INSIGHT & PERSPECTIVE

Path to "Hard Brexit"?

July 29, 2019

U.K. Prime Minster Preparing for "No-Deal" EU Break

New British Prime Minister Boris Johnson appears to be readying for a "no-deal" break from the European Union.

The prospect of a "Hard Brexit," we believe, has increased the likelihood of more accommodative policy from the Bank of England, but has raised business uncertainty.

Boris Johnson left little doubt about his Brexit intentions during his first speech as the new U.K. prime minister (PM). The U.K. Conservative Party ("Tories") appointed Mr. Johnson following the resignation of previous PM Theresa May. Ms. May was forced out after repeated failed attempts to win Parliament's backing for her Brexit deal with the European Union (EU). Now with the Brexit deadline extended to October 31 and patience for a deal on edge, Mr. Johnson takes the reigns in negotiating with the EU. The question now is how will Mr. Johnson manage a U.K. withdrawal from the European bloc? So far, Mr. Johnson is stating a willingness to negotiate with the EU, but is readying an abrupt exit if no agreement is reached. In the interim, EU members have stated there is no room to rework the agreement May brokered. Meanwhile, the new Prime Minister is filling his cabinet with Brexit hard-liners and appears to be solidifying his political position by aligning more closely with the Brexit Party.

A snap general election could be called if Parliament fails to ratify any new deal terms and the October deadline is breached. The combined efforts of the Conservative and Brexit parties would likely be formidable for the Labour and Liberal Dem parties to defeat if an election occurs. Mr. Johnson appears comfortable in both his Brexit trajectory and political backing as he attempts to forge a new negotiating position. To be sure, in taking the necessary steps to finalize a break from the EU, the Prime Minster does not appear inclined to dither.

The calendar ahead of the October 31 treaty deadline, in fact, provides little time to dawdle. Parliament broke for summer recess on July 26 and is not back in session until September 3. Thereafter, U.K. political parties are expected to be in individual conference recesses from mid-September

Table 1: Notable Dates on the Brexit Calendar

Source: Bank of England, U.K. Parliament, European Union

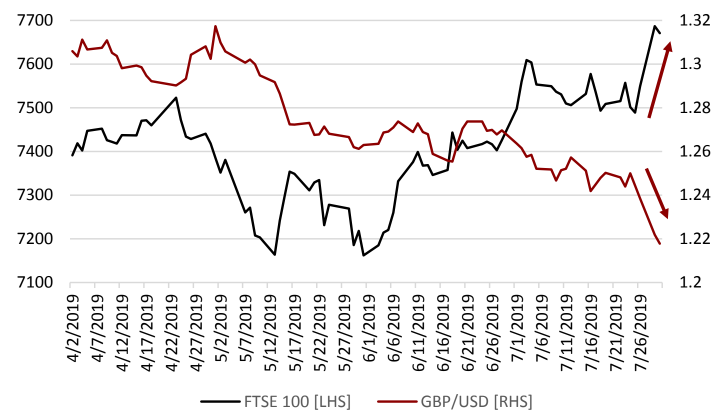
Jul. 26 - Sep. 2	U.K. Parliament summer recess
Aug. 1	Bank of England policy meeting
Sep. 14 - Oct. 2	Conservative, Labour, & Liberal Democrat Party Conferences
Oct. 17 - 18	European Union Council meeting
Oct. 31	U.K./European Union treaty deadline
Nov. 7	Bank of England policy meeting

through early October. The schedule leaves little time for internal deal-making. It appears the path toward a "soft Brexit," or a deal that would maintain some close trade/business ties between the EU and the U.K., is narrowing considerably.

Hard Brexit Good or Bad?

At this stage, we believe the odds seemingly favor a hard Brexit on October 31 or a general election. Given Mr. Johnson's apparent no-nonsense approach, we would label another extension of Article 50 a remote possibility. Notably, a hard Brexit could lead to a material disruption of business and trade that risks destabilizing U.K. and Eurozone financial markets. However, such an outcome may be lead to considerable fiscal and monetary policy accommodation in order to combat any destabilization.

Figure 1: British Pound/U.S. Dollar Cross and London's FTSE 100 Index
Source: Bloomberg



In fact, we anticipate the Bank of England (BoE) could begin to redirect its policy tightening bias, given the prospect for no deal. Previously, the BoE had given indication of potential rate increases necessary to normalize policy. The increased risk of a hard Brexit, in our view, could cause the BoE to shift firmly to an easing bias. BoE Governor Mark Carney has already voiced his concern over the economic risks of a tumultuous EU exit. We expect this view to be displayed in a more accommodative policy bias over the coming days/weeks/months.

Meanwhile, Mr. Johnson has already talked about "turbo-charging" the economy with new fiscal initiatives; and additional measures may be needed to offset potential no-deal Brexit disorder. The International Monetary Fund has estimated a no-deal Brexit could cause the U.K.

economy to contract by 2% in 2020. Such a drawdown, we believe, could be combatted with multiple policy measures. If the days since Prime Minister Johnson's July 25th speech to the House of Commons is any indication, a no-deal Brexit, answered by new monetary and fiscal measures seems to be what the market is forecasting. The British Pound has come under additional pressure as the currency would theoretically be hurt by easier monetary policy and higher debt. Meanwhile, the U.K. FTSE 100 Index has shown some strength in perhaps a reaction to the likelihood of new macro stimulus. From our perspective, the lack of visibility indeed makes taking either a currency or equity position in the U.K. a tough call. Either way, the final months until the October 31st deadline are likely to be filled with political high-drama in London.

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