

Brexit monitor

Get ready for the end-game

Main takeaways

- As the Brexit end-game has started, this report gives an update to the Brexit negotiations, the possible outcomes, what the obstacles are and what we expect of the economy and GBP.
- In our view, the most likely outcome is a ‘decent Brexit’, which is soft in the sense that the UK stays close to the EU but hard in the sense that the UK is leaving the single market. The Irish border remains the most difficult issue.
- The likelihood of a ‘no-deal’ Brexit has increased. While there are most likely enough hard Brexiteers to trigger a leadership contest, it is more difficult for them to win it.
- The deal is likely to include a legally binding withdrawal agreement and a political declaration on what the future relationship beyond the transition period should look like.
- The real test for Prime Minister Theresa May is when the withdrawal deal is put forward for a vote in the House of Commons, as there are enough hardliners to vote it down, unless PM Theresa May persuades Labour MPs to vote in favour. We expect Theresa May to be able to get some Labour support, as her deal is better than the alternative (no deal) and the rationale would be that Labour could try to soften Brexit at a later point.
- The likelihood of a general election or a second referendum before 29 March is low. A soft Brexit keeping the UK in the single market also seems unlikely.
- While growth is still slower than before the referendum, it is still above trend and the unemployment rate is on a falling trend.
- The Bank of England seems to have launched a ‘once-a-year hiking cycle’ and we do not expect the next hike to arrive before May 2019, depending on the outcome of the Brexit negotiations.
- Brexit remains the key driver for the GBP and uncertainty related to the outcome is likely to keep the GBP volatile and undervalued in the coming months. We expect EUR/GBP to break substantially lower when markets can start to price out a ‘no-deal’ Brexit risk premium. We forecast 0.84 in 6M and 0.83 in 12M.
- In case of a ‘no-deal’ Brexit, we expect EUR/GBP to spike higher and a test of 1.00 should not be ruled out.

Table of contents

- Page 1: Main takeaways
- Page 2: Decent Brexit most likely outcome
- Page 3: Likelihood of no-deal Brexit has increased
- Page 4: Divided Conservative Party and the Irish border issue
- Page 5: Likelihood of a Conservative leadership contest and the likelihood of a second referendum or fresh elections
- Page 6: The economic outlook
- Page 7: FX outlook

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Decent Brexit still most likely outcome...

With 185 days to go before the UK leaves the EU formally on 29 March 2019, **we are fast approaching the end-game of the Brexit negotiations, which take place in Q4**. The negotiations must be concluded before the formal exit date, as both the EU and especially the UK need time for ratification of the final withdrawal bill, which will probably take a few months (see also box to the right). In case of an agreement, we think it will be approved easily by the EU institutions but it may be more difficult in the UK Parliament.

While the aim previously was to reach an agreement at the EU summit in October, it is more likely to happen at the extraordinary EU summit on Brexit in November or, if postponed again, at the ordinary EU summit in December. While the EU's chief negotiator Michel Barnier not long ago said an agreement was reachable within six-eight weeks, see *Bloomberg*, the negotiations seem to be standing still at the moment after the Salzburg meeting did not go well.

Our base case remains what we have labelled a 'decent Brexit' (75% probability), which is hard in the sense that the UK leaves the EU single market but soft in the sense that the two parts will reach an agreement, which keeps the UK and EU closely connected. We think the deal will look something like the EU-Canada free trade deal (CETA) but it could be more aligned/harmonised on standards and rules than is the case for Canada in order to make trade more frictionless. The deal may also be more comprehensive on services, although PM Theresa May has said the UK is leaving the single market for services. After the EU's rejection of the Chequers plan, *The Telegraph* says a majority of May's Cabinet members want to push for a pure CETA deal, where the UK does not stay aligned with EU rules and regulations.

Ratification process

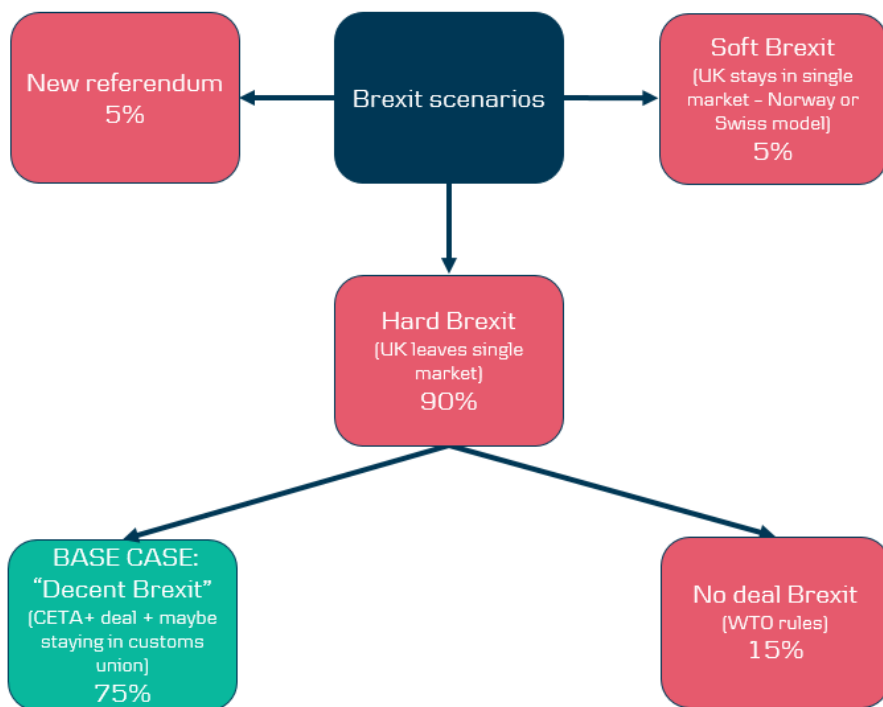
UK: In the UK, the final deal needs to pass both the House of Commons and the House of Lords (simple majority).

EU Council: The negotiated agreement would need to be adopted by a qualified majority of 72% of the remaining 27 Member States, representing 65% of the EU27 population

EU Parliament: Simple majority vote (including UK MEPs).

Source: EU

Brexit scenarios



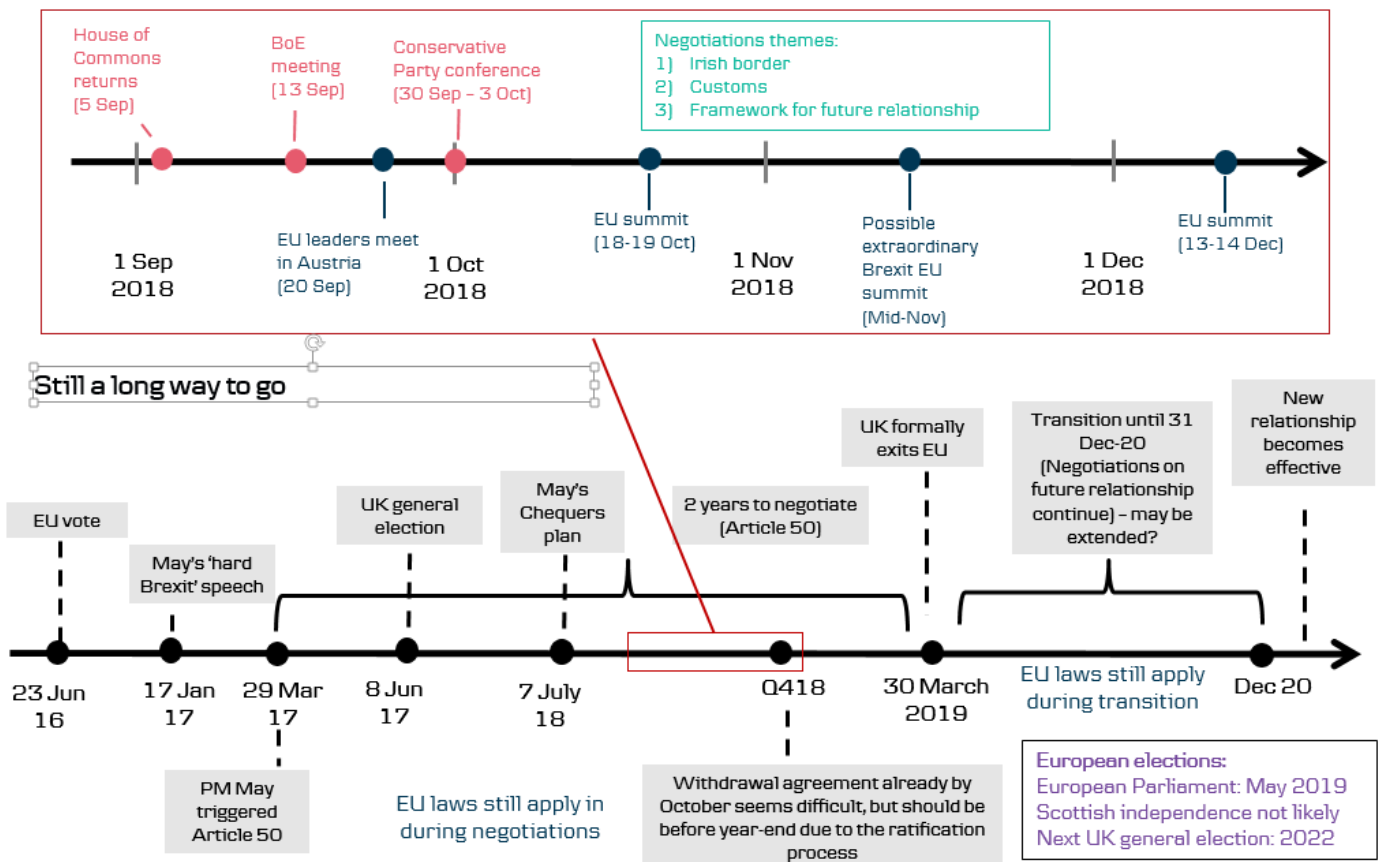
Source: Danske Bank scenarios

To us, it is not a big surprise that there is much political noise, not least ahead of the Conservative Party Conference beginning on 30 September. PM Theresa May is not able to make any compromises right now, as it would be politically damaging. It is very common that political negotiations are not concluded until right before the deadline, when the politicians start feeling the pressure.

We believe the likelihood of a second referendum or fresh elections is low at the moment, probably even less than 5%, see page 5.

A soft Brexit keeping the UK in the single market (Norway or Swiss model) also seems unlikely (5-10%), as the UK would be worse off compared to staying in the EU and many politicians think the voters' opposition to the EU is because of the free movement of people.

Brexit timeline - the Brexit clock is ticking



Source: Danske Bank

... but the likelihood of a no-deal Brexit has increased

While a 'decent Brexit' is still the most likely outcome, the likelihood of a no-deal Brexit has also increased recently (probability 15%), in our view. While we think one should look through PM Theresa May's hard rhetoric at last week's press conference following the Salzburg meeting, it still signals that the Irish border issue is very challenging, see page 4.

The hard Brexiteers may not have sufficient support to oust PM Theresa May as a political leader (see page 5), but they may vote down her Brexit deal in parliament, if they believe it is too soft.

The Financial Times has reported the hard Brexiteers think as many as 80 Conservative MPs may vote against any deal looking anything like what PM Theresa May has proposed in her Chequers plan (which basically suggests the UK stays aligned with EU rules on goods to maintain smooth goods trading). If so, PM Theresa May is relying on Labour support, which they have ruled out, see *Sky news*. **The Labour Party has no incentive to make life easier for Theresa May, but when it comes down to voting, we believe the Labour MPs will have a hard time rejecting what the government has agreed with the EU**, as 1) it would be difficult for Theresa May to get more concessions if she is sent back to Brussels, 2) Labour MPs would fear a no-deal Brexit and 3) you can always soften Brexit at a later point.

Divided Conservative Party complicates negotiations

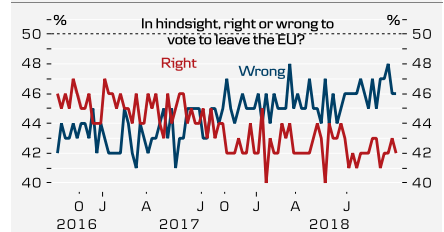
The problem for PM Theresa May is that there is really not a majority for anything in the UK. Roughly speaking, 50% want to remain in the EU, while 50% want to leave (lately an increase in the proportion of voters thinking it was wrong to vote to leave the EU). Brexiteers are also divided into soft Brexiteers and hard Brexiteers. And it does not end here: the hard Brexiteers are also unable to find common ground for what they want. In general, hard Brexiteers think a Canadian style free trade agreement is fine but, unlike what PM Theresa May has proposed, without the alignment/harmonising of standards. Alternatively, Brexiteers like Jacob Rees-Mogg have openly said that trading on WTO rules is not a bad starting point. The moderate Conservatives fear that it would damage the economy if the UK drifts too far away from the EU market.

Difficult to make a border invisible

The main obstacle is the issue with the Irish border, as both the UK and the EU want to avoid a hard border, which is difficult when the UK wants to leave the single market (and customs union) and the EU wants to protect the integrity of the single market. **The withdrawal text is 80-90% agreed upon but the backstop solution on the Irish border (i.e. how do you avoid a hard border after transition ends in the event no permanent solution is found) is interpreted differently by the two sides and is currently being renegotiated.** The EU's proposal is to keep Northern Ireland part of the EU customs union and create a border between Great Britain and Northern Ireland. PM Theresa May has dismissed this and said no UK prime minister could ever agree to split the country in two (and she is being supported by the Democratic Unionist Party from Northern Ireland, who want to keep Northern Ireland a part of the Kingdom at whatever the price). The UK government thinks the backstop should maintain regulatory alignment for the whole UK but the EU is afraid that this is violating the integrity of the single market (still being in the single market for goods but not for services and labour). **And this highlights the main problem: how do you avoid making a visible, hard border where there logically should be one and both the UK and the EU want to respect the Good Friday Agreement?** We think the two sides must be pragmatic and think trusted trade schemes, local control/checks at the companies and preferred access for Northern Irish companies are part of the solution. If so, there would still be a border but the checks would not be carried out at the geographical border.

What the future relationship should look like is another problem. The EU leaders have rejected PM Theresa May's Chequers plan, as they consider it cherry picking. Among the Conservative MPs, they are divided on how close the UK should be to the EU going forward. We think the two sides agree on a political declaration stating that the EU and the UK should stay closely connected, but it is important to note that it is not legally binding. **The final and legally-binding free trade agreement is set to be negotiated during the transition period lasting until 1 January 2021.**

UK is still divided on the Brexit question despite a small increase in voters thinking it was wrong to vote to leave the EU



Source: NatCen Social Research, Macrobond Financial

Difficult for the hardliners to get rid of PM Theresa May

The annual Conservative Party Conference begins on 30 September and lasts until 3 October. It is going to be very interesting, not least since many of the hard Brexiteers speak explicitly about their wish to replace Theresa May with one of their own, most notably ex-foreign secretary Boris Johnson. **While there are certainly enough hard Brexiteers to trigger a leadership contest (requires the signature of 48 Conservative MPs), the challenge for them is that it requires 158 Conservative MPs to vote for no confidence in PM Theresa May, a number which seems more unlikely.** The pro-Brexit Conservatives are very attention-seeking but there are many more moderate Conservative MPs who are supportive of PM Theresa May and have a softer stance on Brexit. Theresa May has vowed to fight any candidate in a potential leadership contest.

In our view, it seems unlikely that the hard Brexiteers will trigger a leadership contest before PM Theresa May's withdrawal bill is put before the House of Commons. The easiest way for the hard Brexiteers to stop Brexit being too soft is to vote down the withdrawal deal in Parliament, which is likely to force PM Theresa May to step down as party leader. More likely is that they wait until after the UK has actually left the EU.

If we end up having a leadership contest, it would increase political uncertainty significantly, as the Conservative Party (and hence the government) may be without a leader for some time, especially if there is no clear selection of the next leader as was the case for Theresa May. With only a few months left to Brexit day, it would create a lot of chaos.

At the upcoming party conference, Boris Johnson will only speak at one event, where he is expected to repeat his opposition to Theresa May's Chequers deal. Theresa May is speaking on the last day of the conference, when she is expected to touch upon what UK immigration policy is going to look like post-Brexit.

Fresh elections unlikely at this point

In our view, the likelihood of a new general election is quite low. The Fixed-term Parliaments Act 2011 created a five-year period between general elections in the UK, meaning that the current prime minister cannot decide him/herself whether to call an election or not. Elections can only be called prematurely if the Commons vote to dissolve parliament (requires a two-thirds majority) or if the government loses a no confidence vote (there would be a period of 14 days during which a new government may be formed without a fresh election).

Even if the hard Brexiteers succeed in ousting Theresa May, we do not expect fresh elections. The Conservative MPs are very afraid of an election, as the Labour Party and the Conservative Party are neck and neck in the opinion polls. And as mentioned above, it is not necessary for the Conservatives to call an election.

A new referendum may not lead to another result

We think the likelihood of a second referendum is small (< 5%). The UK is not used to holding referenda and it is not certain that a new referendum would lead to a different result. Most opinion polls show that UK voters are still very divided on the Brexit question, although we have seen an increase in the number of responders saying that in hindsight, it was wrong to vote to leave the EU. But even assuming there were to be a second referendum and it turns out to be a vote to remain, which would lead a sigh of relief in the financial markets, Brexit would still haunt the UK for years, as the Brexiteers would push for a third referendum. A never-ending story.

Conservative Party leadership contest rules

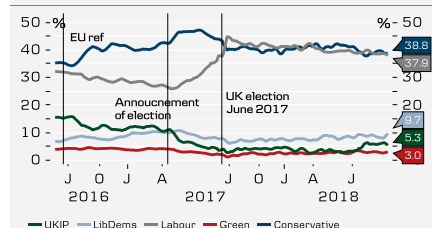
Two ways to trigger a Conservative Party leadership contest:

- 1) The current leader resigns
- 2) 15% of the Conservative MPs write a no confidence letter to the chair of the Conservative 1922 Committee (i.e. 48 out of the current 316 Conservative MPs)

If option 2 is triggered, there will be a no confidence vote among all Conservative MPs. If the PM Theresa May loses, she must resign and cannot participate in the following leadership contest. After that, there is a nomination process following which the Conservative MPs vote the pool down to two candidates. The final two candidates are then put to a ballot of the party members of the Conservative Party. The winner becomes the next leader.

It did not come this far when PM Theresa May became party leader, as the other candidates resigned before the election campaign.

Conservatives are afraid of new elections, as polls are very close



Source: Britain Elects, Macrobond Financial

While the UK formally exits the EU on 29 March 2019, the EU would most likely vote to extend the deadline if the UK calls for a second referendum.

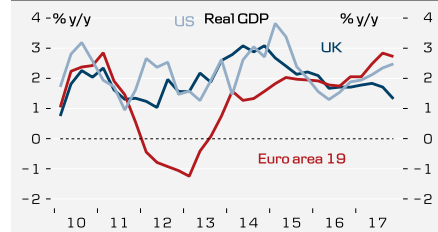
Economic outlook: growth has slowed but remains above potential

Looking at the economy, growth seems slightly stronger than what we outlined in *Research UK: It is still about Brexit*, 15 June. After a weak beginning to the year, GDP growth in July was strong and Q3 growth may be as high as 0.5% q/q. **We expect GDP growth to remain around 0.4% q/q going forward**, which is still lower compared to before the Brexit vote. The reason is that the domestic growth is not exactly thriving. While real wage growth is no longer negative, as the impact of the GBP depreciation on inflation is fading, it is still weak, limiting the scope for private consumption growth to drive growth. Brexit uncertainties are weighing on business investment growth, as between one-third and one-half of UK companies say that it is not the right time to make investments. Some argue the weaker GBP should boost exports, while we think a more important determinant for export growth is global demand. There are no signs that exports have performed relatively better versus other countries, in our view.

While growth has slowed, it is still above potential GDP growth. This means that there is still downward pressure on the unemployment rate. The combination of above-trend GDP growth and a tighter labour market is the main reason why **the Bank of England hiked the Bank Rate to 0.75% from 0.50% at its August meeting and is expected to continue its ‘once a year’ hiking cycle**, as it is concerned about the low unemployment rate and increasing wage growth. However, we believe the Bank of England is too optimistic on the inflation outlook, which may weigh on the timing of the next hike. Our base case is another 25bp hike in May 2019, taking the Bank Rate to 1.00%. This, obviously, also depends on the outcome of the negotiations. If the UK fails to reach an agreement with the EU, it is another situation. This may require the Bank of England to ease monetary policy again to support the economy, just as it did immediately after the referendum. The fear is that a no-deal Brexit would lead to a significant fall in business confidence and hence business investments.

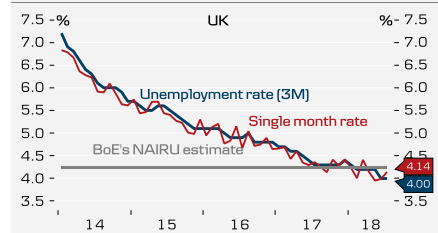
What impact would Brexit have on the economy? **In our view, Brexit is mainly a supply side story, as less frictionless trade with the EU means that potential GDP growth is going to be lower.** So the costs of Brexit, although ‘invisible’, are mostly that Britons are unlikely to be as wealthy over time as they could have been, in our view. **It is still uncertain what the outcome of the Brexit negotiations will be, but we think it is a fair assessment that the impact will be smaller the closer the UK stays with the EU.** If the UK and the EU reach a free trade agreement looking something like the EU-Canada CETA deal (even without alignment on standards/rules/regulations), it would make life more complicated for businesses but not be a disaster. In the case of a no-deal Brexit, where the trade is going to be on WTO terms, we think growth will take a hit in the short run due to a fall in business confidence and hence investments, but it would not be the end of the world to trade on WTO terms. Many Nordic companies do that on a daily basis with the US and China and the average tariff level is quite low. We are actually more concerned about the UK and EU rules/standards/regulations drifting apart over time. One of the single market’s biggest achievements is alignment of rules, as it makes it easier to buy/sell across European countries.

UK GDP growth decelerated while the rest of the world accelerated



Source: ONS, Eurostat, BEA, Macrobond Financial

The Bank of England has launched a hiking cycle, as the labour market continues to tighten



Source: ONS, Bank of England, Macrobond Financial

FX outlook: Brexit remains key driver for GBP

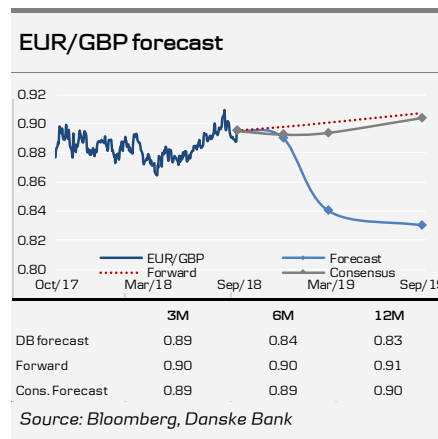
Brexit remains the key driver for GBP, and uncertainty related to the outcome of the Brexit negotiations is likely to keep GBP volatile and undervalued in the coming months.

While the actual Brexit deal and thus the future trade relationship between the UK and the EU will have implications for GBP in the longer run, these effects are secondary in the short term. Hence, **the main driver for GBP will be whether there will be a deal or not.** In that sense, Brexit very much represents a digital event risk for GBP, where EUR/GBP is expected to spike higher in a no-deal scenario, where a test of 1.00 should not be ruled out.

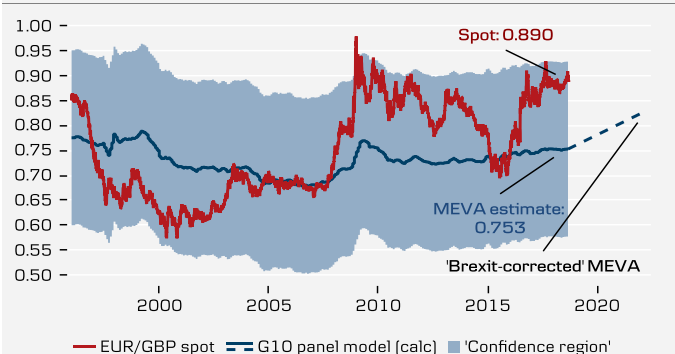
In our base case scenario with a ‘decent Brexit’, we expect EUR/GBP to break substantially lower and erase most of the current misalignments from fundamentally justified levels. **We target EUR/GBP at 0.84 in 6M and 0.83 in 12M**, and we recommend clients to hedge GBP income with options structures that maintain a profit potential in the event of GBP appreciation. Given the potential for a large decline in EUR/GBP, we favour hedging longer-dated income (+3M) via boosted risk reversals rather than using exotics such as knock-in forwards, due to the high knock-in risk. *See Corporate Hedger - Use GBP recovery and high vol. to hedge GBP income*, 14 September, for details.

According to our G10 Medium-term Valuation (MEVA) model, EUR/GBP is significantly overvalued relative to the model’s fair value estimate of around 0.75 (see below). However, assuming that the terms of trade is set to deteriorate substantially as the UK loses its free access to the EU internal market, a post-Brexit fair value very much depends on the actual Brexit deal. **According to our MEVA model, a ‘Brexit-corrected’ MEVA level for EUR/GBP (nominal) would be around 0.83**, assuming a net deterioration in UK terms of trade by 10% vis-à-vis the euro area, which corresponds to terms of trade relative to Germany (considered here for data availability reasons) moving back to historically stressed levels. *See FX Strategy: Danske G10 MEVA: valuation gaps starting to close* (28 April 2017) for more details on Brexit corrected MEVA estimate.

In case of a Norwegian style solution, where the UK to a large degree maintains free access to the single market, we expect the new post-Brexit fair value would be somewhat lower than 0.83 (between 0.76 and 0.83).

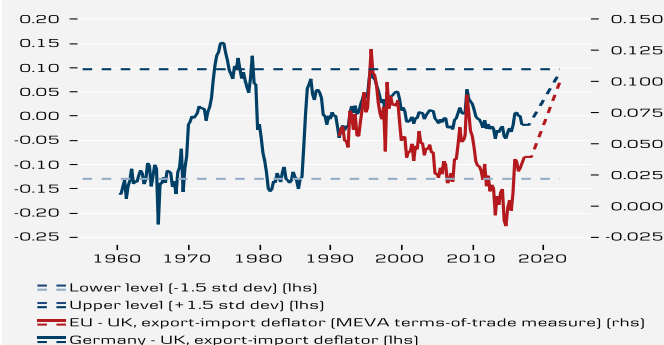


Brexit-corrected' MEVA estimate of EUR/GBP likely to be above 0.80



Source: Danske Bank

UK terms of trade relative to Germany and the euro area (MEVA measure)



Source: Danske Bank

Disclosure

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Senior Analyst, and Morten Helt, Senior Analyst.

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