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Take back control!

Brexit outlook

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Summary

- Prime Minister Johnson has asked the Queen to suspend Parliament. While it was an explosive move, confrontation between Johnson and Parliament has always been inevitable
- The EU has been betting on the UK parliament to intervene, but the window has narrowed
- The risk of a no-deal Brexit is obviously rising, but secondary to the risk of a general election
- We expect Article 50 to be extended once more, one way or another. This will require cross-party cooperation. The prorogation may have provided MPs with a uniting cause
- The general election will be a stand-off between Remain and Leave

Delivering Brexit is Boris Johnson's top priority. He has promised to take the UK out of the European Union by October 31, "no ifs, no buts". While it is extremely difficult to predict how this would come about, it is highly unlikely that he will be able to secure and ratify a deal with the European Union before that date. **The risk of a no-deal Brexit has therefore evidently increased, yet we believe it to remain secondary to the risk of a general election.**

No backing for the backstop

The recent exchanges between Prime Minister Johnson and European leaders have once more emphasised that the Irish border remains the sticking point in these negotiations. The UK and the EU jointly agreed back in December 2017 that there should be a guarantee to avoid a hard border under all circumstances. This guarantee came to be known as the backstop, but agreeing a legal text proved very difficult. It took most of 2018 to get this done and negotiators eventually settled on a temporary customs union that encompasses the whole of the UK, not just Northern Ireland. Furthermore, the backstop will only cease to apply if "the [European] Union and the United Kingdom decide jointly" that it is no longer necessary – for instance, when technological solutions supplant the need for it. **Under the existing agreement the UK will not have the unilateral right to bring the backstop to an end, nor is there a time limit.**

Having invested so much political capital into it, the European Union has stated time and again that it is not willing to re-open the Withdrawal Agreement –the [585 pages of legislation](#) that include the backstop– in any meaningful way. From this point on, any assurances that could eventually break the deadlock should be placed in the political declaration, which is the non-legally binding part of the existing Brexit deal that outlines the plans for the long-term future relationship between the UK and EU.

This will never be enough for Boris Johnson and the Brexiteers in the House of Commons. The Prime Minister has repeatedly pledged to ditch the backstop, ratcheting up talk that a no-deal Brexit on October 31 is the inevitable alternative. At this stage, even 'fixes' such as a time-limit or a unilateral exit clause won't be enough to make the Withdrawal Agreement more palatable. It is obvious that the UK and the EU (and Ireland) are too entrenched in their positions to credibly climb out of this before the October 31 deadline. **The implication is that markets and investors should prepare themselves for a big showdown.**

Strategy, not tactics

Before getting mixed up with day-to-day tactics and headlines, we'll have to at least form an idea of the ultimate strategy of the three main players in this game: PM Johnson, the UK Parliament and the EU. What do they want? What are their strategic goals? Are they able to command a majority to work towards these goals, or is this something that needs to be sorted first? And is it all about economics, as markets still tend to believe, or are catchphrases as 'taking back control' and 'European unity' a reflection of a desire that goes far beyond monetary costs and benefits analyses? No-one has all the answers, but we will outline our assumptions here:

1. **Prime Minister Johnson** is ultimately looking for a free trade deal –with some goodies on top of it, if allowed– that doesn't bind the UK to the EU's rulebook. This would allow the government to strike free trade deals with other countries and to set its own regulations. This means that anything that resembles the current Withdrawal Agreement is unacceptable to him. It also means that the backstop should be removed and that border problems on the island of Ireland should be dealt with separately. A customs union doesn't fit with his strategic goals, even closer alignment is really out of the question.
2. The **UK Parliament** is divided and therefore has no clear strategic goal regarding Brexit. It is not opposed to Brexit *per se*, but at the same time it hasn't been able to properly define what Brexit actually is. Only the opposition against a no-deal Brexit appears to be able command a majority in Parliament, but this requires a cross-party alliance that is weak and prone to fail. However, there are plenty of indications that a majority in Parliament will do whatever is in its power to protect the constitutional balance between Parliament and Government. This means that there will be significant pushback against a no-deal Brexit, and it wasn't a surprise that Speaker Bercow called Johnson's move to prorogue Parliament a "constitutional outrage".
3. The **European Union** wants to protect its unity and the integrity of the Single Market. It fears that the European project will be doomed to fail if any other association agreement with the UK appears to be a more attractive alternative to membership. Moreover, most individual Member States see the economic fall-out of a no-deal Brexit as much smaller than the protection they are getting from being part of a bigger collective. In fact, the protection of Ireland could be their own protection at some point in the future.

With this in mind, we can draw the following conclusions:

A no-deal Brexit is compatible with Boris Johnson's end goal, as it would allow the UK government to strike trade deals with whichever country they see fit. But it comes at a huge cost, and is not the ideal solution. We estimated [here](#) and [here](#) that it would lead to a long and deep recession and structurally lower economic growth. It would also considerably weaken the UK's hand in any post no-deal negotiations with other countries, most notably the US. Moreover, it is much more difficult to strike an FTA with the EU after the conclusion of the Article 50 procedure (NB. the EU's 'regular' FTA's require a unanimous vote of all EU governments and ratification by all member countries). These are *ifs* and *buts* that should be clearly on Johnson's mind.

Whilst certainly not a desired outcome, a no-deal Brexit is not incompatible with the European Union's wishes. After more than three years of lingering uncertainties and endless agenda-consuming workgroups, meetings and discussions, a no-deal Brexit and an ensuing slowdown in economic growth may be regarded by some as a price worth paying as long as it won't have to compromise on its ideals of unity and single market integrity.

A no-deal Brexit would be more problematic for parliament. Whilst a significant number of Tory MP's would be very happy that the Brexit Party would lose their *raison d'être* (for now, at least), there's only a minority of the UK population (let alone constituencies) [in favour of a no-deal](#) Brexit. It is considered as an act of self-harm, and not a right reflection of the referendum outcome of 2016. Moreover, there is a strong consensus within Parliament that it can't simply stand by and watch how it is overruled by the government in a constitutional power play.

Is Boris Johnson's threat credible?

Yes and no.

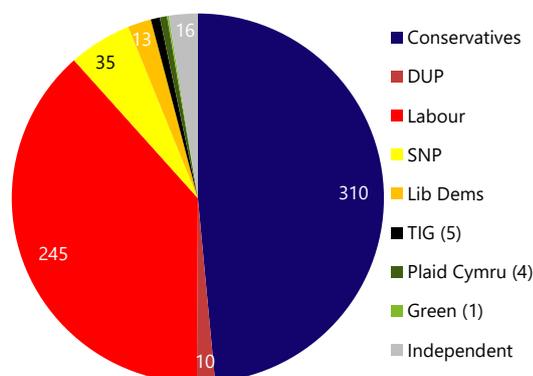
To Johnson's credit, he is doing everything in his power to ensure others that he is serious about leaving the European Union on October 31. His office is "turbo-charging" its no-deal efforts. For example, the government launches an information campaign to inform the UK about no-deal preparations, with costs expected to run into nine figures. There will also be outlays to stockpile medicines, to increase training for customs officials, and to improve infrastructure around ports. There have also been reports about Project Kingfisher – a fund to bail out firms that are in distress due to Brexit– and there have been some details of the UK's no-deal planning in the leaked documents regarding Operation Yellowhammer. Earlier this week, PM Johnson has asked the Queen to suspend Parliament for five weeks, in what appears to be a plan to stop Parliament from forcing yet another extension of Brexit.

While this is a step-up from Theresa May's half-hearted "*No deal is better than bad deal*", Boris Johnson can't escape one fundamental problem. It is the widespread consensus that a no-deal would hurt the UK much more than it would hurt the EU. Are European leaders really scared of the UK shooting itself in the foot? And unless a no-deal means *never* a deal, on anything, then the EU may very well have already calculated that the UK will be back at the negotiating table sooner than later, with an even weaker hand than it currently has. Finally, they may also guess that they can easily escape the blame of a no-deal now that Johnson has prorogued its own Parliament.

Meanwhile, **European leaders are reportedly working on the assumption that Johnson knows perfectly well that he is bluffing with his threat of a no-deal Brexit.** His lack of numerical support in Parliament is undermining his credibility. The government majority has thinned down to just one, and even within his majority there are around two dozen MPs who will rebel against a no-deal. These include some big names, such as former chancellor Hammond. A rebellion would wipe out Johnson's ability to control the House of Commons, if he's still able to exert some at this stage.

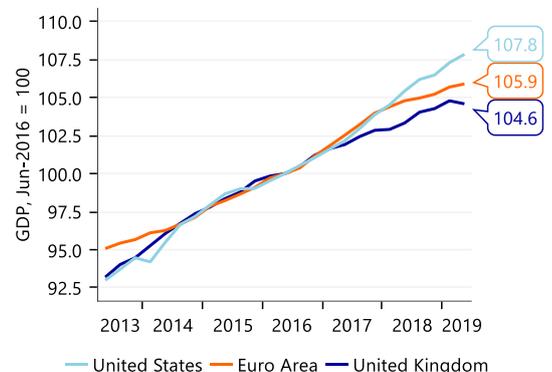
Unless the Johnson cabinet all of the sudden puts forward a proposal with concrete ideas and plans instead of just a vision and unenforceable promises, we are unlikely to see movement of any significance from Brussels. It can't be stressed enough that they firmly believe that the solution to the backstop conundrum lies in future trade discussions, and not in re-opening the Withdrawal Agreement. **So if the EU doesn't budge from this position, it makes a calculated wager that the House of Commons will (and, is able to) stop Prime Minister Johnson from pursuing a no-deal Brexit.**

Figure 1: Johnson's majority has narrowed to one



Note: The speaker plus his three deputies, and Sinn Féin's 7 MPs are excluded
Source: Rabobank

Figure 2: The UK economy is feeling the pinch of relentless uncertainties



Source: Macrobond

The Clash of the Commons

It can't be emphasised enough that the United Kingdom will leave the European Union by default on October 31, unless the government asks permission to change the date again or unilaterally revokes Article 50. So if it is the central assumption that it will eventually be up to the House of Commons to stop a no-deal Brexit from happening, it is essential that the Commons actually has the capabilities of doing so. **This is being strongly contested right now.**

Earlier this week, Prime Minister Johnson asked the Queen to suspend (or, prorogue) Parliament sometime between September 9 and 12, which is just days after the MPs return to work after the summer recess and only a few weeks before the Brexit deadline. A Queen's Speech, in which the government lays out its plans about a new legislative programme, is then to be held on October 14. This speech then needs to be debated and voted on in subsequent days. The votes are likely to fall on 21-22 October. This means that there will be very little time left for MP's to use legislation to force the government to seek an extension of Article 50. **There are only two windows in which the MPs can take action: the first week of September and the last week of October. This is before or after the crucial 17/18 October European Council.**

Table 1: Brexit timetable – as it stands now

<i>Date</i>	<i>Risk event</i>
September 3	Parliament returns from summer recess, starts legislation to avoid no-deal Brexit?
September 4	First possibility for a Vote of No Confidence
Between Sept. 9-12	Parliament is suspended
Sept. 14 – Oct. 2	<i>Conference season starts</i>
October 14	Vote of No Confidence? Queen's Speech ushering in a new parliament
October 17-18	European Council meeting – still room for renegotiations?
October 21-22	Parliament votes on Queen's Speech
October 23-30	Window of opportunity for last-minute, risky interventions in Parliament
October 31	Brexit-day

Source: Rabobank

There are two different ways for pro-deal MPs: through legislation or through a confidence vote. Whilst legislation appeared to be the preferred route, it is also time-consuming and risky. Even though the looming prorogation of Parliament may just be the external trigger that was needed to unite the different groups in Parliament, it requires broad cooperation and trust. But some MPs may decide that it will still be worth trying. We could see something similar to the Cooper-Letwin bill, which was a piece of legislation that required former PM May to seek an extension of Article 50. **But MPs may remember very well that this involved a long and risky parliamentary process: repeating this exercise with only limited time left will be difficult.**

The other way forward is that the opposition will table a confidence vote, possibly already on the first day after Parliament returns from recess. If the vote passes, which will require some Tory MP's to vote against the Johnson government, there will be a 14-day period in which a new majority needs to be formed. Labour-leader Jeremy Corbyn has already challenged opposition parties and Tory rebels to install him as caretaker PM of a government of national unity until a general election is formed, an idea that got quickly poured on with cold water. A more moderate and centrist candidate could be more suitable, if he/she can then demonstrate to the Queen that he/she has the confidence of a majority in the Commons. **But it will require that Remainers work together more coherently than they are doing now.**

Even though legislation was the preferred route, a confidence vote has now become more likely. It is the fastest and cleanest way to change Johnson's course. The timing of it is uncertain: the opposition may even table a vote on the day the House rises, which will then be voted on the next sitting day, i.e. October 14. A confidence vote in the final week of October is also a possibility, but very last-minute and this will undoubtedly roil markets.

To conclude: PM Johnson showed his hand by asking the Queen to prorogue Parliament. And by leaving space open in the first week of September and in the final week before October 31, he is (deliberately?) allowing the MP's just enough time to respond. Moreover, the explicit threat that the government won't make way and will dissolve parliament and call a November election if the MPs do pass a confidence vote, could be interpreted as a signal that Johnson's team is already fully in campaign mode. They are revealing their thinking, and allowing other MPs to organise against it.

If Johnson really pursued a no-deal Brexit, he should have done it differently. The MPs that are against a no-deal Brexit have now learned that they actually can influence his course if they're able to organize. Moreover, his move is widely perceived as anti-democratic (regardless of it actually being so or not) and has given plenty of moral cover to the moderate Tories that were already pondering whether to vote against him in a confidence vote or in other legislation. Finally, it also shows that he is not that serious about looking for a renegotiated deal with Europe.

Assuming that they've thought all this through, it seems as if Boris Johnson is not blocking those trying to stop a no-deal Brexit, but to create a narrative around which he can win a general election and secure a stronger mandate.

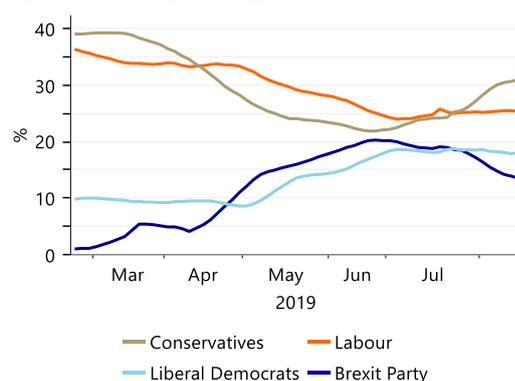
So, an election?

If the UK is indeed heading towards an election, who is going to win? Well, that's impossible to predict at this stage. There is still a lot that needs to happen first, and it's way too early for speculation – all bets are off, basically. But one thing is clear. **The country is split into two different camps, and if an election are held, Brexit will be the battleground.**

The narrative will be that Johnson has done everything in its power to get Brexit done, but that his efforts were being thwarted by *a)* an uncooperative European Union and, more importantly, *b)* a bunch of unwilling MPs that went against the wishes of the British people. **He will run the election on a People vs. Parliament-ticket. And with a stronger backing in Parliament, Johnson will claim, he is going to 'solve' Brexit once and for all.**

The big question is which camp will unite best. The developments in the coming weeks will yield crucial insights. We might see the first signs of an electoral pact between the Conservatives and the Brexit Party, if the Tories promise not to run in Labour/Leave districts. An alliance between the Labour and the LibDems is less natural, especially if Corbyn remains leader of the Labour party.

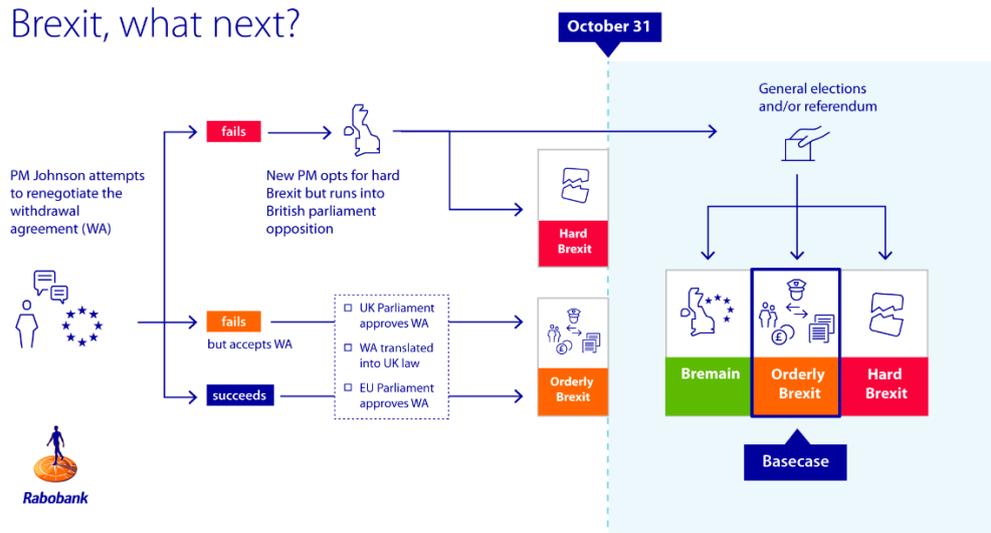
Figure 3: Polling averages



Source: Macrobond, Britain Elects

The polling averages perfectly illustrate the stark divisions within the UK. The electorate is split into four different groups. If we add two and two together, we see that the Conservatives and the Brexit Party combined poll at 44-45% on average, whereas Labour and the Liberal Democrats could win around 43-44% of the seats. But, as we've seen in recent months, it's not unthinkable that big shifts may happen in the next two months, especially in light of the volatile ride the UK has embarked on.

Figure 4: Is the UK heading for an election?



Source: Rabobank

It's going to be a wild ride

It should be clear by now that markets will also be in for a very volatile ride. The most obvious barometer for market sentiment regarding Brexit remains cable. The currency pair has dropped to as low as 1.2033 in early August, before recovering slightly to 1.22 today, but it is still trading on the defensive. **A plunge towards 1.10 on a no-deal Brexit seems plausible.**

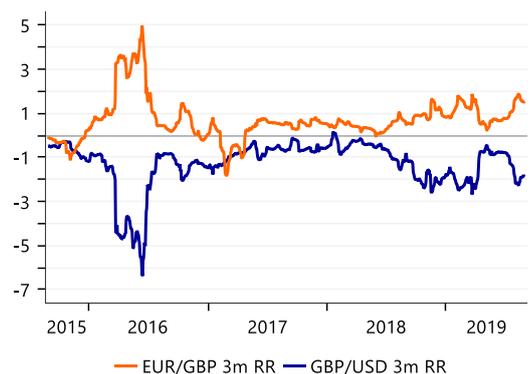
Meanwhile, the cost of protection against big currency swings is rising at a rapid pace, to levels last seen around the March 31 cliff-edge, whereas risk reversals suggest that the risk profile is skewed towards further GBP weakness. This indicates that the expected negative market impact of a no-deal is significantly larger than the positive impact of a further extension of Article 50 (which also opens a path towards revocation).

Figure 5: Implied volatility is high...



Source: Macrobond

Figure 6: ... and skewed



Note: Vol of 25Δ call -/- vol of 25Δ put
Source: Macrobond

The rising risk of a hard Brexit is also reflected in sterling money markets. The market has clearly come to the view that the Bank of England will provide monetary stimulus in terms of rate cuts and potentially QE if it comes to a no-deal Brexit, despite official talk of a non-mechanical and a more balanced approach. While it is true that the BOE MPC has to keep a close eye on the value of GBP, this argument carried a lot more weight at a time when all other central banks were looking up, not down. **But as all other central banks are easing, announcing rate cuts and potentially QE, the Bank of England will then be inclined to change tack as well.**

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