Global Political Drivers

UK CRISIS: HOT POLITICS, COOL MARKETS

Christopher Granville/ Constantine Fraser

- **Already frenzied, the domestic political crisis in the UK over the Brexit endgame is set to get even hotter during the next few weeks. From a financial market point of view, this prospect may seem like good raw material for potential event trades.**
- **As for the views on outcomes required for event trades, we have two such views: the risk of a no-deal crash out remains negligible and the 'Article 50' deadline will be extended beyond 29 March.**
- **In practice, however, our calls do not make the grade as fundamental inputs for an event trading strategy. The reason for this is that far from pointing to any definitive resolution, they imply prolonged uncertainty about the UK-EU relationship.**
- **This would apply even if the UK government reversed its parliamentary defeat last week and got its Brexit package ratified. After a brief rally, sterling would likely retreat to its Brexit uncertainty range: so the most attractive trade may be to position for this reversion.**
- **Chronic uncertainty would more obviously flow if the government's parliamentary opponents were to prevail, as this would likely lead to a further referendum and/or a general election.**
- **The political 'game of chicken' will be a close and intensely fought contest going down to the wire. But all for what? The answer is one or another form of continued uncertainty.**

Illusory event trade

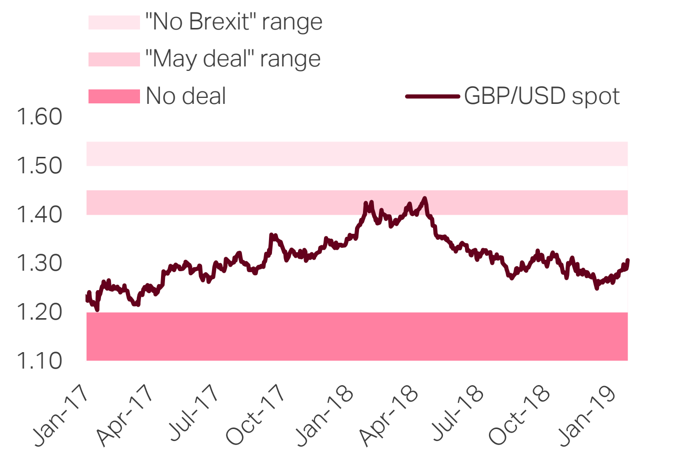
For financial markets, the draw of the escalating Brexit drama will be in event trades. Already at fever pitch, the UK's Brexit drama will intensify still further during the coming (eight) weeks. The spectacle has the power to captivate for a variety of reasons, in a range from trivial political entertainment value to concerns about the short- and long-term future of the UK. These are deeply felt not only by a large number of British citizens but also by many others in Europe and further afield affected by the UK's role in the global economy and security system. As for financial markets, the distinctive and specific draw of Brexit lies in its potential to generate event trades.

We hold to our core call that a no-deal will be avoided. Building on the raw material of uncertainty about powerfully contrasting alternative outcomes, event trades can only take clear shape on the basis of well worked-out assumptions on the probability of the various outcomes. Our coverage of Brexit might appear to supply that ingredient insofar as we have two high conviction views on the outlook. Regular readers will be familiar with the first of these – our call that the UK will avoid crashing out of the EU (the "no deal" scenario). We first came out with this call last July and have since stuck to it in the teeth of serious but – so far, in our view – unconvincing counter-arguments.

The FX markets now seem to agree. We are not complacent, however. In such a febrile political environment – made even more uncertain by the UK's lack of a written constitution – existing or new counter-arguments might suddenly become more powerful. So in this note as in our previous coverage, we subject our 'no no-deal' view to fresh scrutiny: but, to give away one punchline up front, the view passes this latest test. The FX market agrees, as sterling (cable rate) has since last month moved up and away away from what our FX strategist Oliver Brennan identifies as the 'no deal' range (see left-hand chart below).

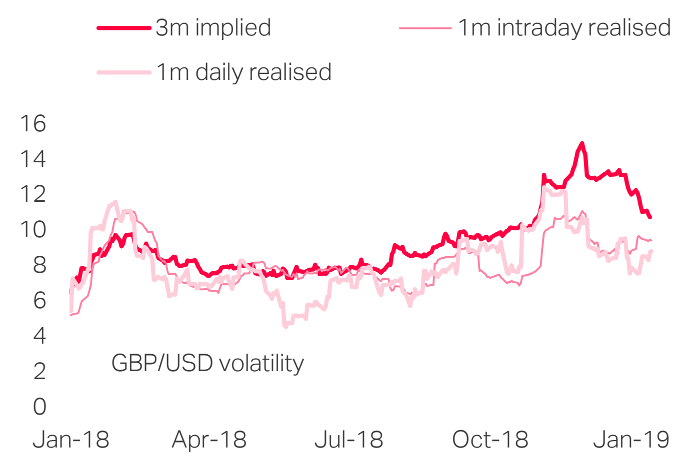
But a break-out will need more than just avoiding the worst. The more interesting lesson from this latest FX market action is a bit different. The perceived decline of "no deal" risk has not caused sterling to break-out of its Brexit-uncertainty range. In this light, our core call does not after all look like much of a fundamental input into an attractive event trade. Avoiding the worst (no-deal) outcome does not make the grade as a break-out event – defined as something that points clearly to a specific outcome rather than the mere avoidance of one possible outcome.

GBP/USD - Brexit uncertainty range



Source: Bloomberg, TS Lombard

GBP/USD volatility: Brexit fatigue



Source: Bloomberg, TS Lombard

We also now expect an Article 50 extension – but this is hardly the basis for an event trade, either. The prospect of chronic uncertainty is reinforced by our other main view – now also closer to consensus – that the 'Article 50' withdrawal process deadline of 29 March will have to be extended. This applies even if the UK government manages by then to reverse its huge defeat last week in the parliamentary vote on the withdrawal package – i.e. the Withdrawal Agreement (WA) and accompanying non-binding Political Declaration (PD).

For an ultimately successful struggle to get that package ratified would still have consumed the time available for passing the raft of legislation required to give practical effect to this exit plan. Arriving at any clear view in the Brexit maelstrom may at first sight seem like analytical progress: but this 'Article 50 extension' view – just like its companion 'no no-deal view' – offers no underpinning for an event trade.

Markets are also starting to price a postponement – and the lack of a climax. This prospect of protracted uncertainty about the definitive Brexit outcome – i.e. the opposite of a break-out event – is also now showing up in the FX market. This can be seen most clearly in another indicator that Oliver has been highlighting – the premium to own 3-month GBP options (i.e. the gap between implied and realised volatility in GBP/USD and EUR/GBP). The right-hand chart above shows this premium steadily declining during January.

The declining volatility premium amid such elevated uncertainty may seem paradoxical. This trend reflects a change of expectations since December. Back then, the market had been pricing the escalation of political battles to a climax during Q1 with one of the evenly-matched competing Brexit approaches prevailing by the end-March deadline. The volatility premium has dissipated now that the March Brexit date looks set to be postponed. This picture suggests the opposite of an event trade – as reflected also in another notable fact brought out in this chart: the extent to which realised volatility remains well contained despite recent large moves in the spot rate. Here is a sure sign of Brexit news fatigue: potential event traders are losing interest.

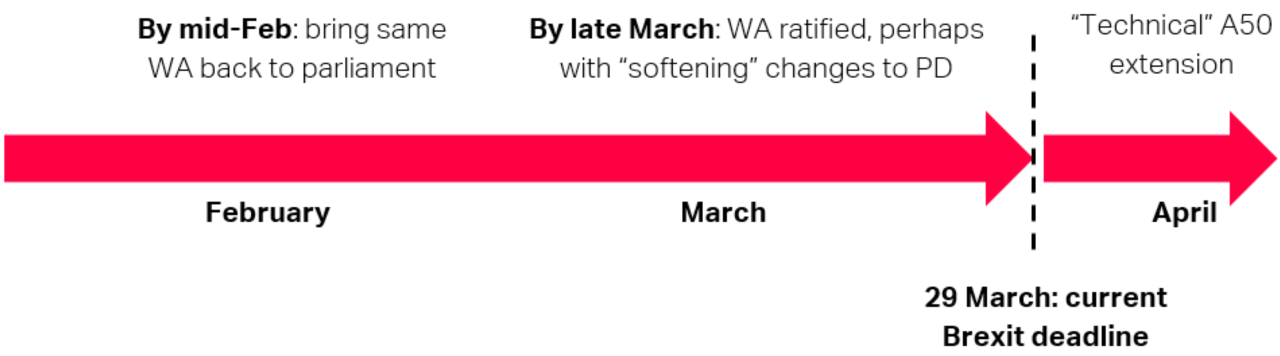
This implied market assumption that the battles will drag on looks sound. Victory for Theresa May in the sense of eventual WA ratification will have some semblance of a clear outcome, but would not change this picture. It would merely buy time for endless re-runs of the same battles over the UK's long-term relationship with the EU. Those battles will rage under the shadow of another unchanged feature: the no-deal scenario – i.e. the risk of a failure to reach agreement on that relationship by the mandated deadline, resulting in the UK tipping out of the smooth standstill transition provided by the WA and over the "cliff edge" into a frictional trading relationship with the rest of Europe requiring customs inspections and/or regulatory checks, together with inferior market access for service industries.

We think Brexit uncertainty would resume almost as soon as a deal was reached. While sterling and UK asset markets would surely welcome WA ratification as staving off that cliff edge for 2-4 years, we think the resulting sterling rally into the "May deal" range (1.40-1.45 vs USD, see left-hand chart above) would be short-lived. The more attractive trade may be to position for sterling's return thereafter into its "Brexit uncertainty" range.

Competing visions of uncertainty

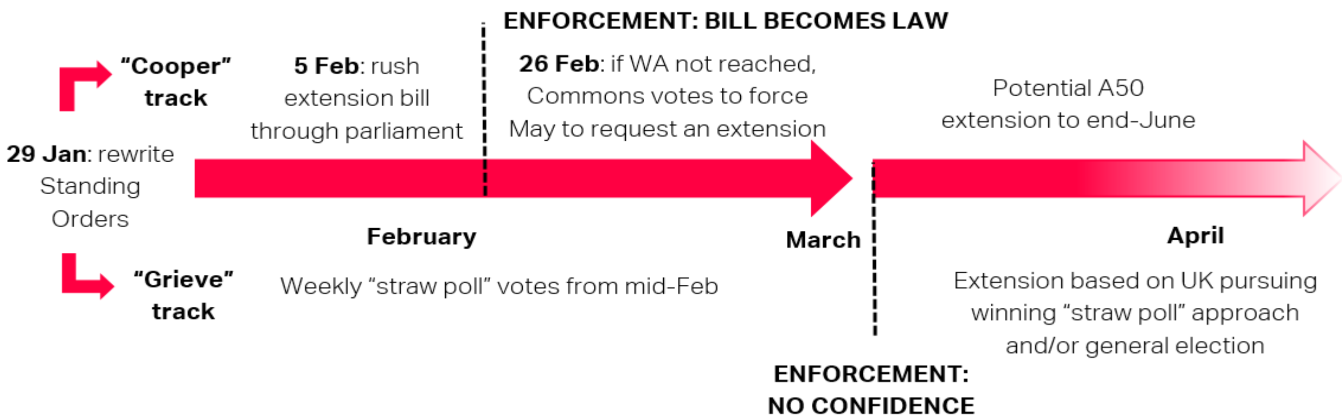
All paths lead to yet more uncertainty. If success for the government would be deceptive in the sense of leading in practice to yet more uncertainty, that same prospect would be all too evident in the event of Theresa May being worsted by her cross-party parliamentary opponents. The two graphics below summarise the main features of the competition between these two camps for differing versions of uncertainty.

UK government plan



Backbench MPs are plotting to stop a no-deal. The second graphic shows how the "Rebel Alliance" of pro-European Conservative and Labour members of the House of the Commons is plotting parallel and complementary campaign tracks named after their respective leaders, Yvette Cooper and Dominic Grieve, who were cabinet ministers in previous Labour and Conservative-led governments. The minimum and paramount aim of both plans, together or separately, is to prevent a no-deal crash out at the end of March.

The Rebel Alliance plan: stopping "no-deal"; potentially setting a new course



The "Cooper" track plans to give parliament a mechanism to force a request to extend Article 50. Both rebel tracks are therefore designed to provide for a situation in which the government had still failed to get its withdrawal package ratified as the end-March deadline neared, but showed no signs of taking any alternative course of action that would avoid a crash-out. Comparing the enforcement mechanisms indicated in our graphic, the Cooper track looks more straightforward. A new law would be in force by the end of February compelling the government in the absence of a ratified WA to request the EU member states to give the unanimous consent required by EU law for an 'Article 50 extension'.

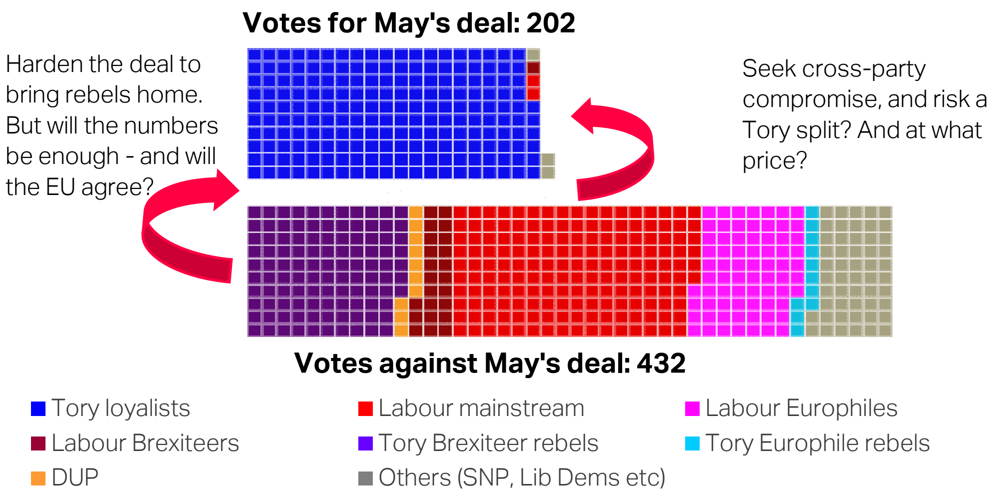
The "Grieve" track aims to provide clarity on parliament's wishes, and thus the basis for an extension request. Since such a request would in practice have to be based on the UK explaining how it planned to use the extension, the Grieve track could then prove complementary in that it would have revealed which of the alternative approaches had majority (or the largest majority) support in the UK parliament. On this logic, the UK would propose to use the extension to pursue that most popular approach – if not the WA/PD in something very much like their current form, in practice a three-way choice between the permanent customs union membership favoured by the Labour leadership, or adding the single market to that (the so-called "Norway +" option), or another referendum.

The possibility of a no confidence vote would remain the ultimate insurance. If the Cooper track were blocked by the failure of her bill to become law, the only remaining enforcement mechanism left on the Grieve track in the face of a government that appeared willing to risk a crash out on 29 March would be for whatever majority that had emerged from the Grieve 'straw poll' process to pass a motion of no confidence in the government. The most likely next step would be the formation of a caretaker government supported by an ad hoc coalition with the sole mandate of securing an 'Article 50 extension' to allow the UK to pursue that majority's preferred alternative course (with the likely addition of a general election in May-June).

But we doubt it will come to that. For all our high conviction that the government would be brought down by the House of Commons for the sake of avoiding a no deal, we also think that this extreme scenario is unlikely. Before matters came to such a head, either or both of the two principal players – i.e. Theresa May's government and the Labour leadership – would have precipitated some kind of result. This coming contest has three predictable features:

- **It will be closely fought.** The parliamentary arithmetic sees to that, as a minority government and hesitant official opposition contend with shifting and increasingly fragmenting factions. The graphic below shows alternative paths by which the government could try to get its version of Brexit over the line.
- **It will be highly interactive.** As the various hands are played, other contestants will react. This spells unpredictable dynamics. For instance, government resistance to the Rebel Alliance initiatives might trigger new ministerial resignations and ever more glaring and

May's options



public dissension in the Cabinet, setting off a snowball effect leading to the collapse of Mrs May's government. Conversely, the reality that Rebel Alliance activities are ultimately targeting either a Remain outcome (via a referendum) or the softest of Brexits might galvanize a counter-group coalescing to ratify the WA, thereby heading off 'no Brexit' or a "betrayal" of Brexit. This group would also be cross-party, even if consisting mostly of Conservative pro-Brexit rebels returning to the fold. Both sides may appear to be winning this race at various stages during the next few weeks before the chequered flag is waved.

- **The end-March deadline makes this contest a game of chicken** which, in the nature of such games, will likely go to the wire. As noted, either the government or the Labour leadership could attempt to seize the initiative with a bold gambit. For the government, that might mean tacking to a softer Brexit by amending the PD, while Labour could – for example – agree to support a referendum on condition that it also got a general election. But each side will have an incentive to hold back from playing any such risky cards in the hope that fear of an impending crash out will induce a majority in the House of Commons to break in its direction. The attraction of this standard game-of-chicken logic of waiting for the other side to blink is that of minimizing the concessions required to secure first preferences (for the government – Brexit based on its WA, for Labour – a general election).

Summing up: Noisy stalemate

Whatever the outcome of this stage, market moves will not be sustained. This characterization of the next dramatic phase of the UK's Brexit crisis is intentionally bald. Keen political watchers can look forward to a feast of innumerable tactical combinations. Already high, the political temperature has much further to rise. The key point for investors, however, is that while the struggle will arrive at some interim destination, that 'outcome' will most likely fall well short of an event that would lead to a sustained move – up or down – in the value of sterling and UK assets and, to a lesser extent, other assets, mainly in Europe, that are exposed to the UK.

The only two exceptions to this conclusion would be a no-deal crash out or a 'Remain' victory in any further referendum. If the Brexit process seemed at all likely to end in either of those two ways, proper event trades in financial markets would be on the cards.

The coming political battles in Westminster will generate continued and perhaps more intense no-deal scares. For example, one of the amendments that may be voted on next week – alongside the Rebel Alliance motions discussed above – "insists" on removing the permanent 'Irish backstop' from the WA. Majority support in the UK parliament for such an impossible goal would spark new fears of a crash out. However that may be, the chances of such a shock remain negligible. Above and beyond the determined procedural and substantive counter-strategies of the Rebel Alliance, the ultimate defence is that the UK political classes and the EU share a vital interest in avoiding this outcome.

As for the Remain outcome, while it is less unlikely than a crash out, in our view, it is still only a remote possibility. Huge political obstacles would have to be cleared for a referendum to be held in a framework that gave Remain a reasonable chance of victory. Detailed analysis of this scenario would only be justified if the combination of tumultuous events in February and March pointed much more strongly towards the referendum track than is now the case.

The base case, therefore, is a political battle leading – for all its fury – to the non-result of one or another version of chronic uncertainty about the UK's relationship with the rest of Europe.

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