

The return of the Brexit saga

Like a long-running TV series, the latest season of the Brexit saga brings new drama and tension. Like all good drama, there are twists and turns in the plot, unclear motivations of key characters, complexity and new set-piece showdowns.

Last season culminated with agreement on the terms of the UK's exit from the EU and a general election that secured a large Commons majority for Boris Johnson, the lead character in the Brexit saga. Under the Withdrawal Agreement, the UK will leave the European single market and customs union at the end of this year.

There was a risk that fans of the series would lose interest as it focused on negotiations over the UK's post-Brexit trade relationship with the EU. But once again there is an unexpected and dramatic twist.

The UK government has submitted new legislation – the Internal Market Bill – that would breach the Ireland and Northern Ireland protocol in the Withdrawal Agreement. As the UK has readily admitted, this would be a break of international law.

The EU reaction has been furious, and it has given the UK until to the end of the month to retract the legislation or face a legal challenge. Former British Prime Ministers have lined up to condemn the breaking of a legal international commitment and American star Nancy Pelosi had a cameo role to warn that if the UK undermines the Good Friday Agreement that secured peace in Northern Ireland by breaking the Withdrawal Agreement, there is 'absolutely no chance of a US-UK trade agreement passing the Congress'.

To recap from the earlier season, the Protocol is the backstop in the Withdrawal Agreement that prevents a hard border in Ireland if the EU and UK fail to agree a tariff-free trade deal by creating a customs border between the UK mainland – Great Britain – and Northern Ireland.

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So why is Boris Johnson threatening to renege on the wonderful exit deal he secured last year? Some have suggested that No. 10 believe that the economic costs of no deal will be lost in the wreckage of the historic pandemic-induced recession and it is better to have a 'clean break' without the constraints, especially on state aid that would come from an EU-UK trade deal. Others say the Prime Minister was outraged at the perceived threat that the UK would not be granted 'third country status' by the EU for food imports, including into Northern Ireland from Great Britain.

Our interpretation is that Johnson is upping the stakes and demonstrating his willingness to contemplate a no deal to secure a more favourable outcome from current negotiations. Essentially, a Trumpian strategy of creating a crisis, then compromising to resolve it and claiming a great win.

The Internal Market Bill comfortably passed its second reading in the House of Commons on Monday with only a few Conservative MPs rebelling. But these rebels were appeased by allowing the passing of a proposed amendment that would require MPs to vote on any action by the ministers under the bill that would violate the Withdrawal Agreement. However, in our view the bill will face fierce opposition in the House of Lords.

But if Boris Johnson does not blink, he will likely win the parliamentary battle. Unlike his predecessor in the role, he is a Prime Minister with a large majority and faces a Labour opposition cowed by its historic defeat in the general election on the back of the slogan to 'Get Brexit Done'.

Despite the acrimony between the EU and UK, negotiations on a trade deal continue with both sides wanting to reach agreement by the middle of October. If a tariff-free trade deal is reached, goods from Great Britain to Northern Ireland will be duty-free and the provisions of the UK Internal Market Bill that would breach the Withdrawal Agreement would no longer be relevant. In other words, despite the fire and fury over the UK government's unilateral threat to breach the Withdrawal Agreement and international law, it does not alter the fact that the future relationship between the UK and EU still rests on securing a trade agreement.

Investors can participate in the Brexit saga by playing the sterling game. If a deal is reached between the EU and UK on tariff-free trade in goods and agriculture, the breach of the Irish protocol goes away and the EU and UK will be just good friends. In our opinion the pound can potentially rally to maybe 1.40 against the US dollar and 85 cents against the euro. If there is no trade deal and the EU and UK divorce slides sideways into a bitter legal dispute and threats, the pound could fall to parity against the euro and 1.20 against the dollar. If these scenarios are broadly correct, the current pound dollar rate of 1.29 implies that the foreign exchange market is pricing a 55% chance of a deal.

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BRITISH POUND VS US DOLLAR & EURO



Note: BlueBay scenarios for GBP/USD under 'deal' and 'no deal'. Source: Macrobond, BluBay Asset Management; latest data at 15 September 2020.

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