



# Countdown to Brexit

Assessing the possible scenarios and their potential impacts.

February 2019

The UK is currently scheduled to leave the European Union (EU) on March 29. While the date is fast approaching, a number of outcomes are still possible—as well as a range of potential pathways to those outcomes.

In the first of a weekly series of updates, Quentin Fitzsimmons, fixed income portfolio manager and T. Rowe Price's resident Brexit specialist, provides an overview of the current state of play.

## What are the current scenarios?

The four primary scenarios currently in play are:

**Theresa May's Deal:** The government, led by Prime Minister Theresa May, and the EU have negotiated an agreement that sets the terms of the UK's withdrawal, including financial obligations, citizens' rights, and how to deal with the physical border between Ireland (an EU member) and Northern Ireland (part of the UK). The deal provides for a transition period (up to December 2020) that enables details of the new relationship to be finalized and for people and businesses to prepare. It also sets some nonbinding guidelines on longer-term trade, defense, and security arrangements.



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The deal needs to be approved by the UK Parliament. To date, Prime Minister May has failed to obtain a parliamentary majority for her deal. This is primarily (but not solely) due to concerns about the border arrangements with Ireland, commonly referred to as the backstop.

A clause in the agreement guarantees an open border between Ireland and Northern Ireland even if trade negotiations fail to resolve variations in customs regulations and standards between the two countries. However, some in the UK government are concerned this would obligate the UK to remain in a customs union with the EU indefinitely, arguably defeating the object of Brexit.

Since the first attempt to pass the deal in Parliament was heavily defeated on January 15, modifications have been sought. A "modified May deal" will still require a further meaningful vote in Parliament in order to pass.

To date, Prime Minister May has failed to obtain a parliamentary majority for her deal.

We anticipate a high degree of immediate and intermediate uncertainty in a no-deal scenario; however, we believe there is potential for this to resolve faster than most fear.

**No Deal:** If the UK government is unable to get a deal approved by Parliament, the UK could exit the EU on March 29 without arrangements in place and with no transition period to enable business and people to prepare. This is sometimes referred to as the “cliff edge,” “hard Brexit,” “disorderly Brexit,” or “crash out” scenario. Trade with the EU would immediately start to be governed by World Trade Organization rules, and tariffs would apply to some goods.

**Extend Article 50:** Article 50 is the legislation that sets March 29 as the legally binding exit date from the EU. The government could seek to extend Article 50 and the associated exit date. However, this would not resolve the impasse; rather, it would merely increase the scope for negotiation of the deal. The EU would also need to approve the extension.

**A Snap Election:** If the government fails to get parliamentary approval for a deal, Prime Minister May could decide to call a snap election in a bid to increase the ruling Conservative Party’s majority and make it easier to push a deal through. Recent resignations of members of Parliament from both the Conservative Party and the opposition Labour Party have increased this possibility. An extension to Article 50 would be necessary in the event of a snap election being called.

#### What has changed in the past week?

Prime Minister May is working to persuade the EU to revisit the terms of the Irish backstop and reopen the withdrawal agreement. She is seeking a solution that will appease members of her party and enable the deal to pass through Parliament. Whether changes can be incorporated into a legal treaty remains open to considerable doubt.

#### Based on events over the past week, what are market expectations about the likelihood of the various outcomes?

Theresa May’s Deal	35%
No Deal	30%
Extend Article 50	20%
Snap Election	15%

Source: T. Rowe Price; as of February 21, 2019.

#### What is your view on the potential economic impact of the various outcomes?

**Theresa May’s Deal:** A modified deal that achieves the support of the government (and passes through Parliament) is seen as a much more controllable outcome with significantly reduced cliff edge effects on the UK economy.

**No Deal:** The prospect of the UK exiting without a transition deal in place has prompted warnings from many quarters. Some business groups have expressed concerns about lack of preparedness, impacts on trade flows, and investment—among them the Confederation of British Industry, car manufacturers, and food exporters. The Bank of England (BOE) has also weighed in, arguing that the UK economy is not ready for a no-deal exit and that economic growth could suffer. The BOE recently cut its growth forecast for 2019 from 1.7% to 1.3%, suggesting that Brexit damage had increased. We anticipate a high degree of immediate and intermediate uncertainty in a no-deal scenario; however, we believe there is potential for this to resolve faster than most fear.

**Extend Article 50:** A delay of Brexit without a clear resolution in sight would also extend the current period of uncertainty for business, making it difficult for firms to make long-term plans and hampering capital formation.

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**A Snap Election:** An extension to Article 50 would be necessary for this to occur, prolonging uncertainty for business, restricting investment activity and ultimately weakening the economy.

#### **What is the likely impact on financial assets of a disorderly exit?**

The uncertainty that would follow a disorderly exit from the EU is likely to generate some market volatility. Our present expectations are as follows:

**Fixed Income:** A disorderly Brexit would heighten uncertainty about the UK economy, likely prompting the Bank of England to adopt a more dovish stance, possibly including interest rate cuts. If this occurs, the yield curve would be likely to steepen because the front end would be anchored and the yields of longer-dated bonds would rise amid the uncertainty over the economy's future. A hard Brexit would also hit credit markets, but in our view that would also create opportunities to buy corporate bonds whose valuations have fallen too far in relation to their fundamental quality.

**Currency:** Sterling is the shock absorber for the UK economy and as such would likely weaken in the event of a hard Brexit—how much weaker would depend on how quickly confidence in the economy is restored. We believe the UK economy might recover more quickly than expected, meaning that any weakness in sterling, and UK assets more generally, could be short-lived.

**Equities:** The UK equity market has already de-rated. In theory, UK equities look attractive on many international comparisons. A hard Brexit would be likely to increase risk aversion given that it comes at a time when concerns are already mounting in relation to international trade and Chinese growth.

#### **What We're Watching Next**

As noted, Prime Minister May is seeking to redefine the backstop arrangements for the Irish border to achieve approval within her party and to enable the deal to pass through Parliament. Negotiations with the EU continue and May has promised that there will be a meaningful vote in Parliament on the deal by March 12 at the latest.

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