For professional clients only
July 2019
Research & Strategy Insights

Managing Inconsistencies

What Prime Minister Johnson means for Brexit

David Page,
Head of Macroeconomics (Interim)
Macro Research & Core Investments

Key points

- Boris Johnson has become the new UK Prime Minister.
- Johnson has made a host of broad commitments, most to be implemented over the medium term and in conjunction with new Chancellor Sajid Javid.
- On Brexit, Johnson has made seemingly inconsistent commitments: to leave by 31 October, to negotiate a new deal without an Irish backstop, and stating there is a "one in a million" chance of no-deal.
- We consider Johnson's statements to be a negotiating stance for the EU and UK Parliament alike.
- We doubt that new PM Johnson would want to be culpable for delivering an economically damaging no-deal Brexit.
- Our conviction remains that the process will be delayed beyond 31 October, despite the recent rhetoric.
- We see a good chance of an early General Election, within the coming 12 months.
- Uncertainty is set to remain elevated and even to rise further after the summer. This is likely to continue to weigh on sterling.
- A highly unpredictable process, with significantly different plausible outcomes will maintain volatility in UK assets.

Boris Johnson becomes next Prime Minister

On 23 July Boris Johnson was elected the Conservative Party leader, beating Jeremy Hunt by 92,153 votes to 46,656 (66% to 34%) amongst Tory Party members. The outcome was as we had expected. Boris Johnson became Prime Minister on 24 July. Opposition leader Jeremy Corbyn stated that he would not table a vote of no confidence in Johnson immediately, preferring to wait until after the summer. Parliament will thus rise for the summer on 25 July, to return on 3 September, with Prime Minister Johnson at the helm.

A full slate of commitments

The most pressing of Prime Minister Johnson's commitments refer to the outlook for Brexit, but on the campaign trail to leadership election, Johnson also committed to:

- An increase to the higher rate income tax rate to £80k (from £50k)
- To raise the point at which workers start to pay tax
- An increase in the National Living Wage
- An additional 20k police officers by 2020
- A "fair" pay rise to public sector workers
- Spend more on social care
- Boost per capita schools spending, with a minimum £5k per student in secondary schools
- Maintain overseas development aid at 0.7% of GDP

Many of these commitments will require implementation in a Budget and we do not expect this to be held before the conventional November period, despite some speculation of holding it in September. PM Johnson announced Sajid Javid as his Chancellor. Javid himself has historically discussed the need for significant public spending and combined with Johnson's commitments, such a Budget looks likely to usher in a period that begins to reverse previous Tory austerity.

Brexit – what now?

The most important issue is how Prime Minster Johnson will approach Brexit. In his leadership bid, Prime Minister Johnson made three key statements over Brexit:

- "do or die, come what may", the UK will leave the EU on 31 October.
- He wants to negotiate a new deal, which will replace the Irish backstop
- He sees the chances of a no-deal Brexit as a "million to one".

These statements are inconsistent – at least insofar as they suggest a 99.9999% chance that the EU will renegotiate a new deal, by 31 October, without an Irish backstop agreement, which has been a core requirement of the EU negotiating position since 2016.

PM Johnson's stance is also time inconsistent – a policy that is optimal at one point becomes sub-optimal at a different point in time.

Admittedly, the Prime Minister's tough negotiating stance makes sense as he re-opens negotiations with the EU. We do expect EU negotiators to re-shape some of the previously negotiated deal – albeit we see little room for manoeuvre on matters of substance. EU leaders remain keen to avoid a no-deal Brexit given the additional headwinds it would create to an already fragile Euro area economy, the risks of unforeseen disruption, the impact on economic sentiment and the longer-term geo-political perspective. Hence a UK that is more ambivalent to a no-deal exit should be able to extract more in concessions from the EU.

Moreover, Johnson is also positioning against the UK Parliament. Parliament has three times rejected former PM Theresa May's negotiated Withdrawal Agreement, in part with resistance from Members of Parliament (MPs) who would prefer a softer Brexit, or no Brexit at all. These MPs may be more willing to settle for a compromise deal if they feared an alternative no-deal Brexit.

However, the tough negotiating stance policy unwinds as it comes closer to delivery. The EU would not want to avoid a no-deal Brexit at any price and may calculate that with costs to the UK inevitably set to exceed those to the EU, either Prime Minister Johnson is bluffing and would also wish to avoid a no-deal exit, or that the UK Parliament would prevent the pursuit of such a reckless path. To our minds, such calculations are not groundless and will diminish the efficacy of such a strategy from the start.

Johnson's attitude to no-deal Brexit

PM Johnson has stated that the application of international trade law GATT[1] 24 could allow a "standstill period" for the UK post leaving the EU. The Attorney General Geoffrey Cox was reported to be "not currently convinced on time-limited breaches [of WTO[2] rules]". Bank of England (BoE) Governor Mark Carney was more explicit, stating "GATT 24 applies if you have an agreement, not if you've decided not to have an agreement, or you have been unable to come to an agreement".

In the absence of a transition, the economic impact of a no-deal Brexit is difficult to estimate but is likely severe. There is no obvious historic precedent for such an abrupt rupture in trade regimes. At the end of 2018, the BoE estimated an impact of 2-8% of GDP from a no-deal Brexit[3]. It has subsequently suggested that increased business preparedness may have lessened that expected cost somewhat.

At the start of the year, we estimated the impact to be around 4% of GDP, largely front-loaded and primarily driven by restricted export access[4] to the EU as entry ports would struggle to cope with new border check requirements – and would be unwilling to waive customs checks as the UK itself may consider necessary. This would deliver an immediate shock to export demand. This headwind would be supplemented by falling business sentiment and financial market effects – primarily as sterling depreciation raises inflation and erodes household spending. We think this would dominate any lift to growth from higher corporate earnings from sterling's depreciation, reduced uncertainty surrounding Brexit and limited policy support from the BoE and fiscal stimulus from the £27bn (1¼% of GDP) Brexit contingency fund. We thus forecast the net effect to be a sharp contraction in UK economic activity beginning in the quarter of separation. This is likely to go beyond the initial "difficulties" that PM Johnson referred to in his inaugural speech.

Hence as the 31 October deadline approaches, PM Johnson himself could face the prospect of delivering a no-deal Brexit – for which he would bear responsibility from inception to delivery – threatening economic recession. Given the political fragility of his government, this could easily result in a vote of no confidence in him and his government, threatening the shortest Prime Ministership since George Canning's (Conservative) 119 days in 1827. This is not what Prime Minster Johnson has worked these years to achieve. We expect the Prime Minister to ultimately act to avoid such an outcome.

[1] General Agreement on Tariffs and Trade
[2] World Trade Organisation
[3] For reference, UK GDP dropped by 6¼% during the 2008-09 Financial Crisis recession.
[4] The EU is the destination of UK goods exports worth 8.3% of UK GDP in 2018.

Beyond PM Johnson's own calculations, Parliament also looks unwilling to test this course. Parliament has already clearly voted to avoid a no-deal outcome. With no change in the Parliamentary arithmetic[5], Parliament looks set to continue to block a no-deal Brexit, with former PM May and Chancellor Hammond both soon to add resistance to such an outcome. Indeed, the announcement of PM Johnson's Cabinet saw little evidence of trying to unite either party or country. Hence parliamentary resistance is likely to continue to be formidable. Of course, no-deal remains the default outcome in the Article 50 process, but we would expect Parliament to compel the government to seek an extension to Article 50, to allow more time to achieve an agreed exit deal with the EU[6].

Much has been made of Prime Minister Johnson's refusal to rule out proroguing Parliament to deliver a no-deal exit. A recent narrowly passed amendment requiring Parliament to provide regular updates on Northern Ireland makes such a proroguing more difficult. However, there are a number of constitutional grey areas that could facilitate delivering the default no-deal outcome. These include both the delay between calling and holding a General Election, or even the fortnight's delay built into the Fixed Term Parliament Act's vote of no confidence process[7]. Quite apart from the contradiction of proroguing Parliament to deliver a Brexit that would allow "democratic self-government", we doubt that Prime Minster Johnson would use such constitutional 'wheezes'. To force a no-deal Brexit in this undemocratic fashion would further compound the Prime Minister's culpability should it go wrong. We doubt Prime Minister Johnson would willingly take that path.

In fact, we consider a slightly greater chance that the new Prime Minister's focus on no-deal could make it easier to pass some form of agreement with the EU through Parliament. Parliament's last rejection of the Withdrawal Agreement was by 58 votes. With a no-deal negotiation likely to deliver at least superficial amendment to the current deal, the growing risk of a Remain backlash spurring some pro-leave Labour MPs and concerns of a no-deal spurring less extreme Tory Brexiters, the odds of Prime Minister Johnson passing a deal through Parliament appear higher than for PM May. That this is unlikely in such a short space of time, by 31 October, only adds to our conviction that a further delay to the Brexit process remains the most likely outcome.

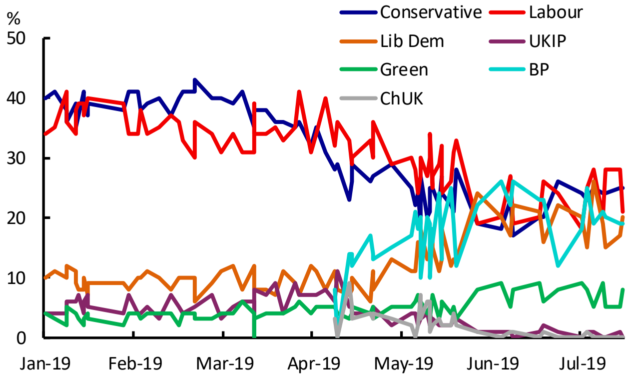
Same impasse needs new Parliamentary numbers

In short, despite the new Prime Minister, we see no obvious change to the Brexit stalemate. This is particularly so as the Parliamentary arithmetic appears even tighter than faced by PM May. This is why we consider a rising probability of early elections. There are several possible routes. PM Johnson could lose a vote of no confidence tabled early in his tenure, or one designed to prevent the Prime Minister following a no-deal path. However, it is also possible that Prime Minister Johnson himself calls an election – frustrated by his lack of influence with current parliamentary arithmetic and perhaps buoyed by any signs of a bounce in the polls on his arrival, and any gains at the expense of the Brexit Party as he campaigns to deliver Brexit. The appointment of Dominic Cummings – an election specialist – as special adviser suggests to us that Johnson is making preparations for an election whether by choice or imposition.

If the UK moves towards holding early elections, it is not at all obvious what they would deliver. Exhibit 1 illustrates current opinion polls. This shows an unprecedented four-way split in the electorate between the Conservative party (25%), Labour (21%), Liberal Democrats (20%) and Brexit Party (19%).

Exhibit 1: Polls provide few clues at present

UK opinion polls



Source: Election Polling and AXA IM Research, July 2019

Given the UK's first-past-the-post voting system, the implications of this split – if it were translated to an actual vote today – is difficult to see. The Election Polling website estimates this would see the Conservatives lose 26 seats to hold 291 seats, Labour lose 25 seats to 237 seats and the Liberal Democrats (Lib Dems) gain 34 seats to 46, with the Scottish National Party also estimated higher at 51 seats – a gain of 16.

Such an assessment is not easy with four parties in the UK's system. It also highlights some of the inequities in the system. These estimates suggest 191 fewer seats between Labour and Lib Dems, despite a polling difference of just 1 percentage point (ppt). This is broadly consistent with Lib

[5] The Conservatives look likely to lose another MP if the upcoming Brecon and Radnorshire by-election on 1 August is lost to the Liberal Democrats as current polling suggests.

[6] This of course only considers one side of the argument. The EU has justifiable reservations about granting further extensions as required in the Article 50. However, we consider the EU, on balance, likely to want to avoid being perceived as responsible for a no-deal exit. We expect the EU to extend Article 50 if requested, all the more so if this is to allow a fresh election or referendum.

[7] This allows a fortnight's delay between the first loss of a vote of no confidence and a second before requiring fresh elections be called.

Dem experience in 2010 when polling of around 28% delivered 57 seats. It also suggests that the Brexit Party would gain no seats, which seems anomalous when even UKIP gained one seat with four million votes in 2015. Assessment based on broad swing methods are likely to be severely affected by four parties contending. These will struggle to account for local concentrations. And we treat such estimates with extreme caution.

Nevertheless, this serves to illustrate that Parliamentary arithmetic means it could be very difficult for the Conservatives to achieve either an outright majority or form a government in partnership. There are few Parliamentary partnerships the Tories could fall back on. Most other political parties would be unwilling to form a coalition with the Conservatives and those that might (the Brexit Party and Democratic Unionist Party) are likely to offer insufficient additional seats. However, we suspect that the Johnson government would attempt to channel the UK's 'Brexit fever' to support the Conservative Party over and above traditional party affiliations.

By contrast, one might consider a Labour, Lib Dem and Scottish National Party (SNP) coalition. In our illustration, this would total 334 seats – a Parliamentary majority, but would likely be a precarious coalition whose cohesive focus would likely be a second referendum to remain in the EU – even as such a stance might challenge a number of core Labour voters.

The outcome

The first half of 2019 was broadly predictable in terms of Brexit. For example, we fully expected an extension of Article 50, rather than no-deal. We considered Johnson the likely favourite in a Tory leadership contest. However, day-to-day progress was highly uncertain.

Looking ahead, we recognise significant uncertainty around the future outlook, but broadly consider the following path as the most likely:

1. We expect a further extension of Article 50 beyond 31 October. We think that such an extension will likely be longer, likely around 12 months to the fourth quarter of 2020.
2. If we do see an extension, we consider the most likely scenario to include a General Election. It remains to be seen how polls will evolve over the coming months to shape the outlook for such an election, though we note that as things stand a new government appears the most likely outcome.
3. This election would determine the resolution of Brexit. We suggest that a Tory victory would likely result in a managed World Trade Organisation exit in the second half 2020, for which the UK will have been preparing since earlier this year. A Labour/Lib Dem/SNP coalition would likely deliver a second referendum for mid-2020. Polling now suggests this would be close to a 50-50 outcome. If the UK voted to remain, the new government would immediately revoke Article 50 (mid-2020). If it again voted to leave, we would expect the UK to leave on a negotiated basis, likely based on a customs union arrangement – although this could be delayed until the first half of 2021.

Looking at the precise outlook for the coming months is likely to be as unpredictable as foreseeing the precise path of developments in the first quarter of 2019. We consider the following six outcomes as plausible and attach subjective probabilities to each outcome:

- Agree to an exit deal, and leave on 31 October **(10%)**
- Extend Article 50 to continue negotiations **(20%)**
- Parliament blocks no-deal, Johnson calls early elections **(15%)**
- Parliament calls no confidence vote to block no-deal Brexit **(25%)**
- Johnson calls second referendum to break Brexit impasse **(5%)**
- No-deal exit **(25%)**

However, we stress the uncertainty around this outlook, which we attribute at least in part to Prime Minister Johnson spelling out different visions of Brexit which we consider mutually exclusive. In lieu of being guided by clear policies set out by consistent leaders, we attempt to second guess underlying political motives and objectives. We explicitly consider one of Prime Minister Johnson's key objectives to be to remain in office for as long as possible.

Market impact

The market impact of Johnson's accession to power should be measured over recent months, not days. As Johnson has spelt out his conviction to deliver a no-deal Brexit over the past months, markets have grown increasingly wary of a worst-case outcome. An increased implied probability of a no-deal outlook is likely behind sterling's 5% decline against both the euro and dollar since March.

We consider our expectation of a further extension of Brexit to be more benign than markets currently consider. As such, this is something that over the medium term should provide some boost to sterling. However, we also fully expect the continuation of Brexit brinkmanship for the coming months to negatively impact UK markets, before a resolution comes into view. This is likely to keep sterling at least as pressured in the short term. Moreover, with recent experience of markets driven by political statements and Prime Minister Johnson's history of flamboyant comments, we consider the likelihood of additional volatility in sterling over the coming months. Finally, the prospect of a General Election and the possibility of a Jeremy Corbyn led coalition could further weigh on sterling.

A no-deal Brexit, further extension or General Election is also likely to have meaningful impact on monetary policy. BoE Chief Economist Andrew Haldane recently spelt out a “strong case” for “holding rates”. We think this would change with a no-deal inspired recession, where we would expect the BoE’s Monetary Policy Committee to ease monetary policy to cut rates by 0.50% and restart quantitative easing. As such, we attribute at least some of the current market pricing[8] for a rate cut as down to the expectation of a no-deal outcome this October. If our central expectation of an extension is correct, those expectations should fade after October. Moreover, a fiscal easing in a November Budget should underpin UK GDP growth and is likely to maintain the case for tighter monetary policy across 2020.

This is also likely to be reflected in broader rate markets. 10-year gilt yields currently trade at 0.68% - the lowest yield since the aftermath of the 2016 referendum. However, the majority of this performance has been driven by international trends, with US Treasury and German Bund yields down 120 basis points (bps) and 90bps, compared with gilts 105bps. Isolating these co-movements, the gilt-US Treasury spread has narrowed by 10bps in recent months. We would expect outperformance of UK gilts in a no-deal environment, but again assuming this is not the case and that some probability of this is currently in the price, we would expect gilt spreads to widen modestly on a further extension – albeit that the overall level of yields will be more determined by the outlook for global rates. The prospect of fiscal easing, and a General Election after 31 October is likely to add to pressures for a modest re-widening in these spreads.

[8] Markets price a 50% chance of a 25bps cut by end-2019 (Bloomberg).

Our Research is available on line:

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826