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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

BREXIT VOTE TRILOGY: PREDICTIONS AND OBSERVATIONS

Berenberg Macro Flash

THE WEEK TO WATCH

The week ahead in UK parliament could be crucial for the long-run economic outlook for the UK. In three votes in three days - beginning on Tuesday 12 March - the House of Commons is likely to (1) reject Prime Minister Theresa May's Brexit deal, (2) reject a hard Brexit, and (3) support a delay to Brexit – currently planned for 29 March 2019.

Such a pattern of votes would demonstrate that the UK parliament, having looked over the hard Brexit cliff-edge, has decided to swerve that tail-risk for now. This scenario is already baked into our view that the probability of a hard Brexit is 15%.

A delay to Brexit would be modestly positive for sterling and UK risk assets, reflecting the further reduction of the implied risk of hard Brexit. However, it would not completely eliminate the hard Brexit risk which could still come at the end of a delay or as a result of a second referendum. Uncertainty would thus remain elevated and any rebound in economic activity that would come from a Brexit resolution would be delayed.

SURPRISE AHEAD? PROBABLY NOT

We see four reasons why the risk of a surprise outcome in the key votes this week is low:

On May's deal:

(1) As May has not managed to get the EU to agree to a time limit or unilateral exit mechanism on the contentious Irish backstop, Brexit hardliners in the Conservative Party plus the Northern Irish DUP – who voted down May's deal on 15 January - have said they will not back the deal this time around either.

(2) Now that parliament has a means to seek a Brexit delay, moderates and pro-EU MPs from all parties that might have backed May's deal this time around to avoid a hard Brexit, have no such incentive to do so.

On a hard Brexit:

(3) In a symbolic vote on 29 January a majority in parliament voted against a hard Brexit. It would be odd if parliament did not repeat this result on Wednesday.

On a delay:

(4) If parliament did not support a delay to Brexit it would imply that May and her advisers had wildly misread the calculus in parliament. May gave MPs a vote on a delay because she feared that MPs would force this upon her.



UK BACKS A DELAY, THEN WHAT?

If UK parliament votes for a Brexit delay on Thursday, what happens next largely depends on how its own debate develops and how the EU responds to a request for a delay.

If parliament votes down May's deal for a second time, we doubt that it will allow May to push on with her negotiations with the EU without giving MPs a chance to see if they can build a majority around an alternative to May's deal. May could be forced to give parliament the opportunity to hold indicative votes on alternatives such as the customs union model, the Norway plus model, or even a second referendum. It is unclear whether this will happen before the UK submits its request to the EU for an extension or after.

On 6 March 2019 the House of Lords with a cross-party majority voted in favour of the UK negotiating a customs union with the EU. The House of Commons will need to vote on this policy before 29 March 2019. We think the Commons has a good chance of backing this deal (35%). It is Labour's preferred solution. Meanwhile, moderates in the Conservative Party – possibly including some Brexiteers – could back it on the basis that it delivers on Brexit by removing the UK from major parts of the EU, including on budget and migration policies, while protecting the UK industrial sector from the economic consequences of Brexit. For our probabilities on other Brexit outcomes see Chart 1.

THE EU HAS MADE ITS POSITION CLEAR

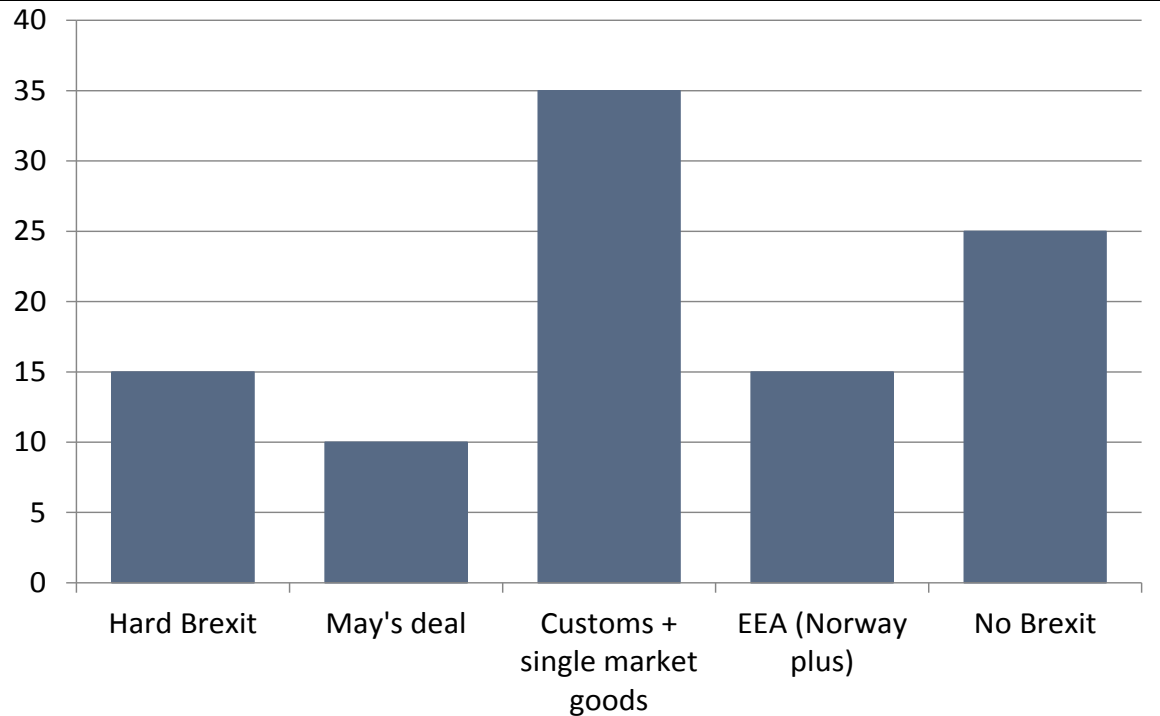
If the UK has made a political decision about what type of agreement it wants for future trade – May's deal, customs union model, or Norway plus – then a short extension of a couple of months would be sufficient. This is our base case. It would avoid a clash with the newly elected European Parliament which first meets on 2 July (the UK does not plan to hold European elections).

If UK MPs can only agree that they do not want a hard Brexit, but not on a future model for UK-EU relations, then the EU will likely argue that a longer extension is needed – maybe up to the end of 2020. Up to a point, the EU will push the UK to make that choice before agreeing an extension. However, we doubt that the EU would reject the UK's request for a short extension, even if there is no majority in the UK parliament for an alternative agreement. If a short delay did not resolve anything, we expect the EU to only agree to a further delay if it were on a much longer basis to give the UK the time to properly resolve its internal issues. This scenario could entail either a snap election or second referendum.



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Potential Brexit outcomes and probabilities (%)



EEA: European Economic Area. Source: Berenberg

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Joh. Berenberg, Gossler & Co.
KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
kallum.pickering@berenberg.com