Brexit update

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Key risk

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Brexit uncertainty continues in the UK. Leaving without a deal by 31 October is a distinct possibility, an early general election looks even more likely. Another referendum in 2020 is also possible. This is all likely to weigh on sterling and UK equities, though UK government bonds are supported by global factors and the expectation that the Bank of England would cut interest rates.

What is so important about the 'deal'?

The Withdrawal Agreement has three parts:

1. financial payments that the UK must make to the EU (estimated at £39bn),
2. citizens' rights,
3. the backstop

The backstop is the controversial part. It is designed to prevent a hard border between the north and south of Ireland by keeping the UK in the EU Customs Union and Northern Ireland in 'regulatory alignment' until suitable alternative arrangements can be found. Critics fear that it could trap the UK permanently in the EU Customs Union, which means it would be unable to strike its own trade deals.

With a deal, the UK has a transition period to the end of 2020 to sort out its relationship with the EU in a myriad of areas (trade, security, air travel etc.). Without a deal, the current arrangements would be abruptly severed.

Scenarios:

There have always been a series of scenarios since the Brexit referendum three years ago. The new prime minister (PM) has dramatically changed the various probabilities.

These are our current guesses:

By 31 October: no deal Brexit 45%; general election 50-55%; leaving with a deal 0-5%. (There is also a chance of a short extension were there to be a general election).

After 31 October, probabilities are even more of a guess: early general election 80%, in which case Conservative majority 20%, Labour majority 10%, Conservative minority government 30%, Labour minority 40%. There is perhaps a 20% chance that the current minority government stumbles on for another year or more.

A Labour minority government (with Lib Democrats and Scottish Nationalists) would go for a referendum, the outcome of which is arguably 50:50 (polls show a lead for Remain by the same amount as they did before the referendum in 2016).

If we combine the probabilities before and after 31 October, the prospects of a no deal exit are well above 50%. Remain is a possibility (given a second referendum which voted to Remain) and leaving with a deal still has a slim chance.

Implications for sterling: a 'no deal' is being priced in but there would still be 10-15% downside given immediate disruption. Longer term, were the Conservatives to win a general election and Brexit proved to be less damaging than feared, there could be a decent recovery. A Labour government would potentially be bearish for sterling. But a minority Labour government and a referendum vote to Remain might reverse at least part of the decline over the last three years. Leaving with a deal, although unlikely, would be the most bullish scenario for sterling.

Implications for UK equities: with most of their earnings from overseas, a weaker sterling would support the sterling price of most FTSE 100 companies. Domestically-focused companies would suffer.

Implications for UK government bonds: the Bank of England would probably ease policy on a no deal Brexit, which would lead to a rally in sterling bonds. The sovereign credit rating might be cut from AA to AA- but market implications of that would probably be modest.

Broader implications: 'no deal' Brexit would be a 'risk-off' event, bearish for the EU, hitting the euro and European equities. But the effects would probably be modest, certainly much smaller than those on the UK.

What has happened in the last few days?

The prospect of the UK leaving the EU on 31 October with a deal have almost vanished. PM Boris Johnson has demanded that the EU27 ditch the Irish backstop in the Withdrawal Agreement. The EU cannot concede this. Theresa May failed to get a deal through parliament; Boris looks like he might not even try. Having said that, with 'no deal' now a serious risk, the Irish government is under pressure to concede changes to the backstop, such as a five-year time limit. This might persuade enough MPs to vote for the Withdrawal Agreement. All this is possible but unlikely.

> Uncertainty will continue for years to come, whatever happens in the next few months, but much of this is already priced into markets.

The chances of leaving with no deal on 31 October have therefore markedly increased yet an early general election could be even more likely:

(i) Parliament has a majority for ruling out 'no deal' though the mechanics of this are difficult. If it succeeded, the government might choose to call an election.

(ii) The government has a tiny majority and enough Conservative MPs have said that they will bring the government down in the event of a 'no deal' being pursued. Again, the mechanics of this have some difficulties.

(iii) The PM is in full election mode, promising tax cuts and higher spending.

(iv) The government has had a bump in the polls. If this were to continue, the PM might gamble on a general election.

The PM would undoubtedly prefer to hold an election after Brexit on 31 October. This looks hard to achieve, given the slim majority and the prospect of Conservative MPs voting the government down.

Economic Impact

The EU is the UK's biggest trading partner, the trading relationship has built up over 40 years and the UK has been the dominant beneficiary of inward direct investment, at least in part because of EU membership. A no deal Brexit would rupture those arrangements. In many cases, there would be stop gap measures but the EU27 would be focused on limiting the damage to themselves and increasing their competitive advantage.

The UK would need to establish a trading relationship with the EU. But they would be negotiating as a third party and any trade deal would have to be ratified by all 27 countries (and some regional parliaments). Even if the EU agreed to a Free Trade Deal and WTO Rules (a big if), considerable trade frictions would remain. A proper trade deal would take years. Trade deals with other countries could be done, notably with the US, but many other countries would likely hesitate.

Nonetheless, trade would continue, and the UK would remain a country with a flexible and well-educated labour force, strong infrastructure and a highly competitive currency. Uncertainty will continue for years to come, whatever happens in the next few months, but much of this is already priced into markets.

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