Countdown to Brexit: Conservative Win Paves Way for UK Exit

UK likely to leave EU on January 31—then the real work begins.

December 2019

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The 75+ seat majority won by Boris Johnson's Conservative Party in yesterday's UK general election makes it very likely that the country will leave the EU on January 31, 2020. Prime Minister Johnson still needs Parliament to approve the timetable for his Withdrawal Agreement Bill (the bill itself was approved in October), but that is very likely to occur given the size of his new majority. However, this is just the end of the beginning. The real work of negotiating the UK's future trading relationship with the EU lies ahead—and that has the potential to become very complicated.

In the eighth of a series of updates, Quentin Fitzsimmons, fixed income portfolio manager and T. Rowe Price's resident Brexit specialist, argues that while Brexit may finally be about to happen, the details of the UK's post-EU existence remain unclear.

What Are the Potential Scenarios?

Regarding the January 31 Brexit deadline, there are three main potential outcomes—the first of which is by far the most likely.

1. Johnson gains Parliamentary approval for the timetable for his Withdrawal Agreement Bill and the UK leaves the EU on January 31.

2. Parliament does not approve the Withdrawal Agreement Bill and the EU grants the UK a further Brexit extension beyond January 31.

3. The Withdrawal Agreement Bill is not approved, and the UK either does not seek an extension to Article 50 or requests on and is refused, and leaves the bloc without a deal on January 31.

What Has Changed Since Our Last Update?

On October 29, MPs finally backed Johnson's request for a general election on December 12 in order to break the Brexit deadlock. Parliament was dissolved on November 6 to enable the parties to begin their campaigns.

Johnson made Brexit a central plank of the Conservative Party's election campaign, promising to "get Brexit done" if the party gained a majority. He insisted that the transition period would not extend beyond December 31, 2020, despite widespread doubt that a trade deal could be concluded by

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then (the transition period can be extended by up to two years if the EU and UK both agree). Johnson claimed that the UK will diverge from the EU on state aid rules, making it easier for the government to prop up ailing industries, and enjoy considerable autonomy on trade and regulation while continuing to have a high degree of access to the EU market. This was met with scepticism from many experts, including Ivan Rogers, the UK's former ambassador to the EU, who claimed that "the biggest crisis of Brexit to date" was "virtually inevitable" in late 2020.

The opposition Labour Party pledged to negotiate a better Brexit deal with the EU and put it to a referendum with a "remain" option. Party leader Jeremy Corbyn said he would take a "neutral stance" in any referendum and would not campaign for either side, acting as an "honest broker" instead. Corbyn's refusal to adopt a clear position on Brexit was criticized for potentially confusing the public, potentially alienating both leave and remain voters.

The Liberal Democrats, the UK's third-largest party, began the election campaign by ditching its support for a second EU referendum in favor of a promise to simply scrap Brexit altogether by revoking the Article 50 exit process. However, this tactic appeared to backfire during the campaign when opinion polls suggested that support for the party was falling rapidly, which prompted leader Jo Swinson to switch back to advocating a "people's vote" rather than revoking outright. The Scottish National Party campaigned for a second referendum with "remain" as one of the options on the ballot paper.

On December 12, the Conservative Party won the election with a 75+ seat majority.

Based on Events Over the Past Few Weeks, What Are Your Views on the Likelihood of the Various Outcomes?

Given the size of Johnson's new majority, it is almost certain that the timetable for the Withdrawal Agreement Bill will be approved by Parliament, possibly before Christmas, and that the UK will leave the EU on January 31. It would take something extraordinary for the bill not to be passed by Parliament now.

However, while the approval of the Withdrawal Agreement Bill will facilitate the UK's departure from the EU, it does not prescribe its future trading relationship with the bloc. That must be determined by December 31, 2020, which leaves a very short transition period in which to negotiate the kind of deal that would usually be expected to take many years to agree upon. The negotiations are likely to be tough—the EU is highly committed to its four key principles: the free movement of goods, services, capital, and labor. The UK would like to opt out of the free movement of labor but maintain a high degree of freedom in the other three areas, but the EU is likely to strongly resist any attempt by the UK to have its cake and eat it too.

Johnson has a very difficult path to tread: If he is seen to give too much ground to the EU, the more hardline "clean break" MPs in his party could prevent a trade deal from being approved; if he demands too much in negotiations, it may be impossible for a deal to be agreed upon before the deadline. In the event that either of these two scenarios occurs, the UK will face the choice of leaving the EU without a deal at the end of 2020 or asking for an extension to the transition period—both of which carry considerable risks.

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What Are the Implications for Financial Markets of the Conservative Party's Election Victory?

It will be difficult for markets to price in the future trading relationship between the UK and the EU because there are very divergent views on what the negotiations will achieve—and even on what the UK *wants* to achieve from them. Until that becomes clearer, asset prices will be determined by the weighing up of contrasting sentiments—relief that a no-deal Brexit has been avoided in the short term and that Labour Party leader Jeremy Corbyn's fiscal policies will not be implemented versus concern that the trade negotiations may not go well and a no-deal Brexit could still occur at the end of 2020.

The fact that a no-deal Brexit is off the table in the near term reduces the likelihood of the Bank of England cutting interest rates anytime soon. As such, UK government bond yields are likely to remain range-bound for the time being, although they may fall if there are increased concerns over a global recession. Sterling is likely to remain capped, then pushed around throughout 2020 depending on how the negotiations are perceived to be progressing. Relief that Corbyn's plans to nationalize key industries are off the table may cause stocks to rally in the short term, but after that, equities are likely to follow a similar path to the pound as the markets scrutinize the trading negotiations for clues about the likely state of the UK economy in 12 to 18 months' time.

What We're Watching Next

We fully expect Parliament to approve the timetable for the Withdrawal Agreement Bill, but we will be watching closely for any signs—however unlikely—that this may not occur. Assuming the UK leaves the EU on January 31, our focus will be on the trade negotiations, which are likely to be complicated and fractious. The year 2020 is likely to be another in which asset prices are buffeted by shifting perceptions of how well talks are progressing between the UK and the EU.

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ID0002847 (12/2019)
201912-1029925