


Market commentary

Brexit vote: The UK runs out of superlatives

16 January 2019



Brexit vote: The UK runs out of superlatives

In summary

- Last night's vote by British MPs tells us very little about what happens next.
- The chances of a delay for Brexit have increased and there is arguably a small increase in the chance of 'no Brexit'.
- We are resisting the urge to speculate and guess.
- In fixed income, we express this uncertainty via a conservative positioning with regards to the yield curve, rates and FX.
- In UK equities, we remain neutral with a preference for defensive names

The headlines

Some of those most vehemently opposed to Brexit warned that the UK would run dangerously low on stocks of essential medicines in the event of Brexit. Ironically, it is superlatives that the UK has exhausted first (along with the patience of its citizens and business leaders), with newspaper editors across Europe struggling to find words that could express the nature of the UK government's defeat last night in the House of Commons.



Impact on Dolfin's views

Despite all the impassioned headlines this morning, we have learned almost nothing as a result of last night's defeat.

Until we begin to know what the future looks like for UK-EU relations, we are resisting the natural human urge to speculate and guess. Because we are unable to know if the eventual outcome of this highly fraught process, we cannot say with any certainty whether it will be good, bad or neutral for the UK.

Within fixed income we express this uncertainty via a conservative positioning with regards to the yield curve (i.e. short-duration), rates and FX.

We remain neutral on UK equities with a preference for defensive names.

What happened?

The outcome of the vote - expected to be a disaster by many from the very moment that a triumphant Mrs May returned from Brussels with her hard-won Withdrawal Agreement - was the worst defeat for a government in British political history. Ironically, of course, it was the pro-Brexit MPs that ensured the abject humiliation on an evening when the Commons voted by 432 to 202 against the deal.

The UK's opposition Labour Party have tabled a motion of 'no confidence' in the government (to be voted upon today, Wednesday, at 19:00 GMT), but neither the European Research Group (a cabal of hard-line Brexiteers within the Conservative Party) nor the Democratic Unionist Party (a group of Northern Irish MPs who provide political support to the minority



Conservative Party government in parliament) are likely to vote against the government and force a general election in the UK.

What has changed?

Very little, if anything, in practical terms.

The margin of defeat was larger than expected, but it was impossible to find anyone yesterday (even those tasked by the UK government to 'sell' the deal) who believed that the deal would pass. Indeed, the Prime Minister herself postponed a December vote in Parliament simply because she anticipated losing a vote back then.

Brussels remains unwilling to reopen the negotiations and any non-legally binding assurances offered by Europe (on topics such as the Northern Ireland Backstop and future trade deals) were not enough to convince those opposed to the deal.

Pro-Brexit MPs were clearly not convinced of the mantra that a vote against the deal was a risk to Brexit itself.

Europe's response

Michel Barnier, the EU's chief Brexit negotiator said: "It is now for the UK to tell us the next steps. We will remain united and determined to reach a deal." He has also stressed in other interviews that the exit deal remains the "best compromise" that Brussels can offer. "The backstop must remain a backstop — it must remain a credible backstop" he said. (BBC)

Annegret Kramp-Karrenbauer, leader of Germany's CDU: "I very much regret the decision in London. A disorderly Brexit without a deal is the worst of all options. It's important to not rush anything now." (FT)

French president **Emmanuel Macron** was reported by Reuters saying: "It creates a great deal of uncertainty and worry." He warned there was little scope to improve the terms of the UK's exit deal and said he expected the British to ultimately ask for more time. (FT)

French Europe minister **Nathalie Loiseau** said: "It's bad news, this deal was negotiated during two years and it is a very good deal and the only deal possible... We have explored all the options with the British. It's up to the British to decide. There is an absence of majority for this deal but we don't know what the majority is in favour of." (BBC)

Sebastian Kurz, chancellor of Austria: "The ball is now with the House of Commons. In any case there will be no renegotiation of the withdrawal agreement." (FT)

Udo Bullmann, leader of the centre left in the European Parliament said: "If their red lines change significantly then we would of course be open to listen and react accordingly. If not, then she should put the deal back to the British people either through a general election or a referendum. Time is running out." (FT)

Guy Verhofstadt, the European Parliament's Brexit chief, urged all of Mrs May's opponents (including Brexit supporters, the Labour party, and the Northern Irish DUP) to "come out of their trenches" to find a cross party consensus for a new way forward on Brexit. (BBC)

Donald Tusk, president of the European Council tweeted: "If a deal is impossible, and no one wants no deal, then who will finally have the courage to say what the only positive solution is?" (a heavy hint at No Brexit). (Twitter)

France's *Le Monde* says Mrs May was subject to a "humiliating defeat" that left the future of her government and Brexit "more uncertain than ever".

Spain's *El Pais* says the "crushing defeat" will make the "crisis" over Brexit worse.

Germany's *Der Spiegel* says Mrs May's Brexit plan has been "shattered" and asks: "Must she go now?" - while a commentator for *Bild* describes the situation as "Brexshit".

Belgium's *L'Echo* headline reads: "The shadow of a hard Brexit", while *La Libre Belgique* mulls "the jump into the void of the British Parliament".

Sweden's *Svenska Dagbladet* leads with Mrs May's "historic loss", and the *Dagens Nyheter* says: "After the historic setback - May's fate can be decided today."

Denmark's national *Jyllands-Posten* leads with the "big defeat for May", saying it leaves Brexit facing "maximum insecurity".

America's *New York Times* describes the loss as a "humiliating defeat" that has "thrust Britain further into political chaos". The paper picks up on Mrs May's warning before the vote that the decision will "set the future of our country for generations". It adds: "Like most others, though, the prime minister had no easy answers about the way forward."



What is the way forward?

Game Theory suggests that the margin of defeat for the Withdrawal Agreement may give the UK greater bargaining power in Brussels, or at least prompt a serious rethink within the EU. It might be argued, for instance, that pressure may start to build on the Irish premier, Leo Varadkar, over the contentious backstop plan for Northern Ireland (which is primarily designed to protect trade for the Republic of Ireland).

We are unconvinced, however, because:

- (i) the EU is extremely unlikely to overrule a remaining member state on a fundamental national interest in order to appease a departing state; and
- (ii) in contrast to the EU's negotiating position, the UK parliament has been completely fractured, has never reached a coherent negotiating position and has already signalled that it will not accept a 'no deal' hard Brexit.

Mrs May must now return to the House of Commons next Monday with her Plan B. In reality, it is unlikely to be anything more than a slightly tweaked Plan A - but those are the rules set by the UK parliament prior to the vote.

Given that this Plan B is likely to be also rejected, parliament itself then has a chance to offer alternative solutions – largely drawn-up by the Liaison Committee (a group of the most senior UK MPs who lead the various parliamentary select committees).

Cross-party talks are supposedly scheduled to begin after today's vote of no-confidence in the government, but the fractures lie across party politics, not within them, so these may not yield much progress.

Under Article 50, Brexit is scheduled for 29 March 2019, but with so much required between now and then it remains our central premise that the UK will apply to the EU for an extension of this deadline. Such an extension, however, may include an EU condition that there will be a second vote.

The idea of a second referendum is still alive and well – but it has at least three potentially fatal flaws:

- (i) it would be seen as undemocratic in the light of the recent 'once in a generation' referendum (and the EU has form when it comes to asking electorates to vote again until they give the 'correct' answer);
- (ii) opinion polls (YouGov) suggest that the post-vote chaos has created a small shift towards Remain in the UK, but only as far as a potential 52-48 result in favour of staying within the EU (prompting the potential need for a third plebiscite); and
- (iii) the opposition Labour Party is led by profound Eurosceptics (*Guardian*, *Independent*, et al.) who resent the restriction that the EU places upon state aid (they would prefer to see a general election rather than another referendum).



Market impact

Because of the chances of a delay for Brexit (and arguably a small increase in the chance of no Brexit), sterling rallied after the vote to c1.28 (vs. USD). The FTSE 100 and FTSE 350 Indices are both essentially flat this morning.

What will be the impact of Brexit?

It is **impossible to know** for sure the exact impact of Brexit for either the UK or the EU27 – not least because there is no clear indication right now as to the route that the UK will take.

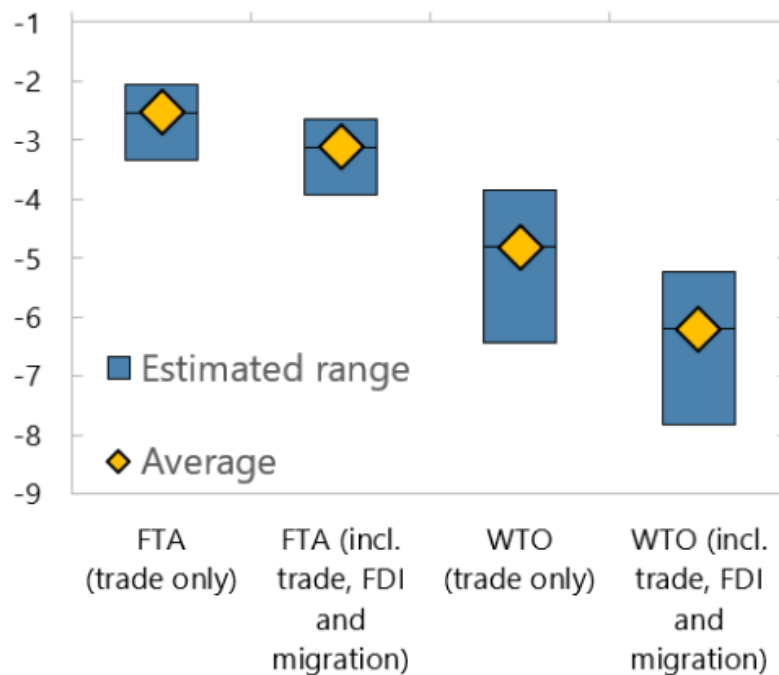
Figure 1 shows the IMF's estimates on the impact for the UK for Brexit, with or without a Free Trade Agreement with the EU.

Figure 1: Brexit costs

Brexit costs

All likely Brexit outcomes entail costs for the UK economy. An agreement featuring fewer impediments would better protect growth.

(percent deviation from a no-Brexit scenario)



Source: IMF staff calculations.

Note: FTA= Free Trade Agreement; WTO= World Trade Organization.



Source: International Monetary Fund (December 2018)

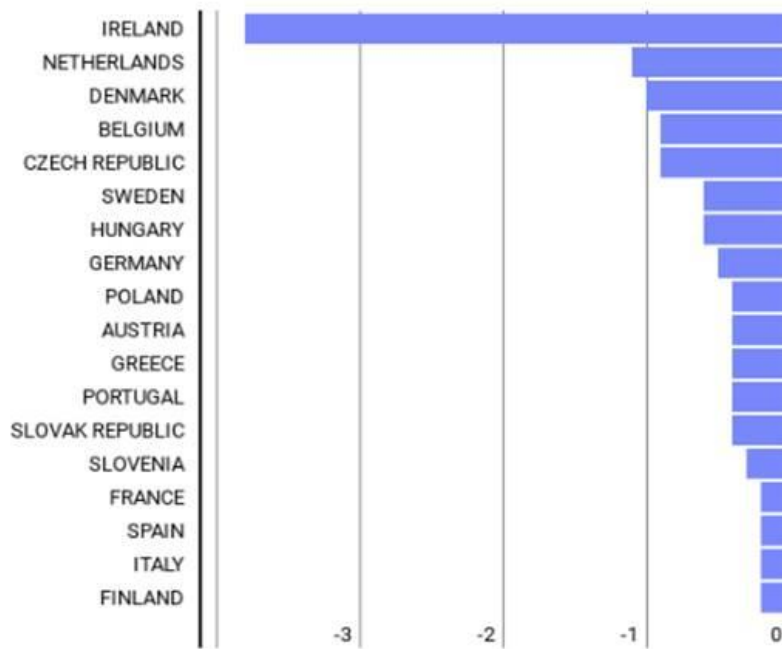


Figure 2 illustrates the IMF's view of the impact on the remaining EU27 of the UK's exit.

Figure 2: Impact on remaining EU27

Different country, different impact
Under the WTO scenario, the decline in the level of output compared to a non-Brexit scenario differs from country to country.

(in percent)



Source: IMF staff estimates.

Note: Unit is measured based on decline in the level of output compared to a non-Brexit scenario.



Source: International Monetary Fund (August 2018)

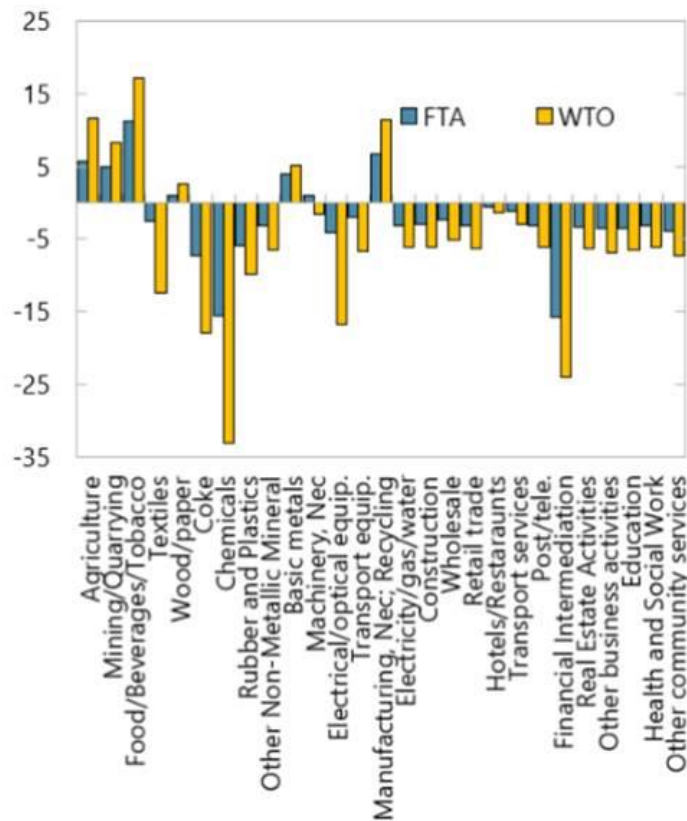


According to the IMF, certain sectors in the UK will benefit from Brexit, whilst others will see a negative impact.

Figure 3: Impact of Brexit on sectors

Post-Brexit: the uneven path ahead
 Brexit could impose greater costs on the chemicals industry and on some services sectors, including the financial sector.

(percent of deviation of sectoral output from a no-Brexit scenario)



Source: IMF staff calculations.

Note: FTA=Federal Trade Agreement. WTO=World Trade Organization.



Source: International Monetary Fund (December 2018)



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