Global Political Drivers

# BREXIT: ROUGH PASSAGE TO SAFETY

Christopher Granville/Constantine Fraser

- **Brexit-related noise in UK politics is rising to a new pitch, prompting a review of our existing call that the risk of a 'no-deal crash-out' is negligible.**
- **Based on the evidence of this noisy season, we stick to our sanguine view.**
- **One piece of evidence stands out: a tussle involving anti-Brexit Conservative lawmakers has revealed the existence of a solid anti-crash out majority in the House of Commons.**
- **The rest of the noise is mere political spectacle and irrelevant to real investment risks: for regardless of the fate of Prime Minister Theresa May and her government, that parliamentary backstop will remain.**
- **Mrs May's present self-preservation manoeuvrings do, however, present a useful stress test for our view: opportunistic attempts to bring down her government are perfectly compatible with the anti-crash out backstop.**
- **Likely episodes of heightened sterling and broader financial market volatility reflecting crash-out fears between now and next March should be viewed as potential buying opportunities.**

# Creeping fears

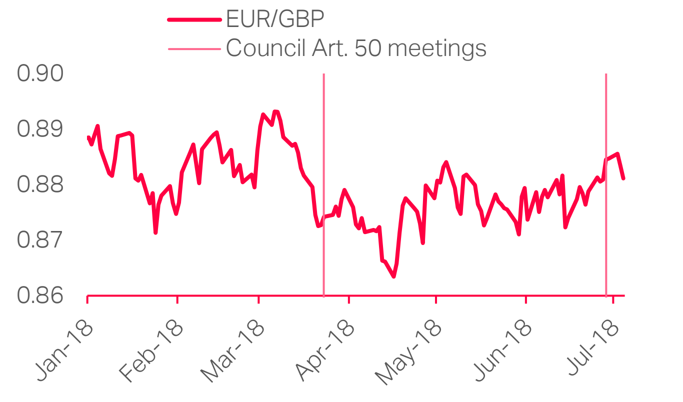
**Fears are rising again of a disorderly Brexit outcome in which the UK 'crashes out' of the EU in March next year.** This tail risk is not a potential *global* game changer – especially in the shadow of trade wars and the end of QE. At the same time, it is one for asset allocators to keep an eye on, since what would be a severe shock to the UK itself would ripple into the wider European economy at a time of – in any case – increasing uncertainty.

**So it's time to review our Brexit call.** We have argued that this 'Brexit crash out' risk is negligible – a view set out fully in the last update we published on this topic in our Global Political Drivers series back in April ('BINO' done deal bar shouting). With noise levels on Brexit rising again, now seems a good time to revisit this view.

**There is more than just shouting.** The domestic political noise in the UK could reach fever pitch this weekend with Prime Minister Theresa May set to confront the strong Brexiteers in her cabinet with her new softer approach. In itself, noise inside the 'Westminster bubble' would not necessarily deserve investor attention – especially as it is not yet echoed by severe volatility in sterling or some kind of seizure in the real economy. At the same time, unease is clearly present.

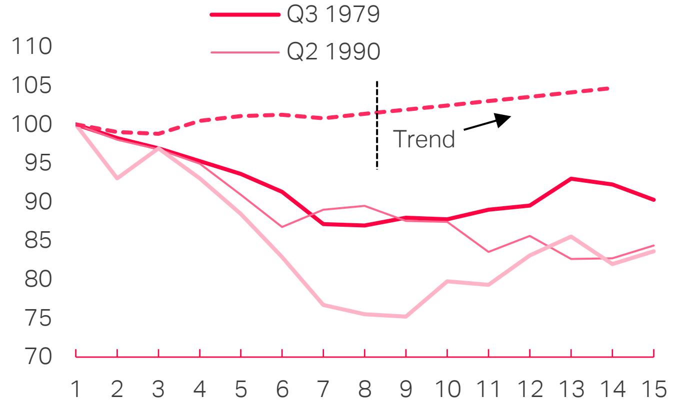
**Sterling was softer against the Euro in the run-up to last week's EU Summit** ('European Council') – reacting, it would seem, to the UK's inability to use that set piece to reduce uncertainties by nailing down the terms of the Withdrawal Treaty. The left-hand chart below points up this market reaction to political failure by highlighting the contrast with the previous Council back in March when sterling firmed somewhat on the back of the Brexit process advancing in the form of agreement on the terms of a 21-month 'standstill transition' once the UK formally leaves the EU next March.

**EUR/GBP this year**




Source: Bloomberg

**Business investment**
Indexed to 100, number of quarters




Source: Datastream, TS Lombard

**As for the real sector, some of the recent headlines are also in the 'noise' category – but not all.** These headlines include warnings about the consequences of a hard Brexit from large European manufacturers like Airbus and Siemens with substantial operations in the UK. Yet there is more to this than noise. While business investment in the two years since the Brexit referendum has held up better than after previous shocks, it should have been much stronger given that, in contrast to those historic episodes, sterling's 'Brexit' devaluation coincided with global economic strength and a tight labour market. Even without the new global uncertainties, the linear extrapolation shown in the right-hand chart above may have proved optimistic. Our UK economist Konstantinos Venetis forecasts FAI growth to slow sharply this year to 1% yoy from 3.4% in 2017. Confidence indicators are negative. Deloitte's latest CFO survey carried out in in early June showed the percentage of respondents expecting Brexit to hurt the business environment rising to 75%, up from 68% in April.

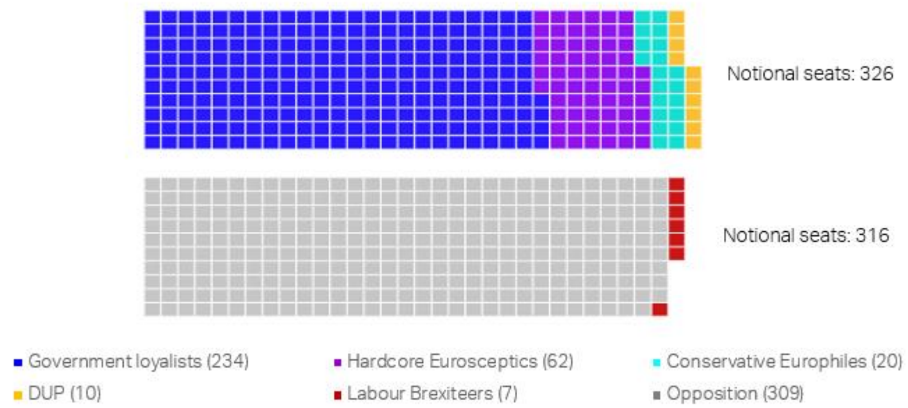
# The backstop that really matters

**Much of the present noise is irrelevant to the only Brexit-related question that matters for financial markets.** That question boils down to what happens in March 2019. Put another way, for many investors the UK's long-term future relationship with the EU – which will probably take until the middle of the next decade to settle – will seem for now an academic question. The main alternatives for next March are a no-deal 'crash out' or smooth passage out of formal EU membership and into the standstill transition.

**The second, benign scenario depends on the Withdrawal Agreement being signed and then ratified** (by the UK and European parliaments). While a crash-out would only happen if the two sides fail to seal that Agreement, that calamitous outcome is not the only possible result of such a failure – which could also lead instead to an extension of the two-year 'Article 50' withdrawal process beyond next March. Any such extension would have to be proposed by the UK and unanimously accepted by the other 27 EU member states.

**The "meaningful vote" row reveals a safe harbour.** As far as investment risks are concerned, we see the most important – and positive – outcome of the present noisy season in UK politics as being a demonstration that the House of Commons would not accept a 'crash-out'. The evidence for this came out of an abortive revolt against the government by anti-Brexit Conservative lawmakers last month on the "meaningful vote" question.

**May's fragile majority**




Source: TS Lombard

Those 'Tory' rebels (turquoise-blue shaded in the graphic below) had insisted that in the event of there being no deal with the approach of the March exit date, parliament should instruct the government on what to do next. Were these rebels to vote with the Labour and other opposition parties, the government would lose its majority, even allowing for the few hard-line pro-Brexit Labour lawmakers (red-shaded on the graphic) who tend to switch sides in the opposite direction. Faced with likely defeat, the government was forced to compromise with the rebels.

**The House of Commons would vote to extend the Article 50 deadline if necessary.** This means that if there was no Withdrawal Treaty deal by next February – either because negotiations on the Treaty had broken down or because parliament had refused to ratify it – the House of Commons would adopt a motion calling on the government to propose an extension of the two-year 'Article 50' withdrawal period. It seems a safe assumption that the other EU member states would go along with this. The alternative for them would be gratuitous self-harm. Their assent would also give them an option on the upside of the political crisis in the UK leading – via a general election or further referendum – to the Brexit project being abandoned altogether.

**None of that is likely to happen: the key point, however, is that a crash-out scenario is even less likely.** The decisive backstop is the majority in the House of Commons opposed to a disorderly 'hard' Brexit. This being so, the political fun and games now unfolding in the UK matters little. At time of writing, Mrs May seems poised to propose to her colleagues a new set of proposals to keep the UK *de facto* in the EU Customs Union (dressed up as a "Customs Partnership") and the single market in goods (but not services). Perhaps this will lead to an attempt by the Tory Brexiters to unseat her. Or she may succeed, only to find that the EU negotiators reject her proposals. Failure can come in many forms. But the House of Commons backstop against a 'crash-out' will remain.

**The present spectacle marks a revealing change from the usual 'can-kicking'.** In the best case – not only for Mrs May, but also for economic and financial market confidence – her gambit works, leading to the Withdrawal Treaty being signed and then ratified in Q4/18 and Q1/19. This uphill task prompts the question of why she is trying so hard. None of the matters she is now addressing are strictly necessary for the Withdrawal Treaty. They could all be put off until after the UK had formally left the EU and negotiated during the subsequent 'standstill transition' period (though the presently planned duration of this transition only until the end of 2020 will prove not nearly long enough in practice to settle the long-term UK-EU relationship). The standard political practice is never to grapple with difficult questions that can be postponed until later.

# Stress test passed

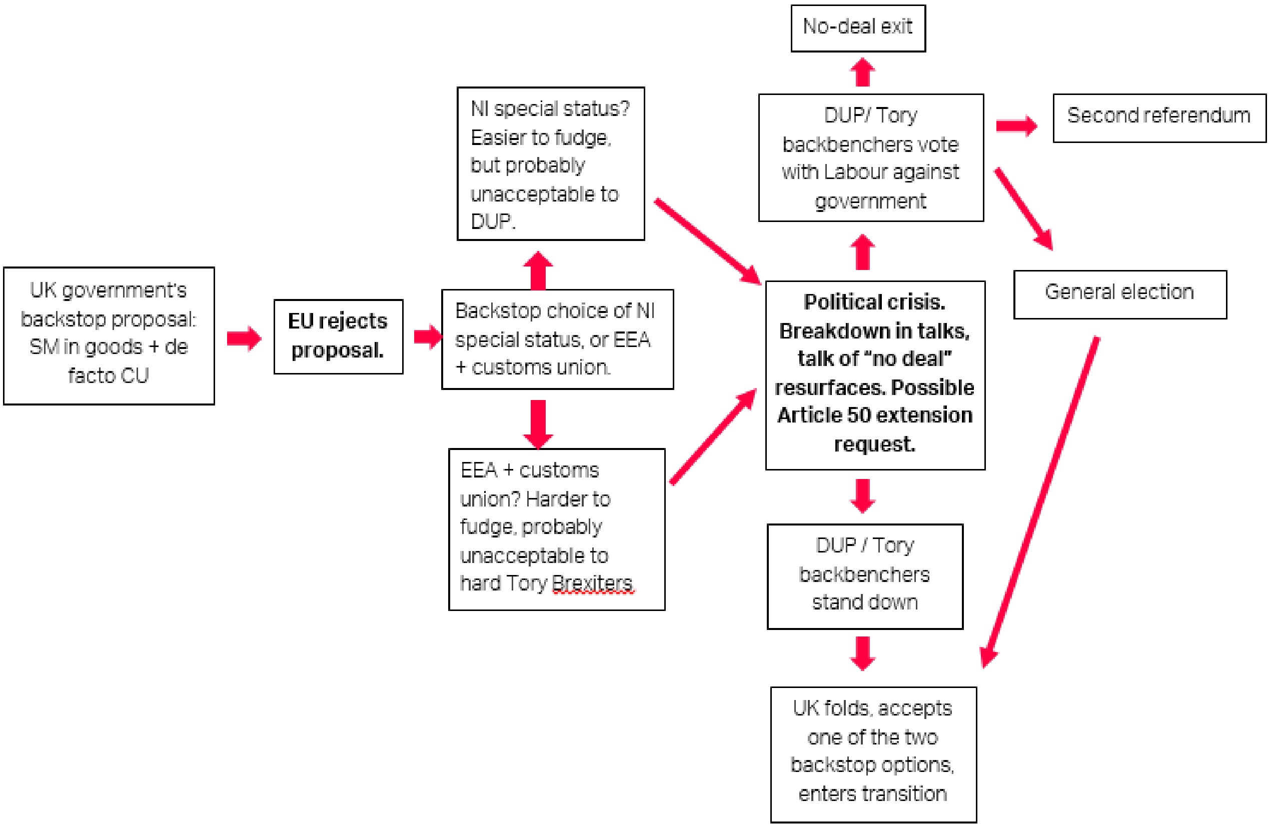
**The reasons why the UK government is tackling such long-term questions present a convenient stress test** of our sanguine view that the risk of a crash-out is negligible. Behind the UK's present political convulsions lies another backstop. This is the famous provision on the Irish border which is the only substantive part of the Withdrawal Treaty that has yet to be agreed.

**To summarize briefly on the 'Irish border backstop':** it was conceded by Mrs May last December as a way to paper over the cracks – or rather, the abyss – between the UK government's stated determination to leave the Customs Union (CU) and Single Market (SM) and, on the other hand, its treaty obligation under the 1998 Belfast Agreement to maintain an open border between Northern Ireland and the Republic of Ireland. The backstop provides in effect that if, further down the road, the UK fails to find some way of squaring that circle which the EU can accept, Northern Ireland would in that case – under the terms of the Withdrawal Agreement (itself an international treaty) – remain inside the CU/SM. In other words, although Northern Ireland would remain in the UK, an economic border would appear in the Irish Sea between Northern Ireland and the rest of the UK.

**Mrs May has stated that "no British Prime Minister could accept such a provision".** However that may be, she herself might not survive in office were she to propose it to parliament, since her minority government is propped up by the ten lawmakers of Ulster's Democratic Unionist Party (DUP). That DUP contingent in the House of Commons might refuse to vote for the ratification of a Withdrawal Agreement with such a backstop. Many traditional Conservatives would also dislike this backstop. But they could be won over by the argument that the backstop is theoretical and will be replaced by the end of the transition period with an acceptable alternative solution. Since the priority of mainstream Conservatives is to leave the

EU with minimal fuss and political danger, that argument would probably work. But it may not sway the DUP, for which this question of diluting the union – possibly heralding a united Ireland – has existential importance.

## Brexit endgame: crisis scenarios




Source: TS Lombard

**EU-acceptable Irish backstops risk rebellions in Westminster.** All this explains why Mrs May is trying to find arrangements for the whole of the UK that would keep the Irish border open. The EU side might reject her proposals as unacceptable "cherry-picking" of the single market. The logical counter-proposal from Brussels would be an alternative backstop whereby the UK as a whole stayed not only in the CU but also in the SM as a member of the European Economic Association (EEA). For the hard-line pro-Brexit group on the Conservative benches (purple-shaded in the graphic on page 3), this would be a "red rag" in the same way that the Ulster-as-a-special-economic-zone solution would be for the DUP. A rebellion by this hard Tory Brexiteer group could also result in a failure to ratify the Withdrawal Treaty.

**Here comes the stress test for our view.** Any scenario of the Withdrawal Agreement being rejected by the UK parliament would involve one or another faction on the government side voting with Labour and other opposition parties. We have argued so far that the opposition lawmakers are the kernel of the anti-crash out backstop. What if they were tempted to try and bring down the government by joining forces with one or another rebel group to throw out the Withdrawal Agreement? Would that not risk a crash-out to which, on principle, the Labour Party – and still more the various other opposition parties (Scottish Nationalists, Liberal Democrats) – are opposed?

The answer is that the same opposition lawmakers who had helped block the Withdrawal Agreement would then regroup with the Tory Europhiles to form the anti-crash out backstop. That is, the House of Commons would still vote for a motion calling for an extension of the 'Article 50' withdrawal period. Even in the most dramatic scenario in which the government was meanwhile being brought down by a motion of no-confidence leading to a general election, the motion to extend 'Article 50' could be adopted either by the outgoing parliament or (depending on the timing of any such emergency election) its successor.

## Investment conclusion

**Noise is inevitable, intrinsic – and a source of opportunity.** All these scenarios are summarized in the flow chart graphic on the previous page. The best one-word description would be: noisy. Noise, in turn, means market volatility, with sterling as ever in the front line. The more important point is that noise is not only inevitable in a political process as fraught as Brexit process but also an intrinsic feature of that process. The reason for this is brinkmanship. It is in the nature of such negotiations to go down to the wire. Moreover, the UK government has an interest in brinknmanship to improve its chances of persuading various potential rebel camps that they must choose between the Brexit solution on offer, however distasteful it may be to them, or the worse alternatives of Brexit never happening and/or a government collapse and the risk of Jeremy Corbyn's Labour Party coming to power.

To sum up, periods of heightened volatility for sterling – and UK financial assets – are to be expected between now and next March. This volatility will reflect fears of a crash-out Brexit. Based on the political realities discussed in this note, such episodes should be viewed as opportunities to buy on weakness.

# 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.<br>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. | |
| Trump Risk | Donald Trump has cultivated a reputation for unpredictability –from military intervention to trade disputes. | "Trade war" tensions have key geopolitical components – both in the case of China and in that of Europe. | ⬆ |
| 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. | The US withdrawal from the Iran nuclear deal will be self-defeating, but it also spells escalating regional conflict. | ⬆ |

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China Stability Risk: Post-Deng Chapter 2, 7 December 2017
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Shale Revolution: Russia's missing trick, 22 June 2017

Closed theme: Great power tension: West-Russia

Russia-West: Cool Peace, 4 January 2018
Cyber wars: Add to the risk-off list, 20 July 2017

Closed theme: European Voter Revolt

Europe and America fear factor review, 24 November 2017
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 opptortunity in the global economy and financial markets. But there are times when purely political factors play a decisive role. Global Political Drivers is a new component of our macro research service that will identify and analyse such factors. As the title suggests, the selection criterion will be 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 will only focus on political drivers that we assess to be globally important, we will occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes will be published every other Thursday (alternating with Macro Picture). Each note will lead 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 will be 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 will be 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 will also include Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team will draw systematically on the insights of our senior economists and market strategists.

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