

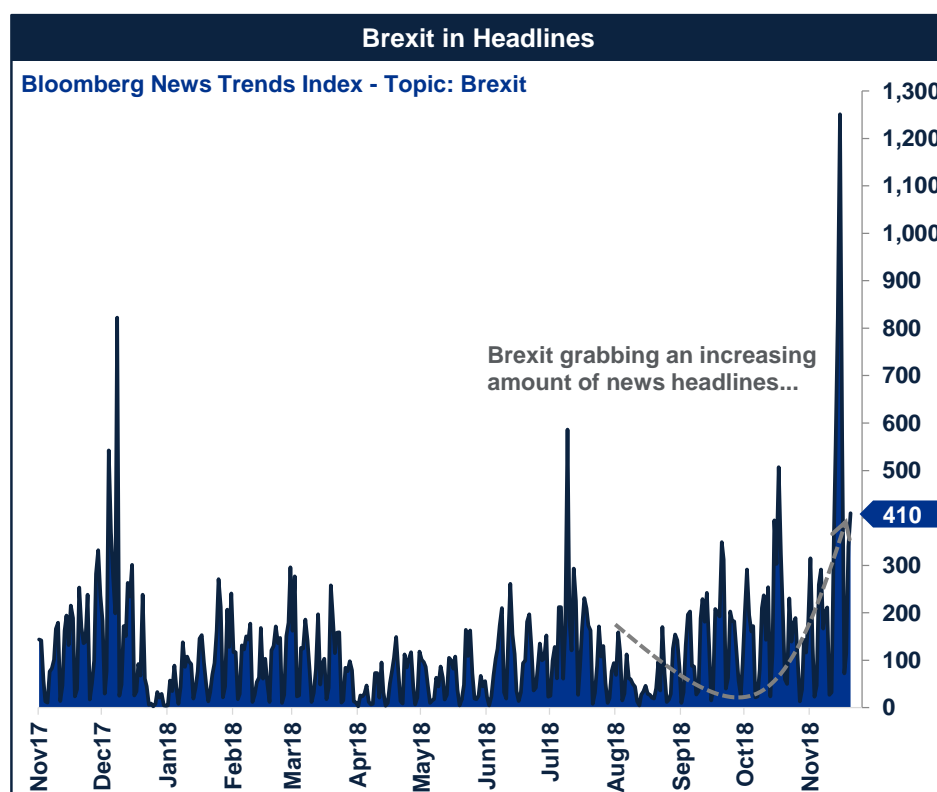
Brexit Update

Still a clear and present danger

The closer we get to March 29th 2019, the day on which the U.K. is scheduled to leave the European Union, the further the U.K. seems to be from agreeing the terms on which the divorce will be struck. However, more than just the pure economic arguments for and against Brexit that have driven the narrative over the past two years, it is now political uncertainty that is weighing most heavily on U.K. risk asset, and currency, sentiment.

The U.K. government now faces three possible outcomes in terms of Brexit itself, regardless of who is Prime Minister.

1. Brexit based on an agreed 'Withdrawal Agreement' after which a transition period will follow to iron out and agree all the necessary trade and financial arrangements etc. According to the wording of Article 50, which stipulates how a member state should leave the EU, the transition period will be set at 2 years. To main Brexiteers, such an 'agreed' divorce would be an unacceptable 'soft' Brexit
2. Brexit, but with no 'Withdrawal Agreement' in place by March 29 2019. A so-called 'no deal' scenario would mean the U.K. leaving the EU with no agreements in place with its trade partners and would need to adopt World Trade Organization rules as it negotiates individual trade treaties. This is the 'hard' Brexit that many Brexiteers are calling for and that Remainers fear so deeply.
3. No Brexit. A second referendum results in the electorate now rejecting the idea of leaving the EU and the project is cancelled.



Source: Bloomberg/FAB

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Striving for the impossible

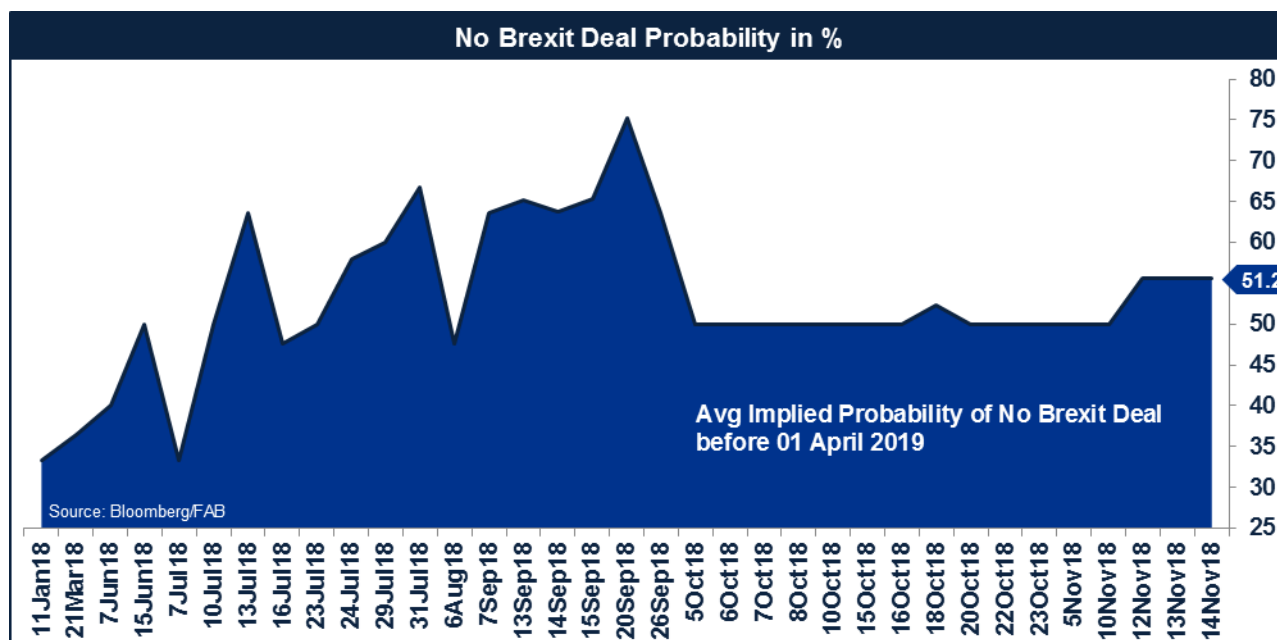
Prime Minister Theresa May says she is committed to delivering the Brexit that the British electorate voted for, but therein lays the overarching problem of the process.

The result of the plebiscite being 51.89% in favor of leaving the EU and 48.11% in favor of remaining a member of the Union, means that, on average, the U.K. electorate actually voted in aggregate for something bang in between 'in' and 'out'. The majority in favour of leaving the EU was just 3.78%.

Mrs. May therefore seems to be on a hiding to nothing trying to accommodate and please all factions. There seems zero possibility of finding a 'one-size fits all' solution.

Delivering what the public voted for is impossible and it is this futility that has resulted in the recent ministerial resignations, renewed Conservative party infighting and talk of a vote of no confidence.

While the threat of a vote of no confidence and a leadership challenge against Mrs. May appears to have eased for now, we would conjecture that the path of least resistance for GBP investor sentiment over the coming months should remain resolutely lower. The threat of a mutiny against Mrs. May remains a clear and present danger for U.K. risk assets, with investor sentiment highly susceptible to headlines concerning her position in 10 Downing Street.



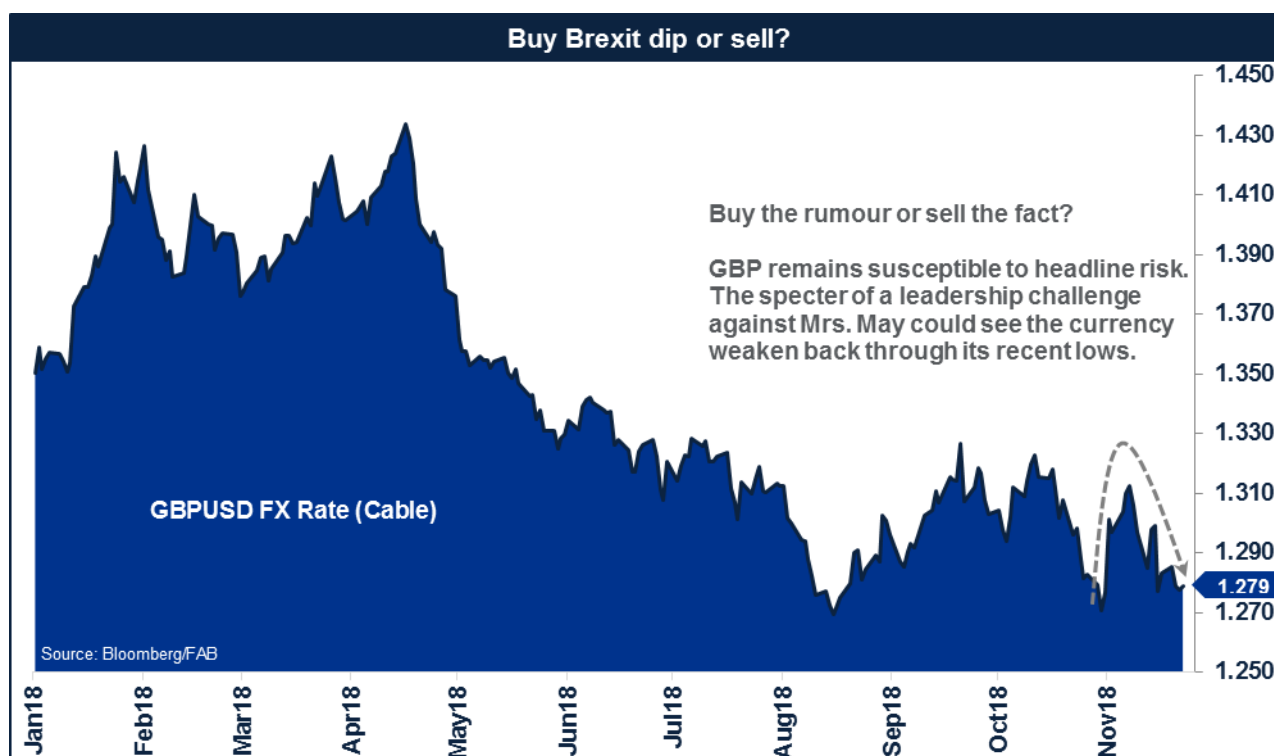
Economic consequences

The economic consequences of scenarios 1 and 2 above ('soft' and 'hard' Brexit) may be near-impossible to quantify accurately at this stage given the uncharted nature of this journey. Anyone telling you otherwise is simply guessing. By definition the in and out campaigns will see very different outcomes.

The bottom line though is that leaving the EU under either guise will have a degree of negative impact on the U.K. economy. The London School of Economics has predicted that Brexit will cost the U.K. economy between 1% and 10% of GDP in the long run, with the more severe impact coming from a hard Brexit or 'no deal, crash out of the EU' Brexit.

Indeed, the U.K. economy is expected to take a (short-term) hit from a hard Brexit outcome as trade flows stall and economic activity shifts capacity and investment into the EU. The Bank of England has warned of 'big economic consequences' and forecast a drop in London property prices of as much as 30% in the case of a disorderly, hard Brexit. Governor Carney has said emergency interest rate cuts may be needed under such a scenario.

Scenario 3 would likely trigger a relief rally in GBP-denominated assets as the macro outlook reverts to the status quo, but even then, this would perhaps only emerge after a sharp spike in volatility and investor uncertainty assuming it is only the result of a second referendum.



When is a deal not a deal?

News that the UK (i.e. Mrs. May) and EU have finalized a draft Withdrawal Agreement brings us no nearer to the decree absolute of divorce process. If anything it has only accentuated the inter- and intra-party disagreements. We see no meaningful chance of the Withdrawal Agreement being successfully voted through parliament, which it must be in order to take effect.

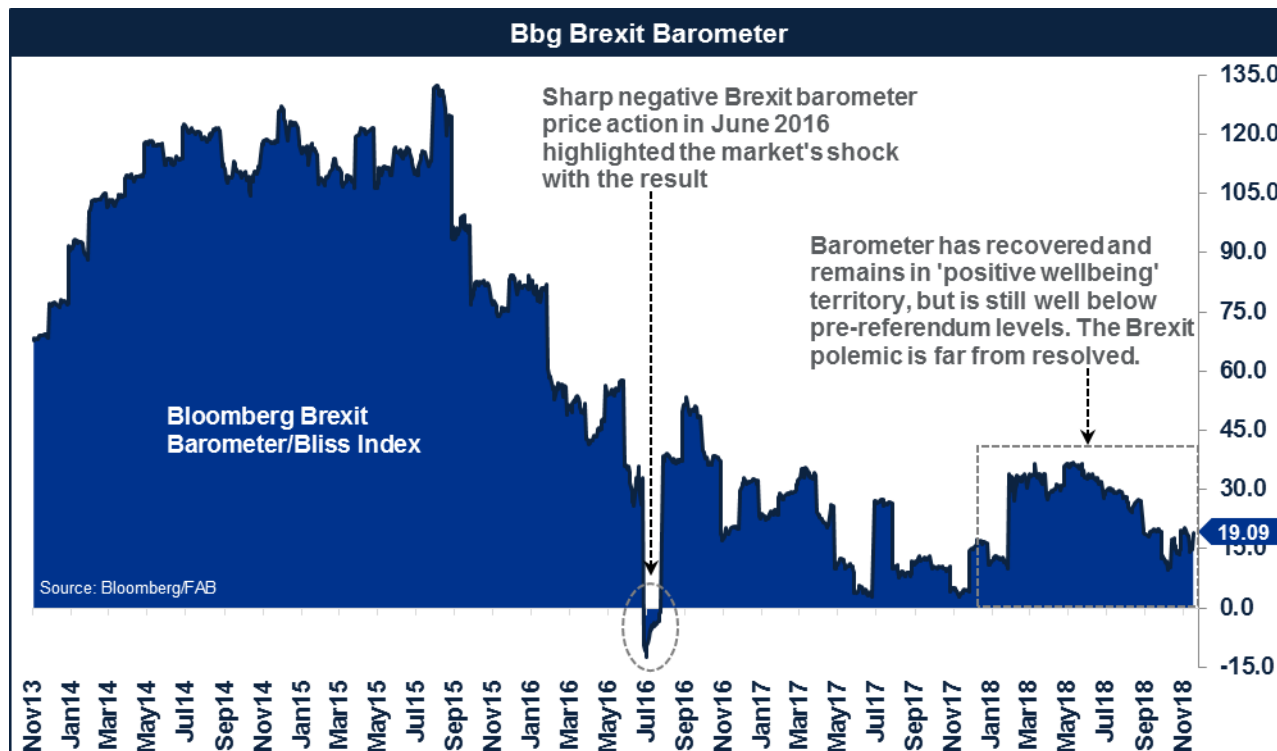
Of the key elements of the proposed 'Withdrawal Agreement', it is argued that one of the major reasons not to support it is that while the document comprises 585-pages, it contains just 23 references to the word 'future' across the entire document; by definition, the balance of the paper is all about the Withdrawal process itself. Moreover, we note that just 7 pages address the future relationship between the U.K and the EU.

The fact that the document recommends that the U.K. remains in the EU Customs Union, to avoid dealing with the currently insurmountable Northern Ireland border question, will also be a point of much contention in the coming months. Moreover, if both parties are unable to arrive at an agreement on Ireland during the 2 year transition period, then the so-called 'backstop' will come into force, meaning that NI will maintain adherence to EU rules, requiring the UK to remain part of the Customs Union. The most contentious part of this arrangement though would be that, in the case that a solution to the Irish border polemic cannot be reached during the transition period, the UK will not be able to unilaterally end the backstop.

As such, we feel that there is little prospect of the 'deal' getting Brexiteers' support since it is based on the principle of the U.K. remaining closely aligned to the EU through the EU customs unions. The pro-Brexit camp wants a much clearer-cut divorce in order for the U.K. to then be able to sign new trade deals with other (EU and non-EU) countries.

The Democratic Unionist Party (DUP), who is keeping the Conservatives in Downing Street through their support arrangement, will also not support this 'deal' if it implies even the slightest differences in the trade treatment of Northern Ireland (via a customs arrangement) compared to that of the rest of the U.K.

Meanwhile, don't expect the 'Remainers' to support the Agreement if/when it comes to parliament. They won't support any proposal that results in the U.K. leaving the EU. The clue is in that group's name.



Where now?

Theresa May travelled to Brussels this week to meet European Commission President Jean-Claude Juncker in a (final?) effort to tweak the terms and wording of the 'Withdrawal Agreement' that both she and the EU elite hope to strike. The coming days will tell whether she succeeded or not.

May hopes that EU leaders will then sign off on the 585-page document as well as the future partnership paper at a special summit due to take place in Brussels on Sunday (November 25th). But watch out for the risk of that summit being cancelled. If May pushes too many changes and concessions the risk is that the EU will walk away.

At some stage in December (date to be set still) we expect Mrs. May to put the 'final' deal to a vote in parliament. She will be praying that MPs vote in favour, but the current backlash, resignations, threat of no confidence vote and general opposition to her proposals suggest that the chances of success are currently very slim, at best.

If the PM loses that vote, she will have set the U.K. on course to crash out of the EU without a deal, on March 29 2019. While we would expect Mrs. May to battle on after such a loss (at least initially) she would effectively become significantly weakened. If her position were then deemed untenable, her options back from there may include calling an election or a second referendum. The Brexit polemic is about to get even more interesting.

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