

UK economy

Brexit brief: "You're joking. Not another one!"

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- **Brexit:** The fallout from the cabinet's acceptance of the Brexit withdrawal agreement (WA) has been larger than we expected. The PM was always likely to face problems gaining approval in parliament for the deal, but with a number of resignations already tendered, and speculation about a leadership challenge, momentum is building behind the possibility of (yet) another general election, or a second referendum.
- **Economy:** Assuming the UK reaches a deal with the EU, growth should rebound next year, opening the way for the BoE to hike rates twice. No deal would likely entail significant economic disruption and a more cautious BoE.
- **Markets:** The pound remains the main focus for the markets with volatility rising in recent days. Sending voters back to the polling booth would likely lead to a further period of uncertainty for the markets, as the result of any vote is highly unclear. This could keep sterling volatile and exposed to downside risk in the near term. Over the medium term, we expect the pound to strengthen against its peers.



Source: iStock

Our view

It is not our base case, indeed a number of hurdles would have to be overcome before it became so, but the chances of the country returning to the ballot box at some point in the near future have undoubtedly risen.

It feels brave (foolish) to be making predictions in light of the current political turmoil, but our expectation remains that Mrs. May will see off any threat to her leadership and present the WA to parliament. The bill is unlikely to pass on the first showing, but our expectation is that a version of the WA will be passed by MPs and the UK will enter the transition period.

Of course, the situation may not go that far. If parliament cannot agree on the way ahead then politicians may ask voters to decide. The hurdles, political and logistical, that would need to be overcome to have either a general election or a second referendum are high, and may require the goodwill of the EU by agreeing to extend delay the Article 50 deadline. In our view, a general election is more likely than a second referendum, although at this stage it seems unlikely that this could resolve the issue. So it could lead to a further period of political uncertainty.

Sterling exchange rates look exposed to further volatility if uncertainty resulting from an election or referendum were to emerge.

"You're joking. Not another one!"

This now famous outburst by Brenda from Bristol on BBC news when confronted with the prospects of a general election back in 2017 may soon be heard again in households up and down the country.¹

The British political landscape has been febrile for some time, but it has reached new levels since the Withdrawal Agreement (WA) was presented to all last Wednesday evening (14 November). Talk of a leadership challenge and the prospective failure to pass legislation in parliament have led many to the conclusion that the only way to get out of the political quagmire is to let voters decide, either through a general election or a second referendum.

In our view, we are still some way away from either of these, but the chances have unquestionably risen in recent days. In our view, returning to the voters is likely to be a last resort option for the government, as doing so would be seen as a huge admission of failure by the political establishment. Moreover, it is not clear whether voters could actually provide a clear answer on Brexit, as opinion polls show that the country remains divided.

We believe that if the political situation were to deteriorate that far, a general election seems more likely than a second referendum for a few reasons. First, an election is likely to be preferred by the main political parties as they are arguably better prepared for this challenge than they would be for another referendum. Second, a referendum risks dividing opinion in the country on this single issue for a second time. Third, it would probably take longer to prepare and hold a referendum (about 24 weeks according to a study from UCL²) than a general election.

However, without a clearer stance on Brexit from the Labour Party, a general election may do nothing to resolve the key issue of Brexit. So, politicians may prefer a plebiscite as the issue at hand can then be answered.

Getting to a general election – the Fixed Term Parliaments Act (FTPA)

A legacy of the Conservative/Liberal Democrat coalition government is the Fixed Term Parliaments Act 2011 (FTPA). The FTPA legislates that a general election has to be held in the fifth year of a parliamentary term on the

¹ <https://www.bbc.co.uk/news/av/uk-politics-39631693/views-from-bristol-after-snap-election-announcement>

² <https://constitution-unit.com/2018/08/30/how-long-would-it-take-to-hold-a-second-referendum-on-brexit/>

first Thursday in May. Thus, the next general election in the UK is scheduled for 5 May 2022. However, the act contains provisions for an election to take place earlier in either of the following circumstances.

- Ministers pass a motion in the House of Commons stating “That there shall be an early parliamentary general election.” This motion has to attract the support of two-thirds of MPs (currently 434).
- Ministers, by simple majority, pass a motion in the House of Commons stating “That this House has no confidence in Her Majesty’s Government.” If after a 14-day period ministers cannot pass a motion stating “That this House has confidence in Her Majesty’s Government” then a general election will be held.

The first option, voluntarily deciding to hold an election, was the route taken by the PM in 2017. Given the two-thirds of MPs threshold it would clearly need the support of the Conservative members for an election to take place. Although the Conservatives currently have a lead in the opinion polls, this is not large and the margin of error we normally assign to these could mean they are actually behind (Fig.1). Thus, voting for an election could prove to be a very risky strategy for Conservative MPs, especially those in marginal seats. Thus, this is not a decision they would take lightly.

The second option, losing a motion of no confidence, is an extremely rare event in UK politics. It has happened on only three occasions in the last century, the most recent of which led to the fall of James Callaghan's Labour government in 1979.

The Conservative Party does not currently have a majority in the House of Commons. They are reliant on their coalition partner, the Democratic Unionist Party (DUP) and their 10 seats for their majority. Combined, this gives the government a working majority of 13 seats in the House of Commons, so the opposition parties could not deliver a vote of no confidence on their own (Fig. 2).

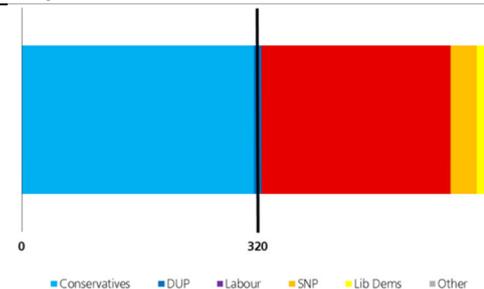
However, the recently published WA, which contains special provisions for Northern Ireland, has raised alarms with the DUP, who have now openly questioned their commitment to the coalition with the Conservatives. We have no insight as to whether this is just posturing, and whether it is a big enough issue that they would be willing to vote against the government in a confidence motion.

Fig. 1: Opinion polls show the Conservative Party have a marginal lead
Voting intentions, five poll moving average



Source: Various polling agencies, UBS, November 2018

Fig. 2: The Conservative Party does not have majority
Composition of the House of Commons



Source: www.parliament.uk, UBS, November 2018

However, the risks of this are not, in our view, immaterial.

Another problem for the PM is the divided factions in her own party. The margins are so slim that it would only need six of her own MPs to vote against her, and a confidence motion would be lost. Given that the hard-Brexiteer wing of her party reportedly numbers between 10 and 20, and the disgruntled remainers who wish to stop Brexit are seemingly similar in number, it is easy to see where these votes could come from.

Summing up, clearly a general election is possible, but not inevitable at this stage. To force an election would require either the breakdown of the coalition or Conservative MPs to vote down their own government. This is always possible, especially if the political situation deteriorates, but not inevitable.

Who would win an election?

If an election were to be held the results are, of course, hard to predict. A lot would depend on each party's stance on the main question of Brexit. If the Labour party were to go into the next election with their current ambiguous stance on Brexit, then voters would have to decide how they cast their ballot based on other issues.

In Fig. 3 we have used a "swingometer" from the website www.ukpollingreport.co.uk to estimate the outcome of an election. We should caution that these are estimates, and we have only moved around the vote share of the two main parties in the scenarios. The general trends, rather than the actual numbers, are probably the most important part to focus on.

If an average of the current polls is realized in a general election (a one point lead for the Conservatives), the result would most likely be a hung parliament with the Conservatives as the largest party. Whether they could govern with the support of the DUP is unknown, but it could be possible for Labour to form a coalition government.

For the Conservatives to gain an outright majority, it seems they would need to win by a margin of five percentage points. For Labour to win a majority it seems they would need to win by more than this margin, but of course this would not stop them from forming a government if they could rely on the support of the SNP and Liberal Democrats. Thus, if a general election were to be held, the possibility of a change of government is reasonably high.

Fig. 3: An election may not be able to break the deadlock
Seat projections based on vote share

	Vote share, %	No of Seats	Result
Conservative	42	331	Cons Majority of 12
Labour	37	239	
Other	21	80	
Conservative	41	322	Hung parliament, Cons short by 4
Labour	38	249	
Other	21	79	
Conservative	40	307	Hung parliament, Cons short by 19
Labour	39	266	
Other	21	77	
<i>current five poll moving average</i>			
Conservative	40	307	Hung parliament, Cons short by 19
Labour	39	266	
Other	21	77	
Conservative	39	292	Hung parliament, Cons short by 34
Labour	40	280	
Other	21	78	
Conservative	38	277	Hung parliament, Lab short by 29
Labour	41	297	
Other	21	76	
Conservative	37	266	Hung parliament, Lab short by 12
Labour	42	314	
Other	21	70	

Source: www.ukpollingreport.co.uk, UBS, November 2018

What would a change of government mean?

Brexit would unquestionably feature as the main point of any election battle, but as yet it is unclear what position the Labour Party would take. The membership of the party currently seem in favor of stopping Brexit, or at the very least holding a second referendum on the subject. However, many of the party's traditional voters opted for Leave in the 2016 referendum. This, combined with the leadership's long-held Eurosceptic views, explain why it is proving difficult for the Labour party to come up with a unified and consistent view.

On balance, we suspect that Labour Party policy will probably end up settling for a softer form of Brexit, rather than no Brexit at all. However, it is likely that they would try to deflect from this issue during the campaign and focus on their domestic policy ambitions.

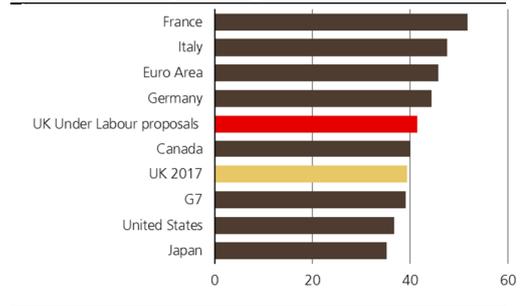
And it is on the domestic agenda that things could be very different. On the basis of the 2017 election manifesto we know that the Labour Party has ambitious plans in terms of increasing taxation, spending and investment, and borrowing. Spending and taxation as a share of GDP would likely return to levels not seen since the mid-1980s, but the UK would still have lower rates of tax and spend than its peers (Fig. 4 and 5).

Other policies under consideration include a program or renationalization for the rail, water, and postal industries. More recently, indications of compulsory share ownership by employees of large companies has been mooted, as has an idea to transform the mandate of the Bank of England to focus on raising levels of productivity in the economy. Officials at the Bank of England were quick to respond to this idea, suggesting that they don't have the necessary toolkit to affect lasting change on matters such as productivity³.

How these policies affect the economy depends on the balance between taxation (negative for growth) and investment and increased spending, especially if this lifted the productive potential of the economy. A further consideration is the effect that higher borrowing could have on UK borrowing costs, which in turn limits the spending power of the government.

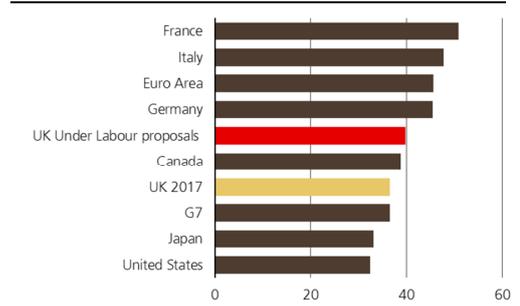
From a markets perspective, we would expect that the reaction to the prospect of a Labour government would initially be negative. Sterling would likely come under

Fig. 4: A Labour government would look to increase spending...
Government spending as a share of GDP, %



Source: IFS, UBS, November 2018

Fig. 5: ...and raise the tax take
Government revenues as a share of GDP, %



Source: IFS, UBS, November 2018

³ <https://www.ft.com/content/dcf9b29e-7ad7-11e8-8e67-1e1a0846c475>

pressure, as investors focus on the possibility of measures to limit any capital flight, as hinted at by the shadow chancellor, John McDonnell⁴. For any economy integrated into the global financial system, the mere hint of such measures may be enough to spook overseas investors.

For equity markets, the potential for higher rates of corporation tax would likely lead to earnings downgrades. The Labour Party has suggested that they would return the level of corporation tax to 26% from 19% today. 26% is still low by international standards, but it would be a reversal of the policy in recent years. Other concerns for equity investors could include the prospect of nationalization of certain industries, and plans to mandate employee share ownership⁵.

Without exact details on likely policy measures, it is difficult to quantify the potential impact on markets. Broadly speaking, if companies are operating at headline tax rates (some have effective tax rates below headline rate), then we would expect an increase from 19% to a 26% tax rate would lead to a reduction in profits for the FTSE 100 of 2% and for the FTSE 250 of 3-4%. We would anticipate a similar move in the index level as that of the earnings. Meanwhile there could be some offsetting benefit from a weaker sterling.

For the gilt markets, higher borrowing could lead to higher yields, but arguably the most difficult area for investors to reconcile could be any change to the BoE's mandate. Inflation targeting has provided markets with a solid anchor upon which they can form expectations about the likely path of monetary policy. Any change to this mandate could have unintended consequences for the market.

Over the medium term, how markets react will have much to do with the success or otherwise of a new government's policies to boost economic output. Higher spending, a fiscal stimulus, and higher investment are, all else equal, normally positive for economic growth, as could be a softer stance towards Brexit and immigration. However, these effects could be offset by other measures that may be seen as less business friendly and could lead to a fall in UK competitiveness and investment.

⁴ <https://www.independent.co.uk/news/uk/politics/labour-pound-sterling-run-john-mcdonnell-economy-government-jeremy-corbyn-party-conference-a7968156.html>

⁵ <https://www.theguardian.com/politics/2018/sep/08/john-mcdonnell-labour-proposal-workers-ownership-funds>

A second referendum – the People's Vote

A final consideration is a second referendum, the so-called People's Vote. Many MPs in parliament have been calling for a second referendum as the only way to overcome the current political deadlock. Moreover, there have been many marches in London and around the UK in support of a second referendum.

As mentioned above, holding a second referendum is potentially quite a lengthy process. Research from UCL suggests this could take up to 24 weeks; with less than 19 weeks to go before the Article 50 deadline, holding a second referendum would likely require delaying the date of the UK's departure.

To hold a referendum would in the first instance require a piece of legislation. This would need to include the question that is to be asked, and this is by no means easy to determine. Some will argue for a simple in/out referendum as per 2016, where others will be championing the idea of a three-way vote with the options of: i) accept the WA, ii) leave with no deal, iii) remain in the EU. The three-way vote option is likely to meet with stiff opposition, as many will argue that it will have the effect of splitting the leave vote, handing an advantage to remain. This could be mitigated to some extent by offering a second preference vote, but this is unlikely to satisfy those on the leave side of the debate.

When these issues have been decided, parliament would then need to vote this bill into law for it to take effect. Following this, a period of question testing would take place, preparation for the poll, and then would come the 10-week campaign period.

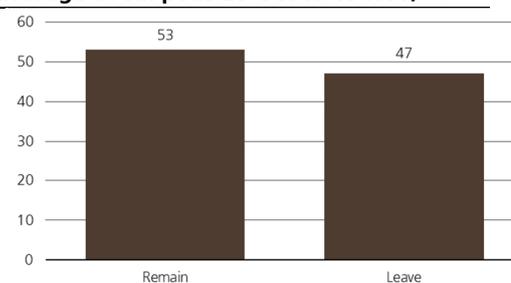
Finally there is outcome. In the two years since the last referendum opinion polls have shown a slight shift in voter's preference to remain, but this is not sizable (Fig. 6). Indeed, one could argue that the polls are similar to what they were in the run-up to the last referendum.

Thus, holding a referendum is itself not without risks for the remain campaign. There is a chance that the result could be the same as in 2016. Or perhaps more likely, it would only be a marginal victory for remain, which would mean the question would still not be fully resolved.

More uncertainty for the markets

As we mention above, we believe that a general election or second referendum are not the most likely outcome from the current political fracas. However, if the prospect of either increases in the weeks ahead it would likely unleash

Fig. 6: A modest shift back to remain
How would you vote in an EU referendum?
average of six polls 20 Oct to 15 Nov, %



Source: whatukthinks.org, UBS, November 2018

another wave of uncertainty on the markets.

Further uncertainty points to further volatility, so taking insurance against GBP downside still makes sense, in our view.

Appendix

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Appendix

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