



Global Political Drivers

NO-DEAL BREXIT: ROGUE MAY RISK

Christopher Granville/ Constantine Fraser

- The possibility of the UK crashing out of the EU without a deal has always been Brexit's main claim to qualify as a Global Political Driver; and with barely a week to go before Brexit Day, fears of such a no-deal shock have never been higher.
- We stick to our view that a no-deal Brexit will not happen.
- The most likely path from here is a short extension of the Article 50 process to allow time for the UK parliament to establish cross-party backing for changes to the non-binding Political Declaration in the direction of a softer Brexit.
- In addition to misunderstanding the essence of the EU position on extending the Article 50 process, the present no-deal scare implicitly assumes that one of the parties were inclined towards serious self-harm.
- That assumption would be rational only in the absence of rationality; and the only remotely plausible scenario here would be one where Theresa May herself turns rogue.
- Exploring this scenario, we conclude that the resulting political storm in the UK would be cut short towards the end of next week by the ultimate weapon of a no confidence vote – with the back-up weapon of the Withdrawal Agreement being ratified under extreme duress on 29 March.
- So it is not complacent to dismiss fears of a no deal outcome. But avoiding that worst case offers no grounds for wider complacency. The conclusions of this analysis – from the base case of a 'soft Brexit' extension to the defusing of a possible rogue threat – point to relentless political battles that are increasingly likely to lead by the end of this year to a general election and/or new referendum.

No deal complacency charge: Not guilty

Brexit has for the most part seemed a marginal candidate for inclusion on our list of Global Political Drivers. However, we have all along seen a couple of reasons for viewing Brexit as just about qualifying for this status. The first is the exposure of many global portfolios to the volatility of sterling and UK assets caused by the upheaval in the UK's trading relationships. The road to a new settled state for the UK lies through several years of uncertainty and turbulence. The second – and more important – reason for global asset allocators to pay attention to Brexit has always been the possibility of a disorderly process (the 'no deal' crash-out scenario). This economic and financial disruption of such a shock would spread throughout Europe from its epicentre in the UK itself. This would likely 'move the needle' of global output and risk aversion.

With a week to go until the legally-defined 29 March Brexit Day, the prophets of crash out have the wind in their sails. Weighty voices have long warned against complacency on this score. They may seem vindicated by the EU reaction to Theresa May's request for a three-month postponement of that deadline to allow time for the UK parliament to change its mind after twice rejecting the Withdrawal Agreement (WA) and non-binding Political Declaration (PD) that she has negotiated with the EU, and then to enact the enabling legislation required to implement the WA. At the time of writing, the EU is signalling that its consent would be conditional on the UK parliament ratifying the WA *before* 29 March. As things stand, the chances of the House of Commons ratifying the WA seem as remote as ever. Given that, and as President Macron put it on arrival at today's regular meeting of the European Council (i.e. EU Summit) in Brussels,

"We will go towards no deal – we all know it"

We have long taken the opposite view – i.e. that the risk of no deal is negligible. Since first making this call last July, we have stuck to it with high conviction – but only on the basis of periodic scrutiny in the light of developments (e.g. Hot crisis, cool markets, 24 January). So we plead not guilty to complacency.

Flesh-creeping scenario

But now that charge – of complacency – is gaining force. To give a flavour, here is a scenario offered earlier today by an anonymous financial blogger leading to the emotional conclusion that "analysts and strategists [on Brexit] are a total waste of space".

This week: EU agrees short extension to 23 May subject to approval of the WA next week. Early next week: the WA will either not be voted on rejected again, then the EU offers a long extension out to 2020, but neither May alone, nor the cabinet or parliament, are able to respond in a timely manner. Midnight on 29 March passes. Much discussion over the weekend – no result. Midnight on 31 March, Asian markets open, with OTC FX markets meanwhile providing the best proxy. At this point, financial reality will start to impact the political process. Within days, May will be blown away. Corbyn, totally unsuited to react, will freeze. The EU economies will lurch and dip but the Eurozone will be flooded with financial support. The BOE will drop interest rates to zero or minus and sterling will collapse . . . and that is just the start.

This note sets out why we believe that this kind of thinking is wrong. In other words, we do not think that 'this time is different' – despite a 'no deal' outcome now being implied by the EU's official position (with the French government heightening the scare by making this implication

explicit). We start by rehearsing the case before examining the most plausible risk to this view, which we are calling 'Rogue May'.

Self-preservation instinct

The reason for focusing on the risk of accidents or rogues is that all parties share a very strong interest in avoiding no deal and will do all they can to avoid it. On the UK side, this was demonstrated more clearly than ever in parliamentary votes on 13 March. The government itself put down a motion against a no-deal exit on 29 March but then instructed its supporters to vote against a backbench-sponsored amendment to that motion ruling out a no deal in any circumstances. But that "under-no-circumstances" amendment was passed anyway. The standard objection is that such parliamentary votes have no legal force and can be ignored by the government. This understates the ultimate power of the House of Commons in the UK system – a question we return to below in connection with the risks to our view.

As for the EU side, there is now plenty of comment about Brexit fatigue spiced with colourful language about amputating gangrenous limbs and (reflecting the UK's 'soft power') other favourite old lines from the British comedy classic, Monty Python. The reality is rather different. The present no deal scare stems more from the way May framed the UK's extension request rather than reflecting the entirety of the EU position. On what is now the hot question of extending the Article 50 period, senior officials in the Commission and key national governments have long been indicating a two-part menu.

- **Short extension of up to three months.** This option is based on the UK finally ratifying the WA and needing some more time to pass domestic legislation giving effect to the provisions of the WA. The consensus time limit appears to be 2 July. That is the day when the newly elected European Parliament is due to assemble for the first time; and since, in this scenario, the UK would not have taken part in the elections to be held in May, the legality of the Parliament could be undermined were the UK to remain a member state beyond that point.
- **Longer extension – until, say the end of the year, or perhaps even into 2020.** This option would be available in the event of a change of tack by the UK. For example, the UK might decide to subject its Brexit strategy to some fresh 'democratic exercise' such as another referendum and/or general election. The longer extension would provide the several months needed to carry out any such "concrete plans", as the EU's chief Brexit negotiator Michel Barnier put it last Monday.

This choice is implicitly borne out by reports coming in as we publish of ongoing European Council discussions this afternoon. Although discussion is still underway, the Council seems set on pre-emptively approving a short extension, very likely conditional on the WA being approved. A longer extension will likely be said to be incompatible with the UK's stated intention not to participate in the European elections. This kind of wording illustrates our point about flexibility, as it implies the EU will respond to changes to the UK's position.

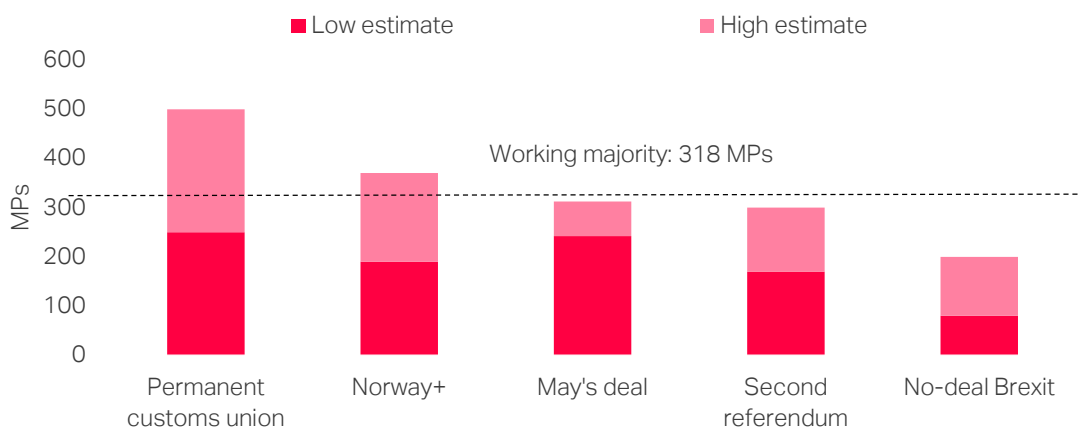
Tact and tactics

May's extension request fell squarely into the first category (this lady is not for changing tack). The EU's reaction was adapted accordingly. EU officials clearly wish to avoid giving any impression of interfering in the UK's fraught domestic politics by making counter-proposals which might be taken as at least implicitly recommending an alternative course of action (i.e. under the second broad option). This tactful approach has been combined with the tactical

gambit of basing the consent on ratification of the WA next week with a view to concentrating minds in the UK parliament which, as it has made clear, wishes to avoid a no deal above all else. These tactics support May's approach. She is the sole official counterparty of the EU Council of Ministers, which is still trying to support her.

An alternative approach is there for the taking. In the likely even that we reach the middle of the next week with the WA still not ratified, ostensibly teeing up a crash out on a narrow view of this week's EU official talk, the UK could easily secure an extension – and without even having to commit up-front to radical new departures like a new referendum or election.

Parliamentary support ranges for alternative Brexit options



Source: TS Lombard

The most likely outcome in our view would be agreement on an extension for the purpose of allowing the UK parliament time to coalesce on an alternative long-term strategy. What the EU calls a “more ambitious” amounts to a softer Brexit strategy that would be captured in a modified PD. The chart above shows the two such options that appear to have potential majority cross-party support in the House of Commons. Any such majority would be revealed by a process of “indicative votes” which the government has so far managed to block but which it could by next week facilitate – or, at least, be forced to accept. An added attraction of this option for both sides is that the acceptably “concrete” project that justified it could comfortably be implemented in the shorter extension period of up to three months – and thereby avoid the sensitive question of the UK participating in the European parliamentary election.

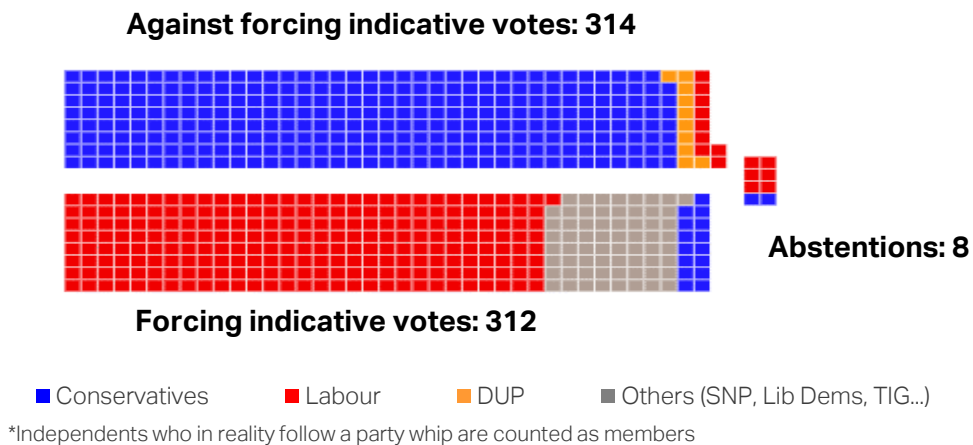
Rogue May risk

The main no-deal risk is that May herself decides to pursue one. With May seemingly increasingly willing to contemplate leaving the EU without a deal, the route to a no-deal exit – and the risk to our view – runs through the Prime Minister herself. After her Downing Street speech on Wednesday night, even the usually-loyal Foreign Secretary Jeremy Hunt suggested to Radio 4 that the strain of the job might be getting to her.

She could yet attempt to defy parliament's wishes for the sake of Tory unity. A view that is gaining some traction in Westminster and the UK media is that May is becoming reconciled to no-deal as preferable to a long extension or to cross-party compromise, either of which could split the Conservatives, spark ministerial resignations and rapidly terminate her premiership. This "rogue Prime Minister" scenario casts May not as captain of the ship of state, but as an airline pilot barricaded in her cockpit and determined to take the flight down, passengers and all. In this scenario, she would attempt to engineer a no-deal in defiance of the explicit wishes of Parliament, which she has repeatedly said she would honour.

Parliament poised to take back control

Votes on the Benn "indicative votes" amendment, 14 March 2019



Source: TS Lombard

Her deal is unlikely to pass on the third time of asking next week. Our strong expectation is now that the government's third attempt at ratifying the WA (the third Meaningful Vote, or "MV3") will not be approved by parliament next week. (The procedural barrier to such a vote raised by the Speaker of the House of Commons this week is a red herring: if a majority did finally swing behind the WA, that same majority could simply vote to remove that barrier before proceeding to the main ratification vote.)

May's suspected preference for a no-deal over a long extension means that hardline Eurosceptics on the Conservative backbenchers – even some who have backed her deal in the past – think that voting against it now will bring about the hardest of all Brexits. Opposition MPs think that the Commons will reassert itself and force a long extension, and eventually a softer Brexit or even a second referendum. Parliament's latest attempt to go down this road was defeated last week by only two votes (see chart above), so would be highly likely to succeed in the even more fraught atmosphere in store for next week. Finally, May's televised statement on Wednesday night has alienated wavering MPs on the opposition benches whom she needs to win over.

The Commons and much of the Cabinet will attempt to prevent a no-deal. If MV3 is defeated, is abandoned or is ruled out of order by the Speaker, the Commons would likely attempt to seize control of the Brexit process. They would certainly renew attempt to legislate for indicative votes as soon as next week, but they could instruct the government in a non-binding manner to secure a long extension, despite May's stated opposition. This would involve the UK submitting a new extension request to the EU next week. Pro-European Cabinet ministers would also likely threaten to resign *en masse* if a no-deal looks to be looming.

But May could ignore them, with the clock ticking down fast. If May is absolutely determined to leave without a deal, she could still try to frustrate parliament's will. She could attempt to prevent the relevant votes in the Commons from being held. She could submit to the EU a revised extension request in such a way as to ensure its rejection (for example, by refusing to provide a coherent rationale, or by attaching unacceptable conditions). She could simply ignore parliament, on the basis that she is not legally bound to follow their recommendations. Or she could dismiss an EU extension offer as being the wrong length or coming with unacceptable conditions attached. In other words, if the EU refuses to relent and offer her a short extension, she could try to lock the cockpit door.

The Commons' only recourse might be a fraught no-confidence vote. In the circumstances, the only tool that the Commons would have to force a change of course would be to remove May via a vote of no confidence – with pro-European Conservative MPs siding with the Opposition to topple a Conservative government. But that would be a highly fraught, last-ditch move, which would likely end the relevant MPs' political careers. Even if it succeeded, the deadline of Friday night to avoid a no-deal will be very close at hand. By 11pm GMT on 29 March, MPs would have to install a new, provisional government with instructions to request a long extension or even revoke Article 50; most likely agree an extension with the EU; and legislate to modify the EU Withdrawal Act 2018 to change the legal date of departure.

So it would seem reasonable to worry about a May-initiated no-deal. At least, this does seem a plausible path leading over the 'cliff edge' at the end of the day on 29 March – i.e. a Prime Minister hell-bent on a no-deal, a divided ruling party and an intransigent and increasingly impatient EU.

Swerve before impact

Despite all this, we still think a no-deal at the end of next week remains very unlikely. For a start, we don't believe that parliament is the only remaining barrier. For all each side's insistence that they are prepared to contemplate it, a no-deal scenario remains deeply undesirable, both for London and for the EU capitals.

The EU wants to put pressure on MPs to ratify the deal. As noted above, this week's hard EU line – with France in the lead – is at least in part aimed at concentrating MPs' minds and seeing the deal ratified in London. But without implying that the EU always compromises at the last minute, as some in London have suggested (in reality, the lesson of the Eurozone crisis is that it is the EU's negotiating counterparts who tend to fold at the last minute), there is probably more "give" in their position than EU leaders' public statements would imply.

We suspect that they will be more flexible than they currently imply. The decision will be made by consensus, in the European Council – and there are several figures there, from Merkel and Tusk to the Netherlands' Mark Rutte, who are experienced in crafting late-night can-kicks. And after several years of strong support for Ireland in particular, would the EU go for self-harm simply because French patience with the UK has run out? We reckon the conditionality for a long extension would be relatively light; and we have already detailed above the plausible scenario of a short extension even if the WA is once again defeated, so long as the UK presented a clear plan and sensible rationale (such as a programme of indicative votes with a view to modifying the PD).

May has a tactical reason to appear open to a no-deal outcome, but the reality may well be different. At the UK end, it's worth bearing in mind that the only chance for May's deal is for

her to convince enough of the Opposition that the alternative is a no-deal. From the outside, and until the end of next week, a May set on no-deal may be indistinguishable from one determined to avoid it. As a matter of fact, she has repeatedly stated (as recently as Wednesday) that if MV3 is defeated, parliament “will have to decide how to proceed”. This has been echoed in ministers’ talking points today.

Either way, she is still hinting she will obey parliament’s wishes. This implies to us that – even if she really were personally tempted by no-deal, as she might well now be – May will not simply ignore parliament’s wishes. Of course, she has said that she is not personally prepared to delay Brexit past the end of June. But that could imply her resignation if she is forced to do so by parliament. Perhaps more pertinently, the past few years of Brexit negotiations are littered with examples of courses of action that May has ruled out and then eventually conceded – from negotiating a transition period, to accepting the Irish border backstop and, finally, requesting an extension of the Article 50 process beyond 29 March.

A no-confidence vote would very likely succeed. When it comes to parliament, we think the prospects for a “no-confidence” mechanism would be high. The government’s majority on confidence votes is very slim – although hard to calculate with precision because of the growing number of independent MPs, a mere half dozen Tory defectors would likely swing the balance. At least a couple have already threatened to bring down the government in the event it pursued a no-deal, and we think more would follow.

As for the constraint of the timetable, that is only a weak barrier to the settled will of the Commons, which can remake its rules of procedure as it likes. By way of example, on 1 September 1939, with the outbreak of WWII imminent, Parliament – both the Commons and the Lords - passed 18 Acts within seven hours.

If all else fails, MPs will approve May’s deal rather than allow a no-deal. Finally, let’s picture the worst-case scenario: on the afternoon of Friday 29 March, no extension has been agreed, May remains in Downing Street and the country is heading for a no-deal. At that stage, MPs would face a hard deadline, and all alternatives will visibly have been exhausted. At that stage, we think it highly unlikely that May would not bring her WA back for one last, final heave. And with all but around 75 MPs preferring her deal to a no-deal – and in the knowledge that the entire future relationship with the EU will remain up for grabs in the next stage of negotiations – we think it almost certain that an exhausted House of Commons would finally approve it, possibly thanks to massive abstentions, setting the scene for a last-minute agreement on a short technical extension.

Going down to the wire has always been on the cards – that is, the Article 50 process entering a period of final, high-stakes political turmoil before it could find its resolution. Back in October, Merkel herself suggested at an EU summit that the negotiations might last until March 28. The fact that the turmoil is now accelerating does not mean the UK is heading for a no-deal.

No complacency about no ‘no deal’

It is all very well to remain sanguine, one week out, about the UK avoiding a no deal shock: but there are plenty of other, if slower-motion, hazards in store. The last ‘swerve’ option mentioned in the previous section – WA ratification in extremis on Friday next week – is a good starting point for gauging this dire prospect of protracted Brexit battles and uncertainty for UK

business. This is not because we regard this 'gunpoint' ratification as particularly likely; but it does exemplify the prospect of all plausible outcomes to the Article 50 process leaving a legacy of bitterness that will generate more political conflict in the next stages of Brexit.

Election/referendum outlook

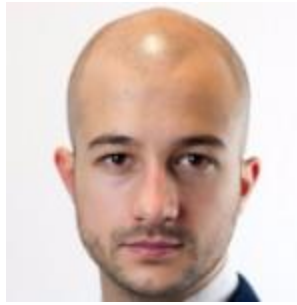
This applies most obviously of all in the event that our main call did prove wrong. A UK crash out would unleash political mayhem, and a general election would soon follow. To return to the prospects following ratification of the WA under duress, even before the UK government got into the arduous negotiation with the EU (a multi-year process in which the UK side would hold very few cards), there would be further domestic political battles over what to aim for in those negotiations. The enthusiastic pro-Brexit wing of the Conservative Party (ERG) has threatened to sabotage the government's business in the House of Commons if it does not get its way – and it would be all the more likely to carry out that threat if the PD had been modified in a 'soft Brexit' direction with cross-party support.

The chances of the present UK parliament surviving its full 5-year term until June 2022 look slim. It would not be in the least surprising to see the end of Theresa May's premiership followed by a general election by the end of this year. Meanwhile, the referendum option still lurks in the background as the last fall-back if the UK's politicians, even after making it into an extension beyond Friday next week, still fail to agree on any other course of action. For that to happen, however, the UK's political battles would have to escalate once again to a new pitch. Even as it blows over as we expect, the present political storm over the no-deal threat is, at very best, merely "the end of the beginning".

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