a ‘softer’ version of Brexit than May’s initial divorce deal.
- > Complicating matters, however, is the Labour Party’s leadership insistence on pushing for new elections. In addition, some Labour party members could still see staying in the EU as preferable to being part of a customs union.
- > Meanwhile, the ‘hard’ Brexiteer minority within the Conservative Party will undoubtedly seek to undermine any attempt to extend the 29 March deadline.
- > Therefore the risk of an accidental ‘Hard Brexit’ – the default option in the absence of any alternative – should not be underestimated if all the different factions cannot be brought together by PM May in time. As a whole, the British parliament remains against a ‘no deal’ Brexit—but the question is to what extent MPs are ready to compromise to avoid such an outcome.
- > Our long-term view is still that the UK will keep close trade ties to the EU economy, whatever happens.
- > From a currency point of view, recent signs favouring a bipartisan approach are supportive of sterling. That being said, the persistently high uncertainty does not favour significant appreciation of sterling above USD1.30 on a three-month horizon.

CHART 1: BREXIT – SIMPLIFIED VIEW OF POSSIBILITIES AHEAD (AND IMPLICATIONS FOR GBP)



Source: Pictet WM - AA&MR

BREXIT UPDATE - PM MAY SEEKS NEW DIRECTION**THERESA MAY REACHES OUT TO FIND ALL-PARTY AGREEMENT ON BREXIT****Different shades of grey in UK parliament**

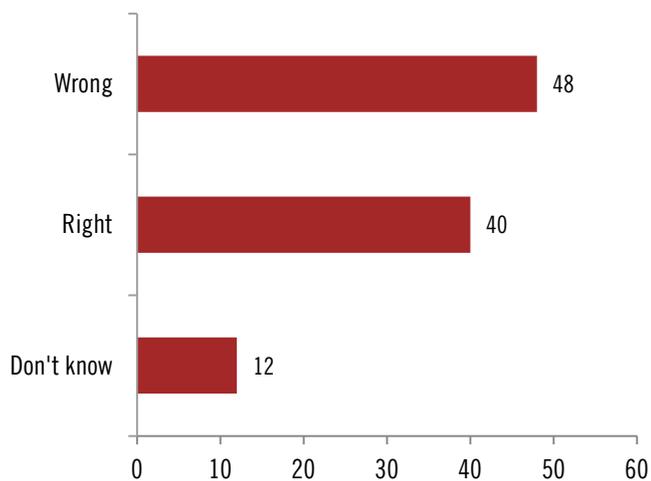
Theresa May will go down in political history books as the prime minister that suffered the heaviest defeat ever on a parliamentary vote, as her divorce deal with the EU was rejected by 432 to 202 votes, i.e. with a 230 vote margin. Up to now, the record was held by Ramsay MacDonald, who defeated by a margin of 166 votes in a parliamentary vote in 1924.

Conservative MPs in favour of the PM's deal numbered 196, while 118 were against, while 248 Labour MPs voted against and only three for the deal. All 10 MPs from Northern Ireland's Democratic Unionist Party (DUP), which has been propping up May's government (since the Tories do not have a majority), voted against the divorce deal.

The following day, May survived a no confidence motion submitted by the Labour Party. The vote was 325 to 306 (the DUP's 10 MPs voted in her favour).

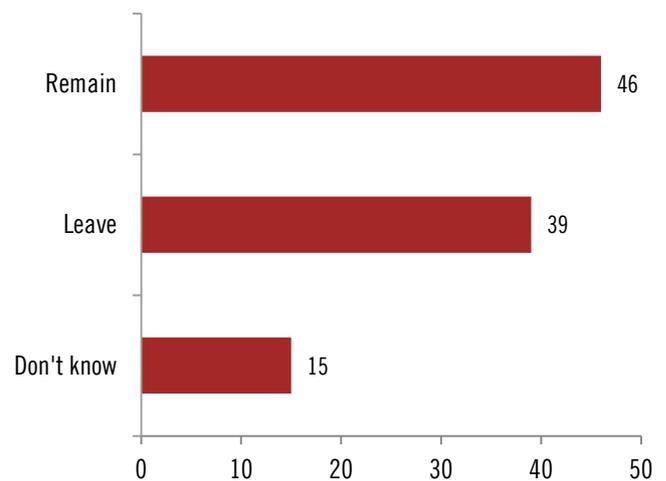
The latest developments mean nothing fundamentally has changed about the Brexit process. The situation remains that there is still no majority for any option, while both the two main UK parties remain profoundly divided internally on the European question. There is also much division about the way forward to break the logjam (A general election? A second referendum?) and about how close the UK's relationship with the EU should be – assuming that some form of Brexit goes ahead. The rejection of Theresa May's divorce deal was just an illustration of how divided the UK body politic remains on this fundamental issue.

CHART 2: YOUNG GOV: UK RIGHT OR WRONG TO VOTE TO LEAVE THE EU?



Source: PWM - AA&MR, YouGov, 4 January 2019

CHART 3: YOUNG GOV POLL SHOULD THE UK REMAIN OR LEAVE THE EU?



Source: PWM - AA&MR, YouGov 4 January 2019

The clear message from her crushing defeat on 15 January is that she must reach out beyond the Tory party if she is to arrive at some sort of consensus on Brexit. This is all the more important as there is a significant faction of Hard Brexiters that are not ready to

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compromise on the terms of Brexit and are also out to topple her, having staged a Conservative Party no-confidence vote against her in December.

Thus, May's plan is to reach out to Labour MPs. This will undoubtedly mean a softening of May's divorce deal and holding out the possibility of a closer relationship with the EU, including a customs union. This may also mean that May asks for an extension of the 29 March deadline, although the EU countries would still have to agree.

Much can go wrong in May's rapprochement with the Labour Party. The biggest issue in our view is time. The clock is ticking and a 'no deal' Brexit by 29 March could still happen if no alternative is found before then. Further discussions between the UK parties, and then with the UK's EU partners will eat into precious time (the EU has said it might be open to an extension on 29 March, but only if there is a valid reason).

The attitude of Labour Party leaders is another issue. While the party's base would seem to like a second Brexit referendum to be held, Labour leader Jeremy Corbyn is adamant his preference is for a fresh general election. One could end up with a 'dialogue of the deaf', especially as many in the Labour Party would prefer the UK to remain a full member of the EU rather than simply end up in a customs union (where, basically, the UK must accept EU rules, but without much say over the formulation of those rules).

Some in the Labour Party might, rather cynically, believe that if they refuse a Brexit agreement with May, the likely economic maelstrom after a 'hard Brexit' could boost their party's chances in future elections.

Our base case now is that the UK will end up asking for an extension beyond the 29 March deadline, but Theresa May's exact intentions remain obscure. May still says she wants to deliver on Brexit and seems inclined to prefer a hard Brexit rather than the UK staying in. The fact that her political career is in tatters may mean she is ready to take risks (the Labour Party has asked May to state that a 'no deal' Brexit is off the table before they will agree to talks).

With negotiations with the Labour Party likely to be complicated and the clock running down, we are worried that an 'accident' could happen and that the UK crashes out of the EU without an agreement. Even though May's belated efforts to reach out to other parties is to be saluted, the risk of a 'no deal' Brexit should not be underestimated.

Sterling appreciates on hopes of a bipartisan approach

Despite the high uncertainty surrounding Brexit, sterling has performed quite well despite the failure of May's divorce deal in parliament. The main reason for this is May's push for bipartisan talks, which points towards a softer Brexit.

We continue to believe sterling could appreciate in the short term as a 'no-deal' Brexit remains unlikely, despite the risks of an 'accident' on 29 March. Our three-month projection for sterling is USD1.32, compared to USD1.29 on 17 January. However, an extension of the 29 March deadline does not mean a 'cliff-edge' scenario later can be ruled out, and the prolongation of uncertainty would be negative for business activity. We believe it will be difficult for sterling to move significantly much above USD1.30 as long as so many divergent outcomes to the UK's place in Europe remain possible.

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CHART 4: GBP/USD SINCE JANUARY 2018

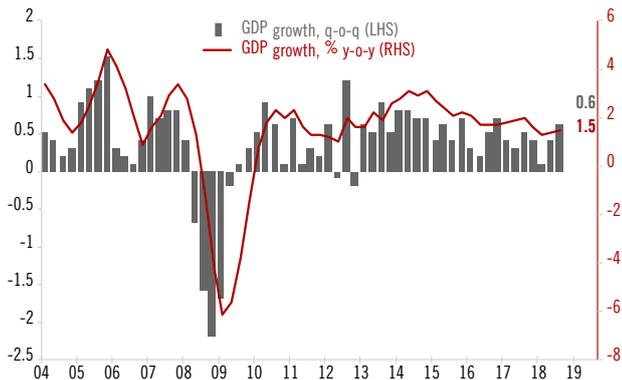


Source: PWM - AA&MR, Thomson Reuters

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UK REAL GDP GROWTH, % Q-O-Q AND Y-O-Y



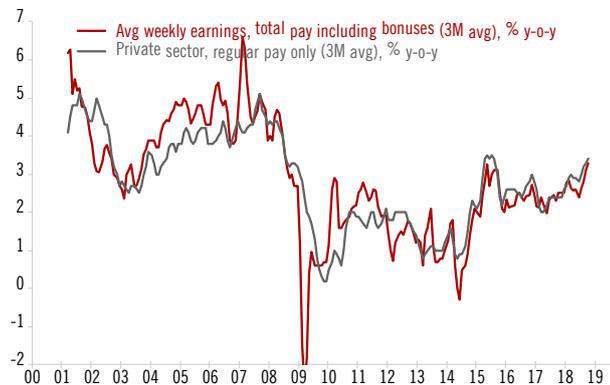
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



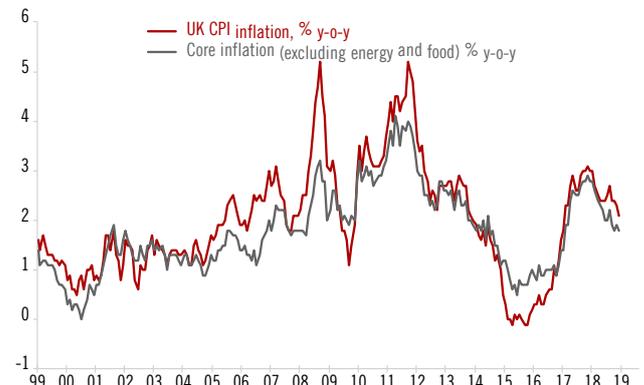
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH, % Y-O-Y



Source: Pictet WM – AA&MR, Factset

CPI INFLATION, % Y-O-Y



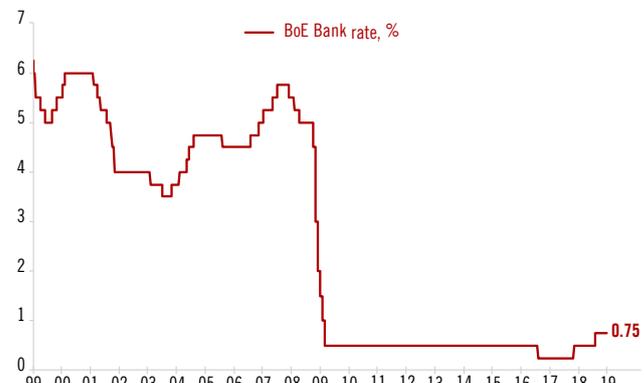
Source: Pictet WM – AA&MR, Factset

HOUSE PRICE INDICES, % Y-O-Y



Source: Pictet WM – AA&MR, Factset

BANK OF ENGLAND RATE, %



Source: Pictet WM – AA&MR, Factset

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