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CIO Viewpoint

Through the Brexit fog: no-deal risk dissipates

Investment Solutions

21 October 2019

In an unexpected turn of events, the House of Commons on Saturday 19 October postponed the vote on Boris Johnson's revised Withdrawal Agreement, and adopted the Letwin amendment, which seeks to prevent a no-deal Brexit by requiring implementing legislation to pass the deal into law. The government will request another vote this week. It seems increasingly unlikely that the UK will crash out of the EU without a deal.

The UK government failed on 19 October 2019 to secure backing for the terms of the country's divorce with the European Union. The failure to vote on the revised deal and the adoption of the Letwin amendment forced Mr Johnson – albeit reluctantly – to comply with recent 'Benn Act' legislation, and go back to the EU to ask for an extension until 31 January 2020. In a second letter to Brussels, the UK Prime Minister expressed his view that any further delay would be damaging. The EU will now examine the UK's request, and hold consultations before providing a formal response in the coming days.

The Irish "backstop", which threatened to restore a hard border between Northern Ireland and the Irish Republic, remained a thorny issue. Mr Johnson's decision to solve the problem by placing a border in the Irish Sea made him increasingly dependent on the support of opposition parliamentarians. The Labour Party's leadership had rejected the deal almost before Mr Johnson had spelt out the declaration at a Brussels press conference.

While Mr Johnson did not have a strong parliamentary record going into the parliamentary session on Saturday, the odds seem to be shifting towards an approval of the new Withdrawal Agreement – even if such an outcome remains a close call. The government needs 320 votes to pass the deal, and will press ahead with another vote this week. Mr Johnson will try to persuade enough parliamentarians to back the revised deal, including a number of MPs who voted in favour of the Letwin amendment as well as some Labour MPs, mostly from Brexit constituencies.

Political victory?

Still, Mr Johnson may have already secured a political victory. The [deal he negotiated with EU leaders] sets out the terms for the two sides to negotiate a free trade agreement to minimise disruption.

The Withdrawal Agreement sets out the political and economic objectives of an eventual trade accord, as well as the ambitions for customs treatment, regulations, investment, financial services, capital movement, intellectual property protection, public procurement, energy, fishing, transport and the end to free movement of people between the UK and EU. Uniquely among trade negotiations, the talks will

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Key takeaways

- The UK parliament passed the Letwin amendment, which defers approval of Boris Johnson's withdrawal agreement until the necessary legislation is adopted
- The Prime Minister has reluctantly asked for another Brexit deadline extension
- Mr Johnson will push a majority to approve his withdrawal agreement, and seek another vote this week
- The proposed transition deal would create a customs border for goods across the Irish Sea
- The risk of a no-deal Brexit is dissipating, and we initiated a GBP overweight last week.

of course be about raising barriers rather than removing them. Phil Hogan, expected to take over as European Commissioner for Trade on 1 November when the current commission's term expires, said last month that negotiations "will take a number of years."

The Johnson government made a number of concessions in order to get rid of the 'Irish backstop', which threatened a hard border between Northern Ireland and the Irish Republic and, in part, sank Theresa May's deal three times in Parliament.

From 'backstop' to 'frontstop'

For Northern Ireland the stakes could hardly be higher. The protocol proposes drawing a customs border through the Irish Sea. While Northern Ireland would remain part of the UK's customs territory, it would also work out a much closer relationship with the EU, and the neighbouring Republic, leaving Northern Ireland within the EU for goods imports.

The solution solves the threat of a hard border between the Republic and Northern Ireland. In practice, this "frontstop" would require a business in Northern Ireland that orders goods from Great Britain (England, Wales and Scotland) to pay EU VAT and import tariffs based on paperwork filed by the supplier, and then claim a refund on those products if sold within Northern Ireland.

The Democratic Unionist Party (DUP), which until now had supported the Conservative government, is opposed to any agreement that would see Northern Ireland's status diverge from the rest of the UK.

The cost

Brexit, even with a transition arrangement, will have a negative impact on the UK economy. According to an estimate by academics at The UK in a Changing Europe, ten years after Brexit the UK's gross domestic product per capita will be between 2.3% and 7% lower under Mr Johnson's agreement. In a worst-case scenario, Brexit may cost the economy as much as GBP49 billion per year (USD63 billion) under this calculation. The prolonged uncertainty caused by Brexit already saw the UK economy contract 0.2% in the second quarter as productivity and capital investment slowed.

The governor of the Bank of England Mark Carney welcomed the agreement in an interview with Bloomberg last week, saying he would expect "the economy to pick up from quite a subdued pace".

Sterling bounce

The odds of the UK crashing out of the EU are dissipating with the UK parliament's efforts to avoid a no-deal Brexit, despite the intricate political battles. With an extension to the Brexit deadline triggered, and a high probability that Parliament will accept Mr Johnson's Withdrawal Agreement, we anticipate sterling rallying further against the US dollar.

As global sentiment started stabilising following the trade truce between the US and China and the risks of a no-deal Brexit started receding last week, we closed our long yen exposure and initiated an overweight of around 2.5% in GBP. These trades were implemented using currency forwards with a spot reference of around 1.2650 for GBPUSD. Compared with our long-term fair value of 1.40, sterling still looks cheap, especially now that the tail risk of a no-deal Brexit is clearly diminishing. While we also see a risk that GBPUSD may also overshoot our 1.35 target, there is no reason to expect it reaching the pre-Brexit range of 1.50-1.60 in the near term.

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06.2019