Global Political Drivers

PEAK BREXIT PANIC TIMELINES

Christopher Granville/ Constantine Fraser

- **The latest burst of political noise over Brexit does not change our view of how this saga will play out: whatever else happens, the UK will not 'crash-out' of the EU next March. This noise surge does, however, provide a timely reminder that the path from here to next March will be turbulent.**
- **This prospect of a choppy path to a (relatively) benign destination tees up event trading opportunities, mainly in sterling and gilts. This note focuses on the timing for such trades.**
- **Volatility will peak around the two key milestones of the signature, and then the ratification, of the Withdrawal Agreement (WA). This document must be signed off by mid-January, with the ratification process being completed in the following 4-6 weeks.**
- **We think it more likely than not that both those milestones will be successfully passed – albeit after nail-biting cliff-hangers accentuating the ensuing relief rallies which make these trades seem attractive.**
- **At the same time, it is possible that the Brexit process will fall at either of those fences – with the ratification vote on the WA in the House of Commons set to be a particularly close run thing.**
- **Failure to ratify the WA would lead to a full-blown political crisis in the UK possibly culminating in an election or even a second referendum. That would mean still higher and, above all, more protracted volatility in UK assets – with some contagion effects across EU markets.**
- **But our firm prediction of no 'crash-out' even in this scenario points to a relief rally along the way – most likely triggered by an agreement to extend the Brexit deadline beyond next March.**
- **Persistent medium-term uncertainties about the end-state of the EU-UK relationship would justify prompt profit taking during relief rallies – especially on FX trades, which we prefer to express in the EUR/GBP cross.**

The dog barks

We are maintaining our Brexit view. As we follow the Brexit process, each periodic burst of political noise prompts us to review our forecast of the outcome – and, so far, to leave that forecast unchanged. By way of brief reminder, our view has three components:

- **A no-deal crash-out will be avoided.** The most important part, and the most high-conviction, is that whatever else happens a disorderly 'crash-out' will be avoided. We base this conclusion on what we see as the political reality that even in the unlikely event that the UK government were inclined to risk such a crash-out, it would be prevented from doing so by a majority in the UK parliament (House of Commons).
- **The UK will very likely move into a standstill transition after March 2019.** With somewhat less conviction but still reasonably high confidence, we see the most likely version of "whatever else" as being the UK moving straight into a standstill transition period upon leaving the EU on 29 March 2019 (aka Brexit-In-Name-Only or 'BINO').
- **But the road there will be bumpy.** The passage to this predicted (relatively) benign outcome will be choppy at least, and could be very turbulent. Whatever the exact path, there will be episodes of elevated volatility, concentrated in sterling and gilts, quickly followed by mean reversion – and here lies a potentially attractive event trade, or series of trades.

Like similar previous episodes, the latest noise surge on Brexit at last week's EU Summit in Salzburg signifies little. Despite the harshest public rhetoric to date on both sides (Emmanuel Macron: the Chequers Brexit plan "is not acceptable"; Theresa May: "we are at an impasse"), we see no reason to modify the substance of our three-part view. As the old Silk Road saying goes, "the dog barks, but the caravan moves on".

But the caravan is moving on with increasingly violent jolts. It is important to keep such turbulence in perspective. Some of the drama will be more theatrical than real. Any agreement can be made easier to sell politically if expectations have been depressed by gloomy talk. Such posturing increases the feel-good effect of a deal finally being struck, while also helping to camouflage the concessions necessary to clinch the agreement.

The impression of victory being snatched from the jaws of defeat can also encourage perceptions that this was only possible as a result of various concessions being extracted from the other side. Even allowing for all such game-playing however, the latest developments point to a higher probability of a rougher passage to Brexit's (interim) destination which, as we predict, in any event avoids a crash-out.

Since event trades hinge on timing, we focus in this new Brexit update note on the varying timelines for peak volatility depending on the different possible paths to that destination. Drawing up this roadmap for Brexit event trading involves looking separately at three plausible paths, and this also provides a convenient opportunity to examine a few of the more interesting fine points coming out of recent developments.

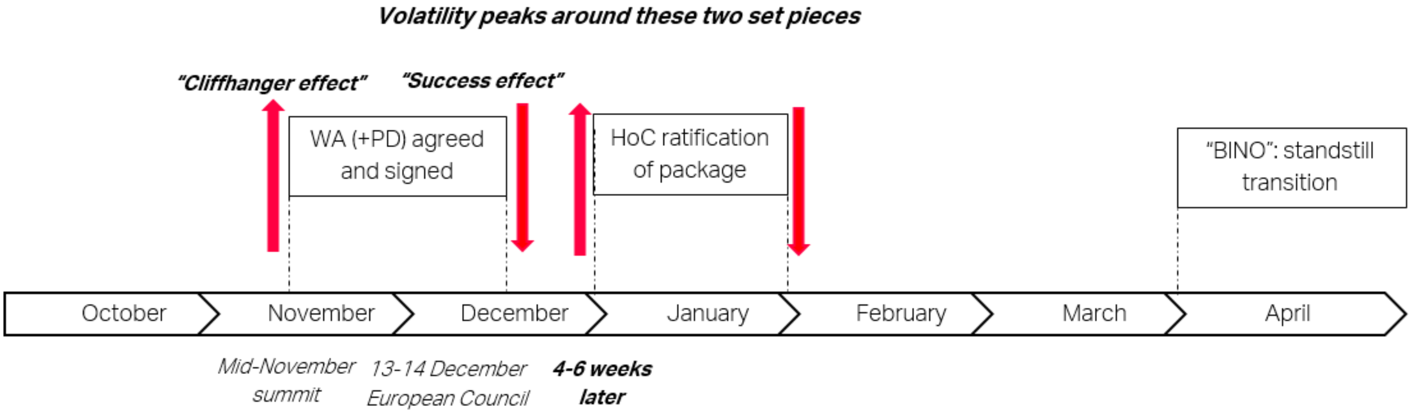
Smoother passage

The smoother route to Brexit still spells volatility around two set-pieces. We start with the relatively smooth 'BINO' path which holds in store a volatility pattern which, as can be seen from the graphic below, hinges on the successful outcome of two set-pieces:

- Signature of the Withdrawal Agreement (WA) – a legally binding treaty – and the accompanying non-binding Political Declaration (PD) on the future EU-UK relationship. This agreement might be signed either at another specially convened EU Summit in mid-November or at the regular scheduled European Council (i.e. Summit) on 13-14 December. Given the March deadline set by Article 50 and now also some specific provisions of domestic UK legislation on the Brexit process, the latest practicable timeline for this final agreement and signature would be mid-January. The probability of this later timing – hence higher 'cliff-hanger' market volatility during the winter months – is increased by the political usefulness of theatrical brinkmanship.
- Around 4-6 weeks later, ratification of this package (WA + PD) by the UK parliament. That means on one or another side of the Christmas/New Year holidays or, if the process does go down to the mid-January wire, during the month of February.

The ratification battle will be fought at Westminster. The ratification process also includes the European Parliament, though we assume – uncontroversially – that this will be a formality. On the EU side, in other words, whatever is acceptable to the Council will also pass muster with the Parliament. So the decisive ratification battle will be fought at Westminster – in the House of Commons.

Scenario 1: Smoother passage



A deal over the end-state EU-UK relationship is not necessary for a withdrawal agreement. This path even now seems widely misunderstood thanks to imprecise talk about the "deal". For instance, standard media reporting of the Salzburg summit concluded that the EU leaders' rejection of Mrs May's "Chequers" plan presages a "no-deal crash-out". That is a false conclusion. The only actual "deal" is the WA. The future relationship will be the subject of the non-binding PD, which can contain as much detail and clarity (detail and clarity being different things) as the UK and EU decide will suit them. Disagreements over the viability of the "Chequers model" as a template for the end-state relationship are not a barrier to the negotiation of a WA.

Irish backstop fudge in sight

The one remaining serious obstacle to signing a WA is the question of the Irish border "backstop". The 1998 Belfast Agreement (aka the "Good Friday Agreement") in effect requires that, whatever else happens to the rest of the UK, the border between Northern Ireland and the Republic of Ireland must remain open - and in order to keep the Brexit process on track, Mrs May agreed this in writing last December. Both sides accept that this in turn is likely to require Northern Ireland remaining in the Customs Union (CU) and Single Market (SM – at least for goods), unless some as-yet-obscure alternative can be dreamt up. May has since balked at enshrining that backstop agreement in treaty form. Her stated grounds are that this would undermine the constitutional integrity of the UK ("something that no UK Prime Minister could ever accept"). In reality, she has one tactical and one strategic reason for drawing this 'red line' on an (economic) border appearing in the Irish Sea.

- Tactically, she must take this question to the wire (and appear to have extracted some concessions in the final agreed version of the backstop text) if she is to have any chance of persuading the ten members of the House of the Commons from Northern Ireland's Democratic Unionist Party (DUP) – on whom she depends for her parliamentary majority – to vote in favour of the WA.
- The strategic ploy is to use this Northern Ireland question as cover for Mrs May's preferred ("Chequers") approach of keeping the UK aligned with the SM (at least for goods) and, albeit less explicitly for now, the CU. The main rationale here is to prevent a shock to UK trade and industry that would result from ending the present friction-free trading relationship with the EU accounting last year for 44% of UK exports and 53% of its imports. The difficulty for Mrs May is that the most enthusiastic Leave supporters both in parliament and the country desire a "cleaner break" with the EU. So it makes political sense to appeal to the Conservative Party's unionist heritage (i.e. compromising on the purity of Brexit for the sake of preserving the union of Great Britain and Northern Ireland that constitutes the United Kingdom).

At the present delicate stage, the tactical motive dominates – for there is no escaping the backstop. This backstop imperative has nothing to do with the EU's objections to "Chequers". Even if the PD were to reflect some Chequers thinking (as the UK government may still claim to be the case once the vague text of that document is finalized), the "all-weather" backstop would still be required. For the PD's non-binding status means that whatever is written there could fall through.

But a possible landing zone for the negotiations on the backstop can be discerned. The compromise around which both sides are circling is to separate the "customs" and "regulatory" sections of the backstop. Northern Ireland will remain *de facto* in the single market for goods, and the current light-touch regulatory checks in the Irish Sea will be expanded – but only by a little, to cover live animals and some agricultural goods. Other regulatory checks will take place away from the border, or indeed remotely. Such details – presented by the EU negotiators as "de-dramatizing" the backstop – might be presented by Mrs May as substantive concessions that somehow remove the previously perceived threat to the UK's integrity.

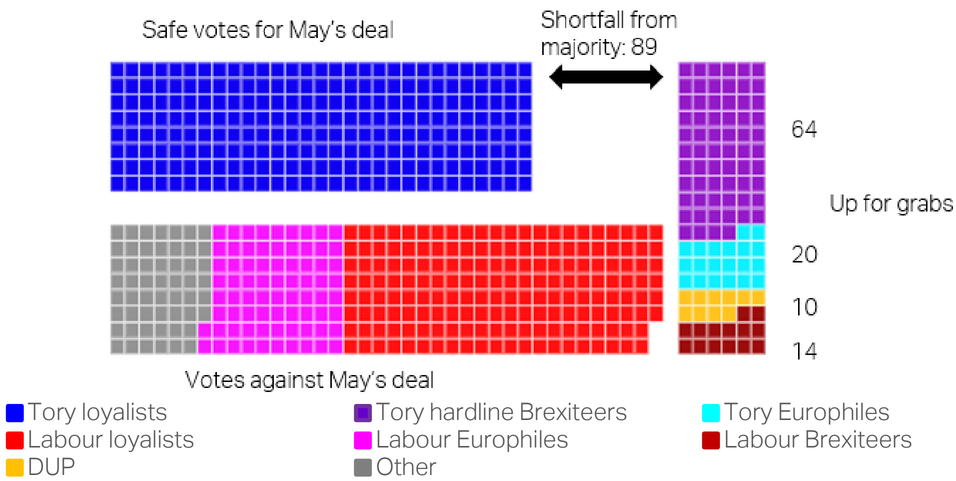
As for the customs issue, the UK's solution may be to promise that the entire UK will remain within the EU customs union pending agreement on the end-state future relationship. And to cap it all, the two sides may yet agree an option in the withdrawal treaty to extend the transitional period past December 2020, which will allow the UK government to make a unilateral promise that it will seek never to invoke the backstop. Since all such elements would be non-binding, they would not provide any kind of watertight reassurance to the DUP. Yet such gambits may be enough to persuade them not to join the opposition in voting down the WA.

Rougher passage

Withdrawal Agreement defeated in the Commons

In our view, the most likely cause of higher and more prolonged volatility is the rejection of the WA by the House of Commons. Under the terms of the EU Withdrawal Act passed by the UK parliament this year, the Commons must approve the WA for it to be valid. But even with the PD little more than an aspirational fudge, this will be an exceedingly difficult moment for the government. The cause of the difficulty and uncertainty is the finely balanced parliamentary arithmetic set out in the graphic below.

Balance of forces in the House of Commons



Labour and the other opposition parties seem committed to voting down any plausible version of the WA. Labour have already launched what looks like an effective argument in political terms – against a "blind jump into the unknown" which is virtually certain to be a fair characterization of the PD as discussed above. At the Labour conference this week, Corbyn offered to support May's deal subject to various conditions – which he knows would be politically impossible for the government to meet. The government will therefore have to scramble for a majority if the WA is to be ratified.

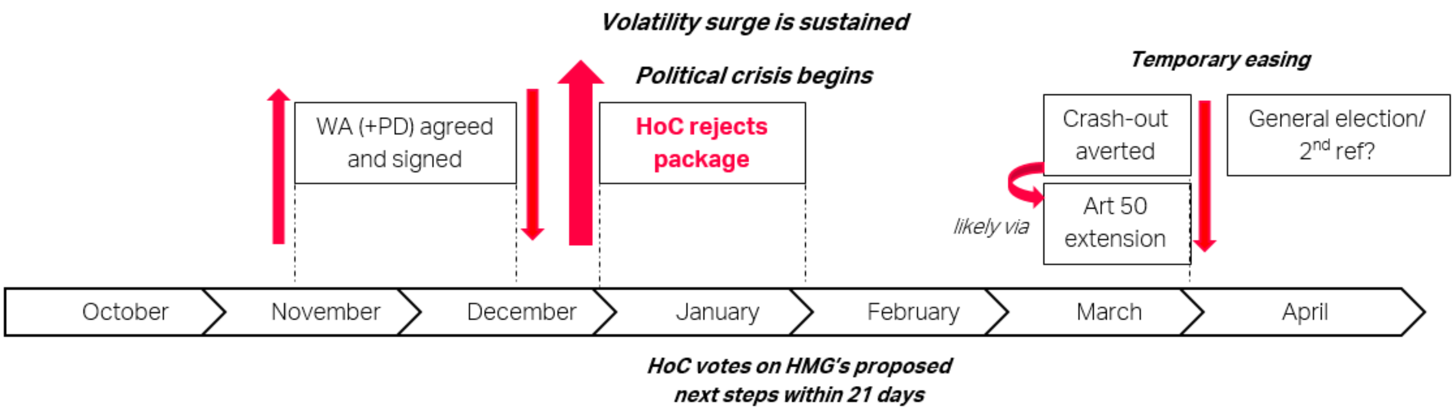
The first challenge will be to win over Mrs May's critics on both outer flanks of the Conservative party – that is, the hardline Brexiteer and pro-European lawmakers. We think that, in the event, all but a very few of these two kinds of rebellious Conservatives will vote for the WA. Their main motive in doing so will be the imperative of avoiding the political risks entailed by a "no-deal crash-out". Parliamentary rejection of the WA would trigger a white-hot political crisis. Such a crisis might result in Brexit – even in 'BINO' form – not happening, shattering the dreams of the hardliner Brexiteers. Preferable from a risk-reward perspective would be to wave through the WA and continue the battle over the final shape of Brexit during the transition period. This last consideration should also appeal to the Tory Europhiles, gunning as they are to fight the same battle only on the opposite side.

As our graphic shows, however, even corralling all those fractious Conservatives would still not give the government enough votes to ratify the WA. A further five votes would be required from among the ten DUP members and the fourteen Labour Brexiteers. If the DUP votes with the opposition, the WA would not pass. If, however, the likely fudges introduced into the Irish border backstop chapter of the WA were to induce the DUP at least to abstain, a handful of Labour Brexiteers would suffice to carry the WA over the line. As it happens, there are seven Labour lawmakers who have always supported Brexit regardless of the party leadership's position. Another seven think that a Brexit on relatively hard terms must now be delivered to honour the referendum, but may waver when it came to the crunch. But the number of 'hard' Brexiteers on the Labour benches would be enough.

Protracted volatility

The ratification vote in the House of Commons will be a close run thing. We think it more likely, on balance, that the WA will be ratified, putting the UK onto the smoother path described in the previous section. But the contrary outcome is clearly all too possible. If the House of Commons rejects the WA, the UK will then enter a period of fast-paced political and market turmoil, and any rally in UK assets following the preceding signature of the WA in Brussels will quickly be reversed. The graphic below shows the likely timing and pattern of the market volatility in such a crisis.

Scenario 2: Rougher passage



In these crisis conditions, the volatility will become indefinitely protracted. Under the terms of the EU Withdrawal Act 2018, the government will have to inform parliament of its proposed course of action within 21 days of a defeat in the Commons; parliament will then have a legally non-binding but politically weighty vote on the government's proposal (the Speaker of the Commons will decide whether this motion is amendable). The process will be messy, and could include parliament being asked to vote again on the withdrawal agreement, perhaps after some symbolic "clarifications"; an extension of the Article 50 process; and even a general election or second referendum.

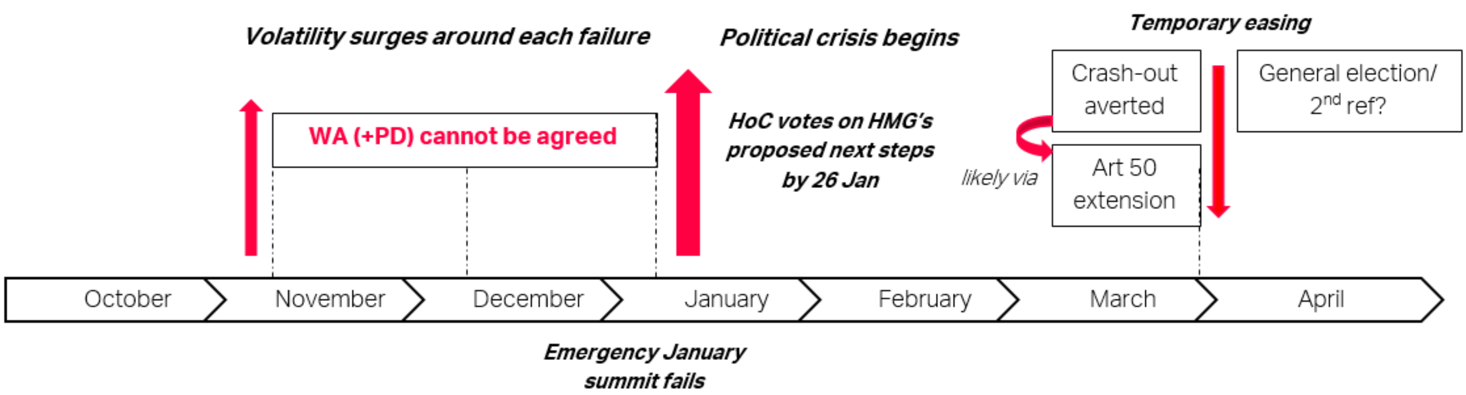
The UK will choose to extend Article 50 in preference to leaving without a deal. The volatility will be calmed by what we regard as a virtual certainty that if 'Brexit day' were approaching without a WA and hence no standstill transition, some combination of decisions by the UK government and/or parliament would produce a request by the UK to extend the deadline for the 'Article 50' withdrawal process beyond the two-year mark that falls at the end of March. The required unanimous agreement to any such extension by the EU-27 would almost certainly be forthcoming in any circumstances – and especially if, as would be likely, the clear purpose of any such extension would be to allow time for a further democratic consultation in the UK (a general election or second referendum).

The respite would only be temporary, however, as uncertainty – and associated volatility – would rise to a fresh peak in the run-up to any new popular vote. The timing, once again, would be tight since the EU would likely agree to extend the 'Article 50' deadline only until the eve of the European Parliament election on 23 May.

Roughest passage

Similar turmoil will beckon if a WA cannot be struck. If a Withdrawal Agreement simply cannot be agreed over the coming few months, perhaps because the DUP has threatened to withdraw its support for the government in the event of the proposed backstop being agreed, the UK will be heading to a similar bout of turmoil as that outlined above.

Scenario 3: Roughest passage



This path involves no progress at the EU summit in October, followed by the postponement of the next summit until the pre-scheduled December Council. The Council then fails to see a deal struck, and with markets increasingly anxious a new emergency summit is convened in early- to mid- January. Finally, the 21 January deadline specified in the EU Withdrawal Act comes and goes. A minister then has five days to inform parliament as to how the government wishes to proceed, as described above. And the UK enters a period of turmoil very similar to that described in the scenario of a parliamentary defeat on the Withdrawal Act – although without the benefit of the prior relief rally on the announcement of a deal – until the approach of March deadline concentrates minds.

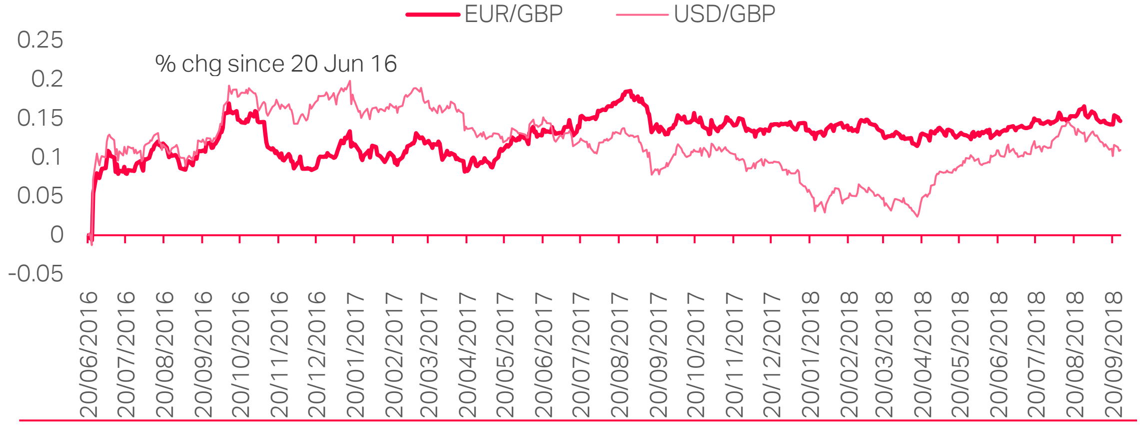
Investment Conclusion

The only possible trading conclusions are short term. The reason for this is that the analysis in this note applies just to what will prove the first part of the Brexit process. Barring only the remote scenario of Brexit being called off (either through a second referendum or the UK government rescinding its Article 50 notification), further chapters of the Brexit saga lie in store. These future episodes might involve even higher stakes since the UK will still have to decide what kind of long-term relationship with EU it prefers – with the renewed threat of a "crash-out" at the end of the standstill transition (now set for 31 December 2020).

Such deep medium-term uncertainty underlines the event-based nature of Brexit-related trades. This applies in particular to the upside potential. The question, in other words, is what kind of relief rally in sterling and/or gilts might reward investors positioning themselves for such a rally during the periods of peak fear along the three paths we have reviewed. The prudent answer looks like being that such rallies might be strong but then peter out soon enough in the face of the next round of uncertainties. So the logic of Brexit-related event trading includes prompt profit-taking. Put another way, GBP will not recover sustainably to pre-Brexit levels but instead continue to discount the outlook for at least some new trade frictions.

Another fine point concerns possible divergence between USD/GBP and EUR/GBP. The relief rally on the back of what we firmly predict will be the avoidance of a 'crash-out' could be equally well played through either of those crosses. But our FX strategist Oliver Brennan recommends expressing the conclusions of this political analysis of the Brexit process in the EUR/GBP cross which, as of now, reflects Brexit volatility in purer form than USD/GBP, in which other potent factors like US-China trade war, Trump risk and Fed policy are also embedded.

GBP vs EUR & USD since the Brexit referendum



Source: Bloomberg

The chart above brings out this point. EUR/GBP has been more range-bound since the referendum than USD/GBP – which fell almost to its pre-Brexit level during the USD sell-off earlier this year. It follows that the Brexit premium is stably and clearly reflected in EUR/GBP while it is harder to isolate in USD/GBP.

GLOBAL POLITICAL DRIVERS – OUR THEMES

Theme	Why it matters	Recent views	Risk
The squeezed middle	Squeezed lower/middle income households in DM countries might be inclined to look for radical solutions – whether to the left or the right.	Corbyn's Labour is interested not so much in redistribution, but in ideologically-driven supply-side changes. The new Italian government could be an unexpected safety valve for discontent.	
Great Power conflict: East Asia	North Korea's nuclear drive threatens to spark conflict in a region that already possesses its share of large-country tensions.	Kim Jong-Un's "Gorbachev gambit" raises the possibility of a geopolitical realignment.	
Cold War 2.0	The new US National Security Strategy implies a global geopolitical backdrop of great power tension.	The logic of Cold War 2.0 suggests that any truce will be temporary – US-China confrontation is here to stay.	
Great Power conflict: Middle East	The Middle East is a flashpoint for conflicts – with potential for spillovers that could affect the oil price, European security or Israel – a key American ally.	A North Korea-style approach with Iran is impossible – and risks perpetuating US quagmires.	

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Closed theme: Great power tension: West-Russia

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Closed theme: European Voter Revolt

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Labour participation unmasks political risks, 14 September 2017

GLOBAL POLITICAL DRIVERS: DEFINITION AND BENEFITS

Political and social developments are for the most part inseparable from economic drivers of risk and opportunity in the global economy and financial markets. But there are times when purely political factors play a decisive role. Global Political Drivers is a component of TS Lombard's macro research service that identifies and analyse such factors. As the title suggests, the selection criterion is the scale of the potential impact – that is, large enough to make the theme relevant for global asset allocators. The detailed insights on the subject matter of many themes should also offer value to portfolio managers and analysts focused on particular geographies and asset classes.

What are these drivers?

The drivers fall into two broad categories:

Geopolitical:

The risk of great power conflict in:

- Western Eurasia
- East Asia
- The Middle East

Domestic politics:

- Voter revolts in Europe
- Trump risk

Publication content and cycle

At any one time, we expect to have around six themes under active coverage. While we only focus on political drivers that we assess to be globally important, we occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes are published every other Thursday (alternating with Macro Picture). Each note leads on a particular driver, while noting more briefly any marginal changes in the risk profile of other topics on the service's current roster.

Core team

The service is led by Christopher Granville, a former UK diplomat who has two decades of experience providing political economy analysis for investors on Russia and the rest of the former Soviet Union. The other lead analyst is Jonathan Fenby, the Chairman of LSR's China Research service and the author of several books on Chinese history and contemporary China. The core team also includes Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team draws systematically on the insights of our senior economists and market strategists.

Authors

Christopher Granville
Managing Director, EMEA and Global Political Research

Constantine Fraser
Political Analyst