



Brexit: Chaos and another public vote?

We think the likelihood of a ‘no deal’ scenario is low, but be prepared for another public vote, be it a second referendum or general election. BlueBay’s macro experts give their opinions on the Brexit showdown ahead.

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Fasten your seatbelts

With the UK currently set to leave the European Union (EU) on 29 March 2019, we are entering the critical stages in Brexit negotiations over the coming months.

The EU council is set to meet on 18-19 October, where negotiators hope to conclude on the Withdrawal Agreement and provide a basic framework for future relations (although there is already talk of this being pushed back to November). The EU has consistently made it clear that their 'four freedoms', set out in the Treaty of Rome, are 'inseparable' and that there will be no favourable treatment for the UK, heightening the possibility of a 'no deal'.

The UK government has still to reconcile its inter-ideological differences. The present 'Chequers' deal put forward by the Tory party in its current state is a no go for both the EU and the 'hard Brexiteers' within the party, so there is still plenty of negotiating to do on both sides with little time and rising stakes.

The Conservative Party conference in early October may be the catalyst point, for good or bad, as hard and soft Brexiteers attempt to resolve the current impasse. Even if they do agree, the 'deal' would need to be passed by the UK parliament through a 'meaningful vote' before being ratified by respective EU parliaments. These are weighty assumptions with the government holding a fragile majority in the Commons, notwithstanding the ongoing developments of the opposition party and ever-shifting public opinion on Brexit.

It all makes for an exciting, uncertain period ahead, with the endgame masked by endless permutations.

Three broad outcomes

The Institute for Government laid out the possible scenarios¹ for the next phase of Brexit in a paper released last month. It provides a good overview of the stages involved in the negotiations and the various paths. However, the paper takes a very simplistic approach and makes multiple assumptions which cannot be taken as given – particularly the assumption that the government or the opposition will not attempt to revoke Article 50 at any point.

Taking into account the complexity and fluidity of the situation, we believe the next phase of the negotiations will come down to one of the following scenarios:

- Orderly Brexit with a transition period
- Brexit with no transition/no deal
- Political chaos/another public vote

¹ <https://www.instituteforgovernment.org.uk/publications/possible-scenarios-next-phase-brexit>

The chances of an orderly Brexit where 'Brexit occurs with a transition deal, in which the UK accepts to pay the EU and retains access to the single market during a period of transition' are 50/50 in the eyes of Co-head of Developed Markets, Mark Dowding. 'The Tories are stubborn enough to drive Brexit through'. However, he believes a leadership challenge is possible soon after Brexit day. Senior Portfolio Manager Russel Matthews believes a 'fudge' would be difficult given the opposition from 'hard Brexiteers'.

On a no deal Brexit, Chief Investment Strategist David Riley thinks a 'No deal Brexit is a diminishing risk as the costs become ever more apparent and there is no support in parliament', and places a low probability on the event. Senior Portfolio Manager Mark Bathgate is a little bit more wary, believing a 'no deal' scenario is closer to a 20% probability at this juncture.

Mark Bathgate believes the most likely outcome is a 'Second referendum held in H1 2019 - possibly requiring a short extension to the Article 50 period to facilitate between Remain on current terms and a no deal exit' because 'the problem with most of the transition/half in arrangements is the rest of the EU is unlikely to agree'. Both David Riley and Mark Dowding also place a fair degree of probability on impending political chaos and/or another public vote, most likely a second referendum.

Russel Matthews agrees with the escalation of political turmoil in the UK, but places greater emphasis on the uncertainty of the outcomes. 'The way I like to look at it is the probability of significant escalation of turmoil in the UK is profoundly above 50%, but trying to ascribe probabilities to specific outcomes is almost pointless. I think a general election is a much higher probability than a second referendum'.

Sterling transmission

We believe that things are going to get a lot worse politically before they get better, and that there is a fair degree of complacency in the market regarding events. However, there will be a favourable outcome eventually, be it a muddle through deal with transition or a revocation of Brexit via a second referendum. We think the likelihood of a no deal outcome is low despite the news headlines.

How does the near-term negative assessment around the UK and the bumpy journey ahead translate into prices? Sterling has been the natural asset of choice for investors in terms of news to price transmission, and the increasing economic and political hazards ultimately risk undermining the pound.

We also feel UK assets, in general, are thematically unattractive and so we would want to position on the short side both on UK government bonds and in sterling.

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