



## BREXIT – AN UPDATE



There is still significant uncertainty regarding the outcome of Brexit, particularly the economic and market impact of a 'hard no deal' Brexit. The probability of a 'no deal' Brexit has obviously significantly risen after Boris Johnson's succession as UK prime minister, given the more hard-line, aggressive stance he has adopted over the last month or so.

However, a possible glimmer of hope was provided last week, when Angela Merkel gave the UK 30 days to come up with a workable alternative to the backstop, which suggests that some compromise is still possible. There are potentially many 'twists and turns' in the Brexit story between now and the end of October, although the risks of a 'no deal' outcome have clearly risen and are now probably closer to 50/50.

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### Boris's stance as prime minister

Since becoming prime minister in late July, Boris Johnson has committed to delivering Brexit on 31 October, and has indicated that he is willing to take the UK out of the EU with no deal if the backstop is not removed from the existing Withdrawal Treaty. He has said that the backstop is "undemocratic" and unviable, and indicated he will not enter negotiations with the EU on a new treaty until the EU agrees to remove the backstop. His stance and threats appear to have made a 'no deal' exit a realistic possibility and a credible threat which the UK is seriously considering.

### Possible scenarios

If Johnson is true to his word and the EU does not give the concessions he is demanding in relation to the backstop, the UK will leave the EU on 31 October with no deal. Other outcomes, however, are still possible. The majority of UK MPs have shown on several occasions that they are against a 'no deal' Brexit outcome. Parliament can try to prevent this occurring, principally through two routes.

#### Route one

The first route is a vote of no confidence in the government – Labour have suggested they will do this shortly after parliament returns in early September. The government could well lose this vote, if enough Conservative MPs vote against Johnson and bring down the government in an effort to prevent the UK going down the 'no deal' route.

Labour leader Jeremy Corbyn has indicated he would be willing to head a caretaker government in the event of the government being defeated. He has also suggested that he'd seek an extension of Article 50 and would quickly hold a general election and a second Brexit referendum. It is, however, believed that Corbyn would not command sufficient cross-party support to head a caretaker government. It has been suggested that more moderate, centrist candidates such as Ken Clarke or Harriet Harman could put themselves forward to head a caretaker government, which would then implement the proposals put forward by Corbyn.

Last week's offer from Merkel giving the UK 30 days to come up with workable alternatives to the backstop indicates that some ultimate compromise is possible. But it does mean that the timing of any vote of no confidence in the government is likely to be delayed until such time as the UK comes back to the EU regarding its alternative proposals to the backstop. If the government fails to put forward acceptable alternatives to the EU, the vote of no confidence is only likely to occur in late September. This would increase the risk of the timing of any general election in the event of the failure to form a new government following a successful vote of no confidence being pushed out beyond 31 October. That means a 'no deal' exit could happen by default. On the other hand, the risk of a 'no deal' exit occurring by default could provide an incentive for those in favour of preventing a 'no deal' exit to form a short-term caretaker government to avoid such an outcome.

### Route two

Another way for parliament to prevent a 'no deal' outcome would be to legislate to force the government to seek another extension of Article 50 before the end of October. While this seems to be the objective of the majority of MPs, it is uncertain whether they would be able to do so under current parliamentary rules and procedures.

### Could Johnson call a general election?

Boris Johnson could call a general election if he believed that he was likely to lose an upcoming vote of no confidence, or if he believed parliament was moving towards a position whereby it would force him to seek an extension of Article 50, resulting in the UK remaining in the EU beyond 31 October. Johnson could use such an election to seek a mandate from the electorate to pursue a 'no deal' exit. The most recent polls suggest there has been a resurgence in Tory support following Johnson's rise to power, with the Conservatives now having a 42% share compared with Labour on 28%, Liberal Democrats on 15%, and 5% for both the Brexit Party and Scottish National Party. This suggests the Tories could win a clear majority in an election, giving them the freedom to pursue their Brexit policy in the new parliament. However, with a two-thirds majority in parliament required for Johnson to call an early election, parliament could attach a condition that Article 50 is temporarily extended before agreeing to the holding of a new election.

### Possible compromises to reach a deal before 31 October

There have been some suggestions that Johnson's current hard-line stance is a negotiating tactic to obtain concessions from Europe, and that he really would prefer a deal to a 'no deal' exit. He voted for the existing Withdrawal Treaty in the last vote held in parliament, indicating at the time that it was better than the alternative of a 'no deal'. It has also been reported that in private meetings during the leadership campaign, he indicated that his ultimate intention is to make a deal with the EU.

The EU has been adamant that the backstop is not open for negotiation, and Merkel's recent comments do not contradict this position. She highlighted the need for greater clarity regarding the intentions for the future trading relationship between the UK and EU, and suggested that the nature of this relationship could result in the backstop being made redundant. She has, however, placed the onus on the UK to come up with a workable solution to the backstop to ensure it does not need to be implemented. Last week's proposal by Merkel provides some space for alternative proposals

to the backstop to be brought forward. Of course, whether this can be achieved in 30 days when acceptable alternatives have not been presented over the last three years is open to question.

There have also been suggestions that a time limit could be put on the backstop, or that mainland UK could be excluded from the backstop. However, it is likely that the hurdles to these compromises could be too high, given the expected objections from key players in the process.

### How could the economy and markets be affected?

In terms of the economic and market impact of a worst-case 'no deal' scenario, there are wide-ranging opinions. In terms of the impact on the UK economy, estimates have ranged from a negative impact of 1–2% to a hit of as much as -8% to UK GDP over the first year, as estimated by the Bank of England in its scenario analysis last year. We think a more realistic impact would be a negative hit to UK GDP of 4–5% over two years.

In terms of the contagion to Irish GDP, estimates vary from a negative impact of 3–4% over ten years to 6.5% over two years. We think a more realistic estimate would be around -4% over two years. A fiscal policy response however would be expected in both the UK and Ireland in the event of a 'no deal' exit which would reduce the negative hit to growth.

In terms of market impact, we think UK equities could fall 5–10% in the case of a 'no deal' exit, with European equities down by -2–3%. Global equities have shown themselves to be relatively immune to Brexit over the last year or so – Brexit is viewed as more of a local issue, and global equities might only be down -1–2% in a worst-case outcome.

While sterling has already weakened from the best levels in EUR/GBP of 0.85 earlier this year to 0.91 currently, we think sterling could fall further to around parity if 'no deal' was confirmed. It should be noted that sterling rallied to 0.90 EUR/GBP following Merkel's comments on 21 August.

UK gilt yields could decline by approximately -30 basis point (bps) in the case of a 'no deal' outcome, while German yields could fall between 5–10bps. Meanwhile, Irish spreads against Germany could rise by 10–20bps.

The table below summarises the estimated direct impacts across economies and markets from a 'no deal' Brexit.

UK GDP	-4–5% over 2 years
Irish GDP	-4% over 2 years
UK Equities	-5–10%
European Equities	-2–3%
Global Equities	-1–2%
EURGBP	+10%
UK 10-year yields	-30bps
German 10-year yield	-5–10bps
Irish 10-year spread v Germany	+5–10bps

Source: ILIM

### When will the outcome be clearer?

There is still a significant amount of uncertainty regarding the ultimate Brexit outcome, with speculation and probabilities assigned to various possible conclusions changing by the day. It could well be late October before it is finally clear how the issue is likely to evolve, but the risks of a worst-case outcome in terms of a 'no deal' exit on 31 October have significantly risen over the last 5–6 weeks.

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