Brexit Status Report—A Waiting Game

Brexit speculation has fizzled out to some extent; May’s political manoeuvrings were more successful in getting herself removed from Number 10 than the UK from the EU and now, the process is essentially on hold until the 124,000 Conservative Party members choose a new party leader who will replace Theresa May as PM and steer the UK on the next leg of its Brexit voyage. We assume that the UK will negotiate a smooth departure still but the risks around that assumption are significant and may grow.

It’s been more than three years since the UK’s historic referendum on Brexit was held and the nation’s verdict delivered but the country seems no nearer to a Brexit solution and the clock is ticking down to the next deadline at the end of October.

As it stands, key dates to bear in mind are:-

- July 23—Conservative leadership winner announced.
- July 24—PM May steps down, new PM takes over.
- July 25—Possible No Confidence vote. Parliament rises for summer recess.
- Sep 3—Parliament returns (usually a short session of a few weeks due to party conferences which are typically held in the fall).
- Oct 17/18—EC Summit.
- Oct 31—Brexit deadline.

If the bookmakers are any guide, a perusal of their latest odds suggests that most believe (or are willing to bet money on); no second referendum (13% implied probability), Brexit not occurring before 2020 (66% probability) and “no deal” being averted (73% probability). Aside from Article 50 being revoked—seen as a 30% probability—no dislocating second referendum and a delay, presumably to get the right Brexit deal, seems like a pretty good outcome for the GBP at this distance.

As we see below, however, joining these dots might only make sense in the event of domestic political gridlock and might only reflect optimistic wishful thinking rather than hard insights into real risks. Handicapping outcomes is extremely hard because the two candidates vying to lead the country are essentially speaking to an audience of 124,000 only at this point and are not addressing cold, hard facts.

The harder the Brexit noises made by the candidates, the better it plays amongst the party members who abandoned the Conservatives (in favour of Farage’s Brexit Party) in droves in the EU elections in May. The positions being taken now do not really reflect viable—that is, workable—positioning for the next government.

Boris Johnson and Jeremy Hunt both suggest that the Withdrawal Agreement can be renegotiated (when the EU says it is not). Hunt apparently favours technological solutions to the Irish border issue (which may not yet exist) and Johnson thinks the UK can avoid tariffs—that word again—being imposed on UK goods under a no-deal scenario (absent an agreement to the contrary) when the EU, the WTO, the Bank of England and even members of the current UK government say that is not the case.

While “no-deal” risks remain, much will hinge on how the next UK leader interacts with his EU counterparts and the UK parliament. An abrasive approach will not go down well in Europe and make it less likely that a further delay will be granted, if needed. Equally though, it seems highly unlikely to us that Boris Johnson would have the numbers to get his “no-deal” exit through parliament. To try and do so might risk triggering a destructive confidence motion and undermine his stint as PM before it really even gets going.

Indeed, it is telling that the same bookmakers quoted above price a 2019 general
election as a 42% risk, against a 30% probability of a 2020 vote and an 8% chance of a 2021 election. Betting also favours no overall majority for any of the major parties (62%). In other words, the delayed Brexit scenario is perhaps more likely in the event of political gridlock and new elections.

Our base case is for a smooth UK Brexit at the end of Oct, allowing for the UK economy to recover and progress and for markets to start considering BoE policy normalization prospects again. But risks around that outlook are clearly elevated and we think that the chances of a further delay are high. Even with the best will in the world, there does not really seem anywhere near enough time to get a Brexit deal that has the support of parliament through the required approval and ratification process before the end of October.

Indeed, EURGBP risk reversals reflect a strengthening demand for EUR calls over the longer run versus shorter-term tenors, reflecting the potential for Brexit uncertainty to extend (and get amplified perhaps by domestic political risks) well beyond October.

Interestingly, UK bookmakers offer 3/1 odds (25% probability) of the EUR trading at par with the pound at some point in 2019—an arb opportunity perhaps against options market pricing which reflects only a 5% chance of the cross reaching par by year-end.

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