Brexit: The United Kingdom’s Departure Deadline Looms

The United Kingdom and the European Union (EU) have signalled that a Brexit deal is still possible, with signs of a potential compromise over the Irish border starting to emerge. Although the prospect of reaching a deal before the 31 October deadline does exist, time is running out. Even if UK Prime Minister Boris Johnson were to strike a deal with the EU, he still needs the backing of the UK Parliament, which remains highly uncertain. This makes an extension the most likely outcome, in our view, potentially followed by an early election. However, calling the outcome of an election is incredibly difficult, for the reasons we set out below.

Is a Deal Still Possible?

We believe there is strong political will on both sides to agree to a deal. Johnson would be seen to deliver Brexit as promised while EU Commission President Jean-Claude Juncker may be keen to ensure a deal is reached by the end of his term in November 2019. The Irish border has long been a key sticking point in negotiations. Johnson has strongly opposed the inclusion of a backstop arrangement, which former Prime Minister Theresa May had been willing to accept. While the backstop would avoid additional border checks between Northern Ireland and the Republic of Ireland if the United Kingdom were out of the EU, it would keep the United Kingdom in a close trading relationship with the European single market and unable to strike trade deals with countries outside of it.

Johnson has proposed a “technology-led” border solution that would keep Northern Ireland aligned with the EU’s single market, thus eliminating the need for regulatory checks when goods cross into the Republic of Ireland, while ensuring it remains in the customs territory of the United Kingdom. While this would result in a customs border between Northern Ireland and the Republic of Ireland, Johnson asserts it would not necessitate a physical border as the proposed customs checks would be carried out at traders’ premises or other points along the supply chain. EU officials believe this to be a complicated proposal—one that requires further discussion before it could be considered a solution—but have not yet ruled it out.

If an agreement on the customs border is reached, this would likely significantly reduce the risk of a no-deal outcome. The United Kingdom leaving the EU without a deal would arguably be the worst outcome for Ireland more so than for the remaining 27 EU countries. Ireland has the highest exposure to the United Kingdom in terms of its total exports and it has been estimated that it would suffer the biggest hit to its gross domestic product.

Any agreement reached between Johnson and the EU still requires backing by the UK Parliament. The Democratic Unionist Party (DUP)—which is in a confidence-and-supply arrangement with the Conservative party and effectively keeping the government afloat—has previously opposed subjecting Northern Ireland to different customs rules than those imposed on the rest of the United Kingdom.

Next Steps:

Key Dates to Watch

- 17–18 October: European Council summit
- 19 October: Benn Act extension date
- 21 October: Scottish court sits to decide whether to sign a letter requesting a Brexit extension if Johnson refuses to do so
- 31 October: Current Brexit deadline
- End of November: Earliest possible election date
- 12–13 December: European Council summit
- 31 January: Brexit deadline if the Benn Act three-month extension is granted
Can the United Kingdom Avoid a No-Deal Outcome?

The UK Parliament has sought to exert greater influence on the actions the government takes in a bid to avoid a no-deal Brexit. In September, Parliament passed a new law, the Benn Act, which would require the prime minister to request a three-month extension to the deadline if a deal is not agreed before it. No request for an extension is necessary if a deal is struck with the EU before 19 October or if members of parliament agree to a no-deal exit by the same date. The latter is highly unlikely given there is no majority in parliament for a no-deal exit, so it would likely rest on whether or not a deal is reached by this time.

Johnson has strongly opposed what would be the United Kingdom’s third extension, but he has insisted he will comply with the law. However, he has alternative routes open to him. He could request an extension but follow up with a letter stating that an extension would not be productive or in either party’s best interests. The EU would then be forced to choose between the first request and the second recommendation. Furthermore, because an extension requires assent from all EU member states, Johnson could request an extension and then persuade one of the EU countries to veto it. However, it is highly unlikely that an EU country would side with the United Kingdom—which is seeking to distance itself from the EU—against its European partners.

In theory, Johnson could also refuse to request an extension, which would set legal proceedings into motion. If legal proceedings take more than 12 days, it would breach the 31 October deadline. However, campaigners are pushing for action that would present the extension request on behalf of the UK prime minister, should he refuse to do so himself. In this context, avoiding a no-deal Brexit on 31 October essentially comes down to whether Johnson requests an extension himself before the end of the month (with any potential subsequent requests to ignore it overlooked by the EU), or if an extension can be requested on his behalf. However, the members of Parliament that drafted the Benn Act believe that the trigger set for 19 October allows enough time for Parliament to mount a legal challenge before 31 October, even if it needs to go to the UK Supreme Court.

What Would Happen if the Deadline Is Extended?

If the United Kingdom requests an extension, and the EU grants it, the extension is expected to stand for a minimum of three months, under the Benn Act. Alternatively, the EU could choose to grant an extension but propose a date other than 31 January 2020. Members of Parliament could reject the proposal, resulting in a no-deal exit, but we believe this is highly unlikely.

As we previously noted in our Market Update: Brexit, What Happens Next?, reaching an agreement in Parliament is likely to remain elusive for any ruling party without a Parliamentary majority. As Johnson lacks a governing majority he has repeatedly pushed for a general election in an attempt to restore the Conservative party’s majority in Parliament, end the political stalemate, and deliver Brexit.

To call an early election, Johnson requires the backing of two-thirds of the members of Parliament. Alternatively, the opposition could call for a no-confidence vote on whether the current government should continue. If the government lost, this would give opposition parties two weeks to attempt to form a new government. However, if they were unable to, this would automatically trigger an early election. Most parties appear only willing to support an early election once the Brexit deadline has been extended, as either of the two routes to a general election mentioned above raises the risk of a no-deal outcome if they were to occur before an extension was agreed upon.

As such, it seems logical to conclude that an election would only follow a deadline extension, making November the earliest possible month in which an election could be held. Although the Conservative party is currently ahead in the polls (Exhibit 1), it is extremely difficult to predict the outcome of an election. Voters are likely to look beyond their party loyalties and treat the election as a referendum vote, siding with the party that reflects their views on UK-EU integration, irrespective of that party’s domestic policies or leader. Johnson’s decision to remove the whip—a disciplinary action that effectively expels someone from the party and means they sit as an independent until the whip is restored—from 21 Conservative members of Parliament who opposed a no-deal Brexit effectively freed them to cross the political aisle.
Unite to Remain, a newly formed organisation, is looking to work with the Liberal Democrats, the Green Party, and Plaid Cymru in Wales, alongside pro-European independent members of Parliament to assess all of the Parliamentary seats in England and Wales on the basis of whether the voters in any given constituency would vote for a remain candidate. The organisation is looking at how it can act as an effective mechanism for voters who want to remain in the EU and how to support them in delivering that outcome by backing a single candidate.

If the Unite to Remain alliance pulls off this optimised method of tactical voting, it could potentially be quite powerful and effectively narrow the Conservative’s current lead in the polls considerably. However, as there are many different permutations to consider, and given that voter behaviour has become increasingly volatile in recent years, anticipating the outcome of an election is virtually impossible.

Findings from the British Election Study (BES), which has been looking into Britain’s electoral behaviour since 1964, support that voter party loyalties are breaking down as a result of “electoral shocks.” The BES found that the 2015 and 2017 general elections saw the highest levels of voter volatility in modern times. In 2015, 43% of voters voted for a different party from the one they had supported in 2010. In 2017, 33% switched from their 2015 vote. This trend of voting volatility will likely persist into the next general election, particularly as the narrative—and public sentiment—around Brexit remains in flux.

Investment Implications

The response of the Europe ex-UK equity market to Brexit news flow has become more muted over the past year and instead become more sensitive to developments in global economic data. There is, at present, an underlying negative trend in global economic news flow, and this would likely intensify if a no-deal Brexit materialised. However, outside of this, the Europe ex-UK equity market will likely continue to be influenced more by trade developments between the United States and China, policy decisions from key central banks, and economic data (both from continental Europe and the United States).

Deal or Extension

UK equity markets continue to respond to Brexit news flow and remain sensitive to changes in sterling levels and bond yields. Aside from the United Kingdom remaining in the EU, a negotiated deal would likely be the next most market-friendly outcome, and we would expect the most suppressed domestic sectors—such as house builders and retailers—to benefit the most. Even though sterling would be expected to firm, we would not expect this to hold back the performance of large-cap, non-sterling earners—a segment that comprises a large proportion of the UK market—as the UK market would likely experience a broad-based rally. Similarly, if an extension is agreed upon, this would be seen as a positive by investors in our view, as it pushes out the prospect of a no-deal scenario, although markets may not react as strongly as they would under a deal scenario.

No Deal, or Heightened Uncertainty

Sterling’s relatively muted reaction to Johnson’s suspension of Parliament in September suggested that investors have factored in much—but certainly not all—of the weakness one would expect in a no-deal situation. While the Bank of England would be widely expected to cut interest rates in a no-deal outcome, we believe such action would provide little support to the UK economy given that rates are currently at such low levels. For instance, bond yields have already made investing in the financials sector increasingly challenging to justify at current levels, in our view. Likewise, any fiscal stimulus would also be expected to have a muted impact beyond domestically focused stocks, given that the UK market is predominately composed of overseas earners.

Conversely, the UK market’s heavy exposure to international markets means there are plenty of stocks that would benefit from a weaker sterling and, by extension, are less exposed to the UK domestic economy. Should uncertainty around Brexit increase, we would expect these stocks to remain in favour despite, in some cases, their relatively stretched valuations. This could in fact support the UK market should uncertainty build—for instance in the run-up to an election. Indeed, in the wake of the referendum result in June 2016, large-cap stocks did outperform smaller-cap stocks as a weaker sterling helped to counter some of the negative impact.
Investor uncertainty remains high and could continue for some time yet, but we continue to see UK equity risks skewed to the upside. Even when accounting for the headwinds the United Kingdom faces, we would argue that the relatively low valuations of UK equities are unjustified. UK equities offer attractive yields relative to other equity markets as well as to fixed income securities (Exhibit 2), suggesting that under the right circumstances, the United Kingdom has significant value waiting to be unlocked.

A number of events over the coming months could prove to be positive catalysts for UK equities, which could help the UK equity market narrow its significant discount relative to European peers. We believe even an incremental positive shift in sentiment could have a materially favourable effect on UK equities given our view that so much pessimism is accounted for in current valuations.

Still, much will depend on how the political process plays out over the coming days, weeks, and months. The United Kingdom’s decision to leave the EU is an unprecedented event. However, we believe that the scenarios framed in this paper can help guide investors when considering the potential market implications that could arise during this complex process.

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