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BREXIT TALKS HIT A WALL - WHAT HAPPENS NOW?

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Two steps forward, one step back. Brexit negotiations hit a wall last night shortly after head UK negotiator Dominic Raab arrived in Brussels to meet with his EU counterpart Michel Barnier. The meeting followed widespread reporting earlier in the day that UK and EU technocrats had agreed the terms of the final deal. News that talks have crashed will likely stoke market fears that the final negotiating hurdles may be insurmountable and that the risk of a no-deal hard Brexit has risen. This is not a forgone conclusion, in our view. Of course, there remain real differences between what the UK is currently ready to accept and what the EU can offer. However, the latest breakdown seems worse than others for two reasons: 1) time is running out; and 2) it follows the heavy reporting last week that a deal was in sight. The implosion highlights the tail risks – totaling 40% – around our call that UK Prime Minister Theresa May will eventually sign up to, and parliament will ratify, the EU's offer in the end.

TROUBLE IN WESTMINSTER

Different factions of the UK government are completely at odds over Brexit. But as the Brexit talks have come to a head and negotiators have closed-in on a deal, such groups have begun to express their grievances with more venom than before. The current “backstop” plan to guarantee an open border in Ireland under all circumstances is highly controversial in the UK. The EU demands that: first, Northern Ireland would remain in the EU customs union indefinitely if no other solution could be agreed before the end of the transition period in December 2020 (as per the UK's demand, this would apply to the whole of the UK); and second, Northern Ireland would de facto remain part of the EU single market for goods by staying in “regulatory alignment” with the EU, implying a need for some border controls for goods moving between Northern Ireland and the UK mainland.

The Northern Irish DUP (Democratic Unionist Party), whom May's Conservatives need for a working majority in parliament, threatens to bring down the government if May accepts a deal that could involve a border down the Irish Sea. In addition, at least another 20 hardline Brexiteers among the Conservatives look likely to vote against any deal that could keep the UK in the customs union indefinitely. As the Conservative-DUP alliance has only a 13 seat working majority, May will almost certainly need support from moderates in opposition parties to get a deal ratified in parliament.

To add to May's woes, ex-Brexit secretary David Davis wrote a scathing criticism of her negotiating approach in yesterday's Sunday Times and called for a revolt in cabinet. Meanwhile, several UK news outlets reported that the 1922 Committee – the parliamentary group of the Conservative Party – is just four signatures short of the required 48 to trigger a vote of no confidence in May. The UK Prime Minister is walking a tightrope. It seems likely that Mr Raab could not shake hands with Mr Barnier last night as he did not have the nod from the May that the tricky balancing act of passing the deal and remaining in power could be pulled-off.



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A DEAL IS STILL MORE LIKELY THAN NOT

At home, May has already paid a significant price for softening her stance during the Brexit negotiations. The risk of a leadership challenge hangs over her like a sword. She cannot be seen as taking a soft approach with the EU at the final stage of the talks. She may indeed hope that, by pushing the negotiations to the line, last minute concessions from the EU are possible. This is unlikely. While the EU will probably be open to altering the language here and there - as long as principles of its offer remain unchanged - if it could help May sell the deal at home, the EU27 has already agreed its position. It is therefore unlikely to shift much at this stage. Even if May does not manage to get the EU to change its tune much, she is likely to strengthen support within her own ranks if she heads to Brussels Thatcher-style ready throw some weight around.

Watch the tail-risks: We see a 20% chance that the Brexit negotiations fail and the UK rolls out of the EU on 29 March 2019 without a trade-deal in place. But for that to happen, the Tory-DUP alliance would have to remain intact to deliver a hard Brexit. As a large group of Conservative MPs are staunchly pro-EU, a failure on the part of the current Conservative-DUP government to pass any final deal would significantly raise the chances of snap elections. We thus see a 25% chance that Jeremy Corbyn could become Prime Minister in either a Labour majority government or a coalition government.

Labour's current policy on Brexit is to negotiate a customs union. Therefore, we would stick with our base case for the Brexit deal if Labour won an outright majority in a snap election (5pts). However, based on current opinion polls, it seems unlikely that Labour would manage to secure such a majority. Labour would therefore likely need the help of either the very pro-EU Liberal Democrats (Lib Dems) and/or Scottish National Party (SNP) to govern. Our bet is that both the Lib Dems and SNP would only join Labour as a junior coalition partner if Labour either went for a soft Brexit (10pts) or a second referendum that could end in a no Brexit outcome (10pts).

If our logic prevails, the Conservatives' real choice could be between remaining in power in a customs union style arrangement, or losing power and potentially seeing Brexit softened/reversed. In the end, these risks will probably focus the minds of most Tories and act as the glue that binds them together around the EU's current offer.

SO WHAT HAPPENS NEXT?

Brexit talks are on hold until May meets with other European leaders at the EU summit on Wednesday. For now, it is hard to say which way events will progress in the coming days. On the one hand, there could be a final push from May and her team to muster enough support at home ahead of the EU summit so that May can signal to EU leaders that the UK is ready to agree to the deal. On the other hand, to keep her safe for now, May could bend to the hardliners within her party - that would probably lead to a confrontational meeting on Wednesday. An emergency Brexit summit is scheduled for November. Whether the November summit is used for UK and EU leaders to shake on a final deal or for EU leaders prepare for a hard Brexit is largely up to the UK.



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After that, the next EU summit would be in December. In our view, a deal would still be possible even at such a late stage.

At any rate, the range of possible outcomes remains wide. But then again, did anyone seriously think this would be a walk in the park?

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