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Market Update: 4th September 2019

Brexit brinkmanship comes to a head as Parliament takes control of the agenda

In the most recent development in the continuing Brexit saga, last night the Prime Minister suffered a major setback to his Brexit plans, as a cross-party group of MPs voted to take control of the Parliamentary agenda to propose a bill aimed at preventing a no-deal Brexit. The move, which throws the Prime Minister's plans to exit the European Union by the 31st October into disarray, now means that MPs will vote later today on whether to delay the withdrawal deadline.

What does this mean?

Boris Johnson's defeat in last night's vote suggests that the risk of the UK crashing out of the European Union without a deal is reduced, and that a general election may be on the cards. From here a number of possible outcome scenarios exist, with a general election being the most likely next step. As it stands however, opponents are unwilling to back a general election unless no deal is off the table, with MPs reluctant to trust the new Prime Minister to hold a general election prior to the Brexit deadline given his ambitions for a no-deal Brexit. The PM will need two-thirds of the House of Commons to vote in favour of an election, and he has already lost his Parliamentary majority after the defection of Phillip Lee during his update on the G7 summit yesterday, compounded by the decision to expel 21 rebel MPs from the party after voting against the government last night. A vote on legislation to block a no-deal exit is set to take place later today.

As a result of the recent developments, according to PredictIt data, the odds of the UK leaving the EU by the 1st November have now dropped to 35%, with expectations that there will be an extension to the deadline followed by a general election. If a general election is called, it is likely that uncertainty will continue to weigh on the UK economy, which is already showing signs of weakness due to trade uncertainty and cooling global growth. This would cause the economic fundamentals to potentially deteriorate further, with consequences of an extension being further postponement of investment decisions and loss of potential growth.

How likely is a General Election and what would be the outcome?

Immediately following the votes last night, the Prime Minister called for an election, however he would need the support of the opposition for that, and Jeremy Corbyn has declared that he would not support a general election until a delay to Brexit has been written into law to avoid the UK crashing out of the EU if the election is held too close to the deadline.

With the Tories remaining in pole position in the polls, a no deal Brexit either on the 31st October or 31st January remains a real possibility, with all eyes now on a vote later today to decide on whether to implement the Bill to delay Brexit. It is expected that the vote will pass, and from there the plan will be to write it into law before Parliament is suspended next week. Should Parliament vote to request a further extension, the EU is likely to comply to avoid a costly no-deal Brexit and given the political turmoil experienced in the UK in recent months, and to allow time to hold an election.

An election would almost certainly be fought along Brexit lines, and the predictability of the outcome is very low. Current polls have the Tories in the lead and on track to win a majority of 62 seats. That would give Boris a mandate to seek a Brexit deal or to leave without a deal if necessary, with a no-deal scenario likely to result in recession. On the other hand, the current close Parliamentary arithmetic indicates that a labour government of a coalition government could also be a possibility. Given the wide spectrum of potential outcomes, the Bank of England remains unlikely to make any changes to monetary policy until the Brexit outcome is known.

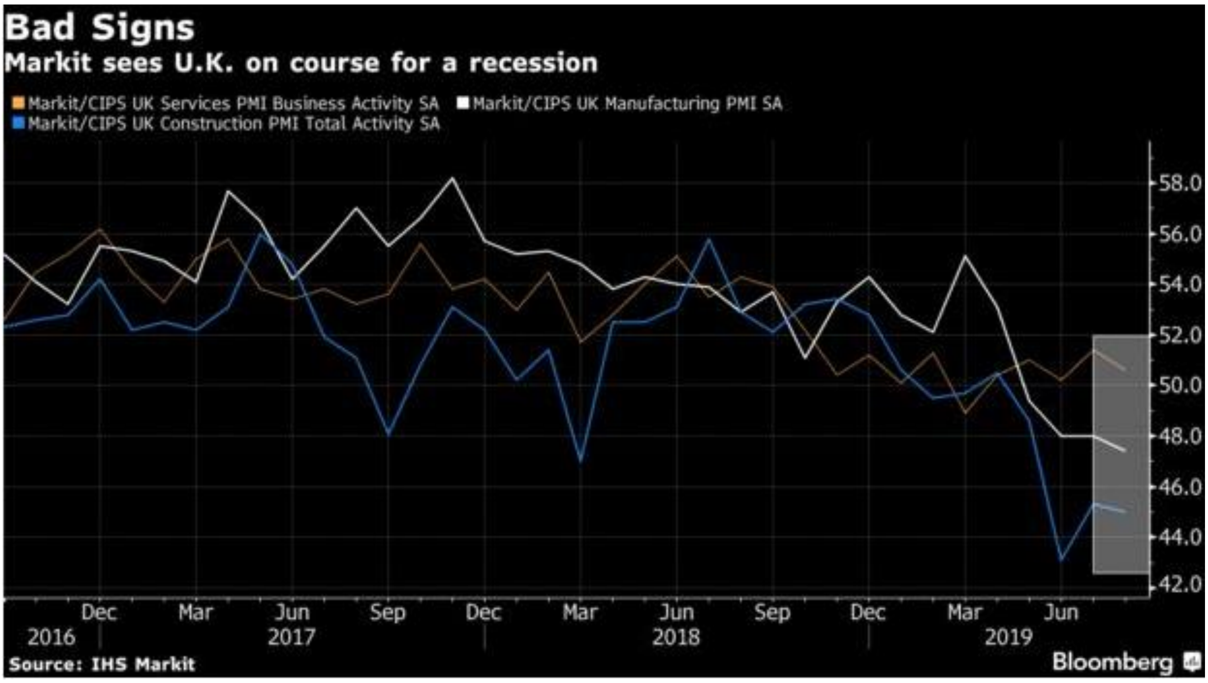
The threat of a Labour government

If Labour were to win the election, the near-term downside risk of a no-deal Brexit would be removed, boosting the economy in the near term as a Labour government is likely to negotiate a softer Brexit deal or after a second referendum, have no Brexit. In the medium term however, a Labour government would bring many anti-business policies that would restrain economic growth, such as higher taxes, tighter labour laws, increased spending and the nationalisation of network industries. As it stands, a labour government remains unlikely, but would clearly spook the City and currency markets and those companies which will have the lingering threat of renationalisation.

UK recessionary fears

As financial markets grapple with this week's Brexit-induced turmoil, it is becoming increasingly likely that the UK economy may be on course for its first recession since the financial crisis, as Brexit uncertainty begins to feed through into sustained weakness in UK economic activity.

According to the recently published IHS Markit Purchasing Managers Index data, growth in the UK services sector almost stalled last month, with similar surveys indicating that the manufacturing and construction industries are in deep downturns, with the readings implying a 0.1% contraction of the UK economy in the third quarter of the year.



Output already fell by 0.2% in the last quarter, therefore such a contraction would mean that the country had entered a recession even before it leaves the EU next month. Business activity in the service sector has been impacted by escalating Brexit-related concerns, with consumers and business spending cooling. Previously, the services sector has been propped up by growth in the services sector, therefore pronounced slowing in the sector is likely to result in problems for the UK economy, increasing the likelihood of recession.

The already struggling economy could come under further pressure should Boris Johnson's government continue to pursue an economically damaging no-deal exit from the European Union. Increasing risks of a no-deal Brexit sent the pound tumbling earlier this week, with sterling dropping below $1.20 for the first time since early 2017 yesterday. The services sector PMI fell to 50.6 last month, while manufacturing PMI showed that the manufacturing sector is in its worst downturn since 2012 while construction activity contracted for its fourth straight month. According to Bank of England Governor Mark Carney, in a worst-case scenario no-deal Brexit, the UK economy would likely shrink by 5.5%, which is the same pace the economy shrank at between 2007 and 2009.

Market reaction

The pound has fallen sharply since Boris Johnson took power, however clawed back some of the move after last night's events, as investors judge a no-deal Brexit on 31st October as a less pressing threat. The pound jumped 0.7% to $1.2163 in the second day of gains and 10-year UK government bonds gained 6 basis points to 0.47%. The FTSE 100 rose 0.7% with UK-based shares gaining. Negative economic data failed to dim the rally, with investor attention still focussed on the Brexit outcome and other key trade headlines around the world, disregarding the economic data and creating excess volatility in intra-day movements.

What next?

Investors will be closely watching today's developments in the UK, with Prime Minister's questions, a spending statement from the new Chancellor Sajid Javid, and the Governor of the Bank of England Mark Carney testifying in front of the Treasury Select committee. Most importantly, MPs are set to vote on a draft law in Parliament which would force Boris Johnson to delay Brexit until 31st January 2020 if no deal is reached before the current deadline. If the bill passes through Parliament, legislation would be drafted in the coming weeks prior to the suspension of Parliament, and this is likely to be followed by calls a general election.

Overall

It is clear that the future growth prospects of the UK economy are largely dependent on the Brexit outcome, therefore political brinkmanship is increasing uncertainty while the economy is also grappling with slowing global growth and the deterioration of key trading partners. Uncertainty is expected to remain high right up to the Brexit deadline; however the impact of prolonged Brexit-related uncertainty is beginning to weigh on the UK economy, which is also grappling with the impacts of lower global growth and trade conflict. Political events over the next week could result in a general election which would have a profound impact on the UK economy, either the near-term pain of a potential no-deal Brexit or the medium term restraint of a Labour government. Caution is key as the Brexit outcome remains so uncertain, and sterling remains extremely volatile in the near term. For now, we choose exposure carefully and retain a low exposure to UK equities alongside a short on the FTSE 100 which seeks to benefit when the market declines given the current deterioration of the economic fundamentals.