Brexit Status Report—Johnson in Waiting

The Tory leadership election wraps up next week; the winner will quickly move into Downing Street as PM May's replacement and assume control of Brexit negotiations. All indications suggest that Boris Johnson will beat Jeremy Hunt to the top job. This prospect is boosting investor concerns that the UK will tilt towards a harder, or no-deal, Brexit. Sterling, which fell to a two-year low versus the USD this week, is liable to remain weak—or weaken further—until Brexit risks are clearer.

The Tory Party leadership election wraps up next week; balloting closes on Monday at 5pm (BST); on Tuesday, PM May will take her last round of Prime Minister's Questions in parliament and then resign to allow the new PM to be formally appointed by the Queen. All indications suggest that the former Foreign Secretary, Boris Johnson, will win the leadership election handily.

While Johnson has been the obviously more popular candidate among Tory party members in the hustings, early reports did indicate that postal votes were being returned at a much slower than anticipated rate. That might reflect the somewhat archaic process itself along with the onset or summer. Or it might suggest that voters were not entirely persuaded by Johnson and wanted to see how the run-off with Hunt evolved.

Now, with the handover less than a week away, investors appear to be getting anxious about what Johnson's leadership will mean for the Brexit process amid signs from the Johnson camp that the tough ("do or die") Brexit line adopted in the leadership campaign was not just for show. The GBP has weakened, reaching a two-year low against the USD (and revisiting the late 2018 lows against the EUR) while risk reversal pricing indicate a renewed pick up in bidding interest for downside protection in GBPUSD.

Johnson's team, it would seem, are keen all of a sudden to ditch the backstop—rather than try to fix it, as Brexiters had wanted until recently. But they have not made any serious (as afar as can be seen) moves to outline how they would renegotiate the Withdrawal Agreement – that the EU says in not negotiable anyway.

Moreover, Team Johnson conceded that they were considering tabling the Queen's Speech, which usually marks the commencement of a new parliamentary session, for early November. This would have the effect of suspending parliament through late October and—possibly—allow the new government to push through a no-deal Brexit unencumbered. The Brexit minister said today that "no deal" risks were "underpriced" and Johnson has lined up a long-time political collaborator and "hardline Eurosceptic" as a Brexit policy advisor. This smacks a little more than just "window dressing" for the leadership campaign.

It's hard telling what, precisely, a Johnson government would do to get Brexit over the line (or what sort of Brexit it would be) but there will be just 99 days between PM May stepping down and Oct. 31 to put a plan into action. Indications suggest that, with little time and perhaps no real alternative, Johnson is quite prepared to take the no deal Brexit route. The suggestion this morning that Johnson would like to hold an early general election in the next year—while the unpopular Corbyn remains Labour leader—only really makes sense if he thinks he will have something to boost the flagging Tory party's chances of securing a majority—such as delivering Brexit this year, even if that means a no deal departure.

Our base case assumption remains that the UK will achieve a negotiated departure from the EU in time—with the caveat that this might not be doable by the end of October. We think the GBP is "cheap" on a number of metrics and would expect a smooth-ish exit to allow the pound to recalibrate. However, we are concerned that the start of the Johnson leadership era for the Tories might represent a turn away from the negotiated approach towards a fuller embrace of no deal, regardless of the

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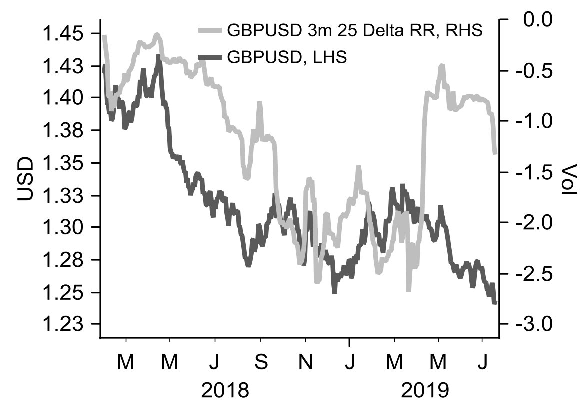
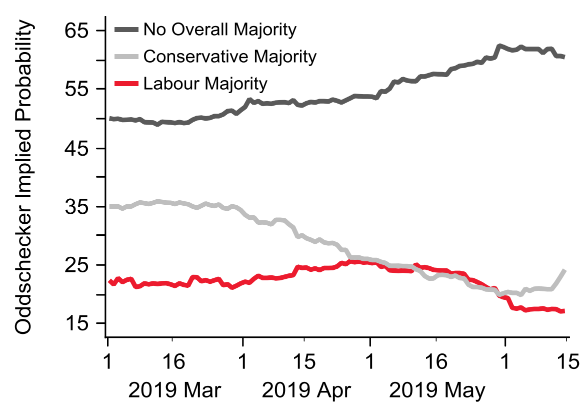
GBP Sentiment Turns on BoJo Brexit Fears



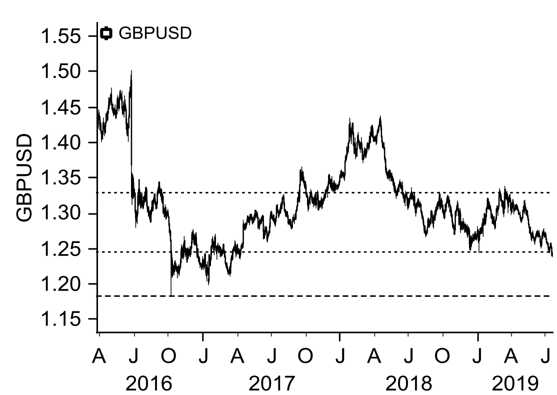
Source: Macrobond, Scotiabank FICC Strategy

Can Johnson Lift Tory Support?



Source: Macrobond, Scotiabank FICC Strategy

GBPUSD Pushes Below Jan Low



Source: Macrobond, Scotiabank FICC Strategy warnings of the dire consequences this might involve. At USD1.24/1.25, the GBP is already discounting a fair degree of pessimism, we think. But the risk of a downside overshoot seems to be rising more obviously now and we are less confident that the pound can avert another, sharp—if perhaps brief—turn lower in the next few weeks.

There is a lot that remains uncertain; the tough positioning on Brexit might well be all about electioneering—or positioning ahead of new talks with the EU; the new PM might well yet face a confidence vote in parliament soon after assuming office; parliament generally remains opposed to a no deal outcome and would do its level best to avert that. Mr. Johnson's first moves as PM will be closely scrutinized; it would, for example, be highly unusual in the modern era for a new UK PM not to make a visit to France and/or Germany a priority shortly after taking office. A quick, transatlantic jaunt would signal the new PM's priorities were somewhat different.

Market price action is bearish for the GBP and technical signals tilt the balance of risks heavily in favour of further weakness in the near-to-medium term. The GBP's loss of support around the 1.2440 level, the Jan low, and a consistent and strong alignment of oscillator signals suggest an intense GBPUSD downtrend is still developing. This also implies limited scope for counter-trend GBP gains (at most, the 1.2450/1.2550 area for now, we believe) and points to a renewed test of the 2016 lows near 1.20 in the next few months.