



**GENERALI  
INVESTMENTS**

## Focal Point

# Brexit: A bumpy road but we favor a benign outcome

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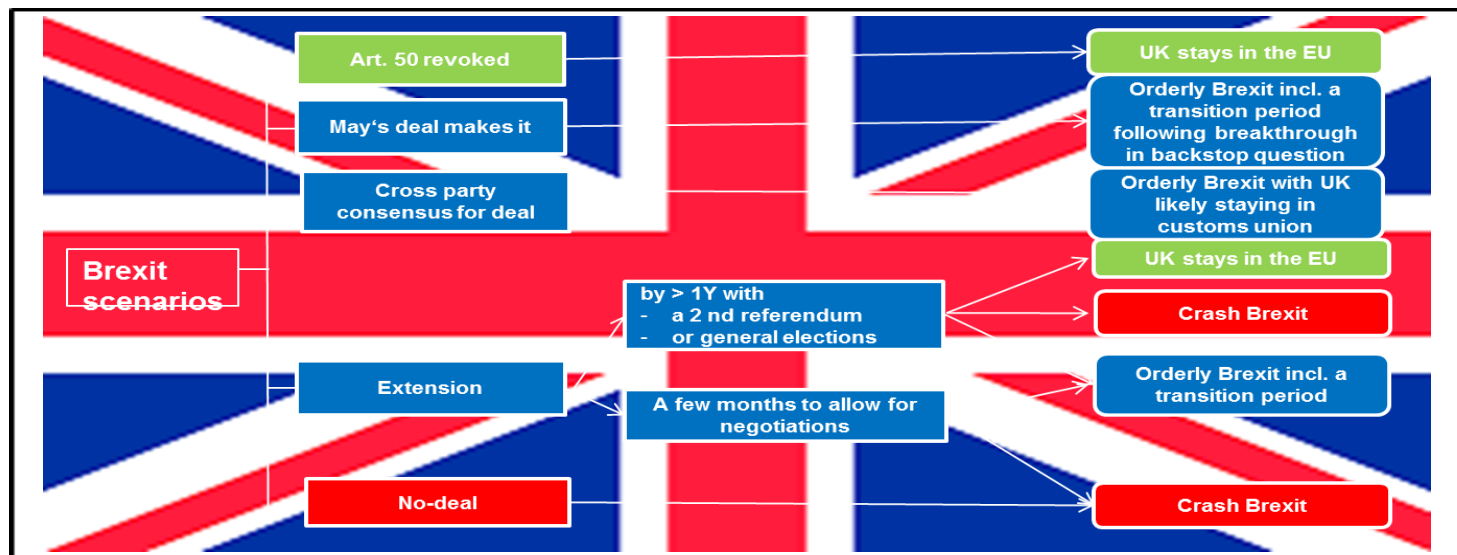
- Only 36 days before the scheduled Brexit date on March 29, 2019 UK PM Theresa May's Brexit deal with the EU still lacks parliamentary approval. Overall, the current situation is very fluid.
- PM May is trying to win over the hard Brexiteers within her own party by demanding additional concessions from the EU. While the EU avoids renegotiating the withdrawal agreement, a legally binding addendum remains an option.
- PM May intends to further run down the clock, in order to present her deal as the only possible alternative to a crash Brexit. But Parliament is likely to stop that process on Feb. 27, by forcing an extension request for the Brexit deadline.
- Alternative options (e.g. second referendum, new elections or the withdrawal from Article 50) are hardly attractive.
- In sum, we still see a benign outcome of the Brexit showdown still more likely than not, as hard Brexiteers throw the towel in on the fear of a Brexit unwind and/or rebel labour MPs help the deal pass. As in any chicken game an accident cannot be excluded, but our underlying views create a positive bias towards GBP and domestic UK stocks.

The Brexit drama is in full swing. Just 36 days before the UK is scheduled to leave the EU on March 29, the uncertainty and conflicts surrounding the fate of the Brexit deal are still substantial. On January 15, UK Prime Minister (PM) Theresa May finally brought the withdrawal agreement – that she had negotiated with the EU over the past two years – before parliament and suffered a crushing defeat (rejected by 432-to-202 votes). Subsequently, PM May presented her proposed next steps (Plan B), on which lawmakers voted together with their own amendments on January 29. UK MPs passed only two of seven amendments: first a weak anti-no-deal amendment (Spelman), and secondly the Brady amendment, sending PM May back to Brussels to renegotiate the backstop agreement. On February 15, PM May faced again a vote on her plan B including the two amendments but was defeated, raising doubts on her ability to provide a stable majority and thereby undermining her negotiation position in Brussels.

The next parliamentary Brexit “showdown” will likely take place on February 27, after PM May will have presented her negotiation results for a meaningful vote. Pressures will most likely rise. On that date, the so-called Cooper amendment (that would give parliament the power to request a delay to the exit) will probably be resurrected, after voted down on Jan. 29. Moreover, some ministers have threatened to rather resign than to allow negotiations to be dragged further into March. However, the January voting on the amendments was very much along party lines, frustrating to some extent hopes on a bipartisan agreement, but this may change this time.

### The Gordian Brexit knot not yet cut

By demanding a renegotiation of the backstop, the British Parliament sent only a very veiled message. The backstop basically foresees the whole UK to stay in the EU customs union as long as no other solution to avoid a hard physical border within the two parts of Ireland can be found in the upcoming trade negotiations. Limiting the backstop would imply the EU to jeopardize (open up a backdoor to) the integrity of its Common Market. The Common Market, however, is regarded as a corner stone of European integration which politicians often consider more important than a crash Brexit and a hard border within Ireland (a result that politicians from both sides of the Channel want to avoid). The EU made clear, that the Brexit deal is not open for renegotiation. So far, there is no press report on substantial progress for PM May in Brussels. Conversely, from the British hard Brexiteers' perspective, the backstop threatens to align the UK to the EU unlimitedly, preventing the country to negotiate its own trade agreements with third countries. Both positions look materially incompatible. Alternatively, Labour leader Jeremy Corbyn wrote PM May a letter putting forward five demands on the Brexit deal, including a “permanent and comprehensive” UK-wide customs union, a close alignment with the single market, “unambiguous agreements” on future security arrangements, and commitments on UK participation in European Union (EU) agencies and funding programs. Not surprisingly, the EU welcomed the customs union as a possibility to overcome the backstop conflict, but PM May stuck to the party lines and rejected this view.



### Brexit talks resemble a chicken game

Considering the mutually excluding red lines of the UK, the EU and also the diverging views within the UK parliament any compromise looks hard to reach. In fact, PM May has been repeatedly accused to deliberately run down the clock in order to present her deal as the only possible in the last minute (possibly only after the EU summit on March 21/22). In our view, the situation resembles the so called ‘chicken game’ in economics: Given that two cars are on a course to crash, the first to blink, loses. If no one blinks, a crash Brexit would be the result. However, rational players driving one car would swerve in order to avoid a costly (and maybe even deadly) crash. In what follows, we argue that the UK as well as the EU have strong incentives to avoid a no-deal Brexit with the EU-UK relations suddenly falling back to WTO standards.

A crash Brexit would come at high economic costs. Studies for the UK compute losses between 4% and 10% in terms of long term GDP. For the EU the estimates are at around 1½%, with the projected Irish loss of close to 4% being the highest among remaining EU countries. In any case, a crash Brexit would come at a time when the global economy shows signs of weakening, euro area growth falling below potential in H2/2018 and January sentiment indicators consistent with even a further weakening of activity. A crash Brexit could even push the euro area into technical recession. In the UK, the latest activity indicators also signaled a significant cooling, with GDP growth down to 0.2% qoq in Q4, and 1.4% in 2018, the lowest rate since 2009. Firms on both sides of the channel are increasingly concerned about a crash Brexit. Uncertainty is high and many firms already triggered contingency plans and investment plans are being postponed. Some firms already announced to relocate their headquarters outside the UK (e.g. Nissan, Ford has threatened to do the same). A crash Brexit would push the UK in outright recession, as we had already [explained in greater detail](#) before. It has been also feared that a crash Brexit could well trigger fresh violence in Northern Ireland.

### Wide Range of Brexit outcomes still possible

Against this backdrop, it would make sense for both sides to compromise, while a crash Brexit cannot be excluded. The current situation looks still very fluid, providing a range of possible outcomes:

### Preserving May’s (slightly modified) deal with the EU:

PM May’s defeat on the first vote on the withdrawal agreement did not come as a surprise. Hard Brexiteers within her own party as well as its coalition partner (DUP) had announced to object the backstop. The press reported that PM May had already shifted to a (at least) second vote strategy over last Christmas. Given, that the Brexit is still handled very much along the party lines, this case builds very much on the hard Brexiteers to be the ones to blink. On the positive side, this faction of the Conservative Party already moved from a general disapproval of the Brexit agreement to a limited time horizon on the backstop. In our view, May’s strategy to run down the clock essentially targets this group, given that they do not want to be blamed for the recession in case of a hard Brexit. On the other hand, it remains unclear whether there is a “hidden” agenda which only seeks to divert the blame, but essentially welcomes an immediate exit. So far, May did not manage to get any meaningful concession on the backstop from the EU. Brussels always pointed out that the integrity of the common markets stands at the heart of the EU and it will not allow cherry picking or to jeopardize its stability. A legally binding addendum remains an option. Right now, it remains unclear what would be sufficient to convince enough hard Brexiteers to vote in favor of the agreement. All in, we see a good chance of this scenario to play out.

**Cross party consensus for a deal:** Right after the January 15 vote there was some indication that a cross-party coalition could form in order to engineer a smooth Brexit. However, this turned out to be difficult. The parliament voted on the amendments on January 29 along the party lines, which was considered a success for May, being able to discipline the factions in her party. At the same time, Labour has tried to oust PM May. Corbyn’s alternative Brexit plan centering on a customs union has been rejected. Nevertheless, PM May seems to try to win over some (pro-Brexit) Labour MPs, implicitly exerting pressures on hard Brexiteers in the form: support my deal or I’ll have to work out a softer one with the help of Labour. The recent exit of some Labour MPs (followed by some Tories) signals some cracks within the Labour party. However, the group of Tory hard Brexiteers is large, so to win over only a few Labours could fail to do the trick.

Conversely, pro-European Conservatives might also agree to a Labour (Yvette Cooper) proposal to give the parliament to power to request a delay to the exit date. This could well happen on 27 February, by forcing the request for an extension on 13 March (likely into 23 May or 1 July) if May's deal can not be ratified by then. For this to pass, some conservative MPs will have to vote contrary to the party lines. Recently, even some ministers from her cabinet threatened to do so. However, such a move would limit May's "run-down the clock" strategy, as she cannot credibly present the "no-deal abyss" as the damaging alternative to her plan. The threat of a no-deal exit to extract 11th-hour concessions from Irish and European negotiators as well as from her party hard Brexiteers would soften. The rift within the Tories would become more visible.

**Postponement of the Brexit date:** The extension of the Brexit deadline runs into complication due to the European Elections, taking place on May 23-26. If the UK's exit date was postponed beyond the constitutional sitting of the new European Parliament at the start of July, the UK needs to participate in the European election. Conversely, if the UK does not participate in the European election, early July would be the ultimate exit deadline that could not further be postponed. However, the merits of a limited extension of the deadline are also being questioned. Apart from the topics discussed above, EU officials and especially France already stated that meaningful reasons for an extension must be given, not just to postpone fruitless discussions. On top, on the EU side, the extension needs unanimity. In essence, this scenario would be very much built on a delayed passing of May's deal, to provide more time for the legal process.

Alternatively, the UK could stay in the EU for a much longer period. This would make sense if the British people would be given the opportunity to decide anew over the Brexit stance, either by means of a referendum or indirectly through a general election. In case of a referendum, PM May would clearly prefer a vote on her Brexit deal. However, this would be highly controversial, given the public demands for a second referendum on the very Brexit decision. Therefore, the referendum question would be highly debated. In terms of outcome of such a referendum, polls suggest that public opinion shifted towards considering it the wrong decision. However, it is far from certain that the Brexit would ultimately be rejected. Also, in case of general elections – most likely if PM May decided to step down after she did not manage to gain support for her final deal with the EU - a benign Brexit outcome is not guaran-

teed. Recently, a long-term delay has become more likely as PM May's Brexit adviser Robbins was overheard, stating that MPs would be given the choice of either to back her deal or a lengthy extension of Article 50.

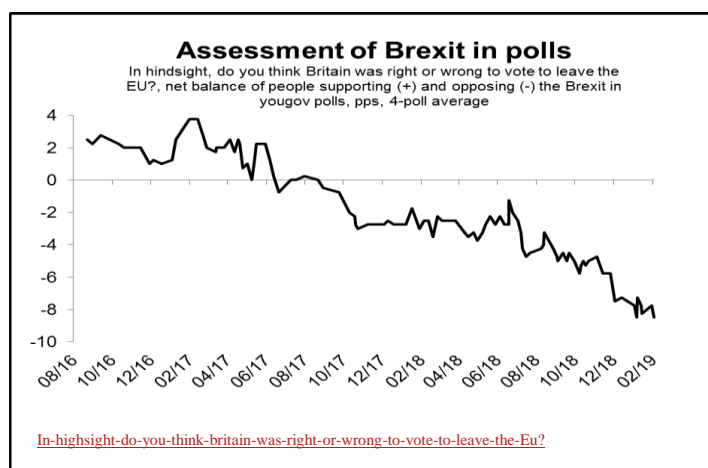
**UK revokes Article 50:** Finally, the Parliament could exclude a no-deal Brexit on a legally binding basis. If at the same time, PM May had no majority for a deal, this would leave her with the only option to withdraw from the EU exit at all. The European Court of Justice had judged last year that this is possible, given that the legal requirements in the country are fulfilled. However, such an extreme turnaround of the UK government would ignore the outcome of the 2016 referendum. It would likely also force the hard Brexiteers in May's party to rather agree to her deal than see their Brexit prospects evaporating. For such a case we would expect significant turmoil within the UK probably triggering a constitutional crisis. We consider the odds of this scenario rather slim.

### Conclusion: Orderly Brexit still our base case

In sum, the situation remains highly fluid with extreme outcomes not off the table. For the time being, we see the highest likelihood that PM May will stick to her strategy to bring her own party in line. To this end, PM May will try to keep the Brexit deadline as long as possible, and shift only on the very last moment. Parliament looks likely to stop that process on 27 February, by forcing the request for an extension on 13 March (likely into 23 May or 1 July) if her deal can not be ratified by then. Alternative options (to eventually ratifying a deal) are hardly attractive (Crash Brexit, a second referendum, new elections or the withdrawal from Article 50). The most important question, however, is what change to the backstop (given the reluctant stance of the EU) would satisfy enough hard Brexiteers and the coalition partner DUP to change their minds. PM May's main arguments to pressure her hard party members are the blame to for pushing the UK into a recession, and the options (referendum, new elections, exit from the exit) that could increase the likelihood for hard Brexiteers that the exit would slip away altogether. Given the highly damaging economic consequences, there is also still a decent chance that MPs find a bipartisan solution.

In sum, we still see a benign outcome of the Brexit showdown still more likely than not, but – as in any chicken game – the accident option is real.

For markets, we see the impact rather digital. In case of a crash Brexit, the pound would suffer. Given the prospect for a UK recession, BoE fears of inflation would likely take the backseat despite still high wage growth. The recession would quickly limit underlying inflation drivers, while the impact of the depreciation on input prices would constitute a supply shock anyway. In case of a benign outcome, we see one hike slightly more likely than not and the pound to appreciate amid the reversal of the heavy political discount before.



# Imprint

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