

Brexit blog: Why 'no deal' may still be avoided

Plus: What markets should look out for in this year's political party conferences, and is the UK economy heading into another rough patch?



Theresa May, UK Prime Minister

Source: Shutterstock

With six months to go until the UK leaves the EU, our weekly Brexit update/blog is back. Each week we'll try to give a brief digest of the twists and turns of the negotiations as the clock counts down, as well as provide our latest thoughts on the UK economy and markets.

Has the Salzburg meeting really raised the odds of no deal?

We kick-off following what has been, even by Brexit standards, a tumultuous period.

The big hope for the meeting in Salzburg last week was that at long last, EU leaders would signal talks were moving closer to a positive conclusion. But in the event, the week ended in bitter disagreement and stark warnings from both UK and EU leaders. So what went wrong?

Cast your mind back to July when the UK government reached a tentative (and ultimately short-lived) truce on what the future trading relationship should entail. The so-called Chequers plan, which was effectively centred on single market access for goods, was met with a cold reception in Europe. But despite a range of concerns - chiefly on the issue of cherrypicking - EU negotiators had appeared wary to completely destroy May's plan publically.

In fact, EU leaders had sounded decidedly more upbeat in their tone of language over recent weeks. With the UK political situation in a fragile state, Brussels appeared keen to tread carefully and if necessary, support the Prime Minister, Theresa May, where possible to boost the chances of parliament approving the final deal.

However, EU Council President Donald Tusk's warning last week that "the obvious truth" was the UK's Chequers plan would not work, signalled that the European side may be changing tack. Some reports indicate EU leaders were left frustrated by the hard-line May took in Salzburg, while others suggest Tusk's statement was designed to focus minds in London.

Either way, the question now is: does this latest impasse raise the risk of 'no deal'? Well, firstly it's worth remembering that there are actually two deals in play here. One of these will cover the future trading relationship, and for all the current disagreement on Chequers and other possible models, this is not what stands in the way of avoiding a cliff-edge Brexit next year. While both sides are hoping to agree a fairly vague political declaration on what a future trade deal might look like, full discussions were never going to start in earnest before March 2019.

Instead, the focus now is on getting the other deal, the withdrawal agreement (covering all the formalities of the UK's EU exit), wrapped up in time to avoid the UK leaving the EU unexpectedly on World Trade Organisation terms. This relies on reaching agreement on the so-called Irish Backstop, and it's clear both sides remain bitterly divided on this issue.

We still think it's likely a deal between the EU and UK is struck

But remember too that May's tougher rhetoric comes just days ahead of the Conservative Party Conference, where she is already engaged in a very public battle with the more hard-line factions of her party on Brexit. Assuming the Prime Minister can survive the conference season, it looks likely she'll be more open to reaching a deal.

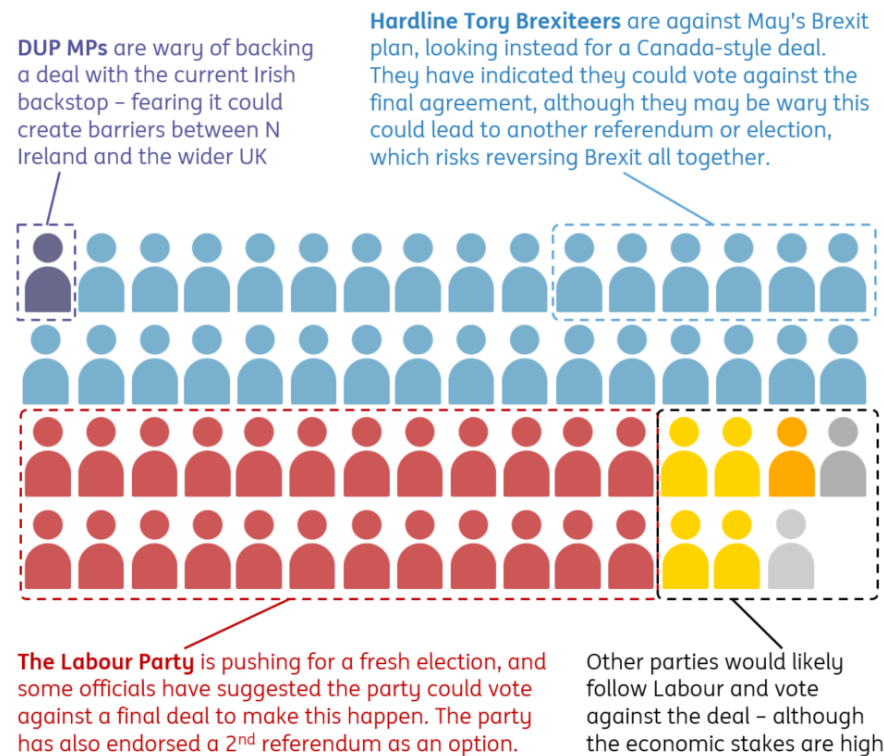
So despite the recent noise, we still think it's likely a deal between the EU and UK will be reached. But with no majority for any kind of Brexit in Parliament, the big challenge is going to be getting this withdrawal agreement approved by UK lawmakers, and one possible way the EU's Chequers dismissal could make life more awkward for May is on Ireland.

For all the flaws of the Chequers plan, it did arguably give the Prime Minister a political tool to convince MPs that, while the Irish backstop will be hard to swallow, it should never need to come into effect. The government believes the trade model it is proposing is sufficient to avoid a hard border within Ireland.

But with this plan now formally off the table in Brussels, May could face an even steeper uphill

battle to convince MPs that the Irish backstop is a necessary compromise.

How different Brexit factions line up in Parliament



Source: ING

All eyes on Conservative Brexiteers as Labour reiterates it'll reject final deal

Away from the contentious border issue, there's also the big question of how the opposition Labour Party will vote.

Speaking at the party's annual conference, Shadow Brexit Secretary Keir Starmer made it pretty clear that Labour will reject any deal that PM May agrees with the EU. Of course, the main motivation for that is that it could force a general election. If that's not possible, Starmer said that the party would be open to a second referendum, possibly including the option of 'remain'.

Given the economic carnage that 'no deal' would likely induce, it's possible that not all Labour MPs will be so willing to reject the deal with the stakes so high. But with the likes of the Lib Dems and other smaller parties, as well possibly even the DUP, likely to follow the bulk of Labour MPs if they vote against the final agreement, the chances of 'no deal' may well hinge on what the Conservative Brexiteers decide to do.

This is set to be the key theme of next weekend's Party Conference and following the EU's Chequers rejection, there is immense pressure on PM May to take a harder stance and commit to something closer to a Canada-style free trade model. So far May has resisted this pressure, and talk of a leadership contest has failed to materialise over recent weeks. Assuming she can survive the conference season, the Prime Minister may be calculating that in the end, the Brexiteers within her party will approve the deal. Faced with the possible options of 'no deal', another election or a

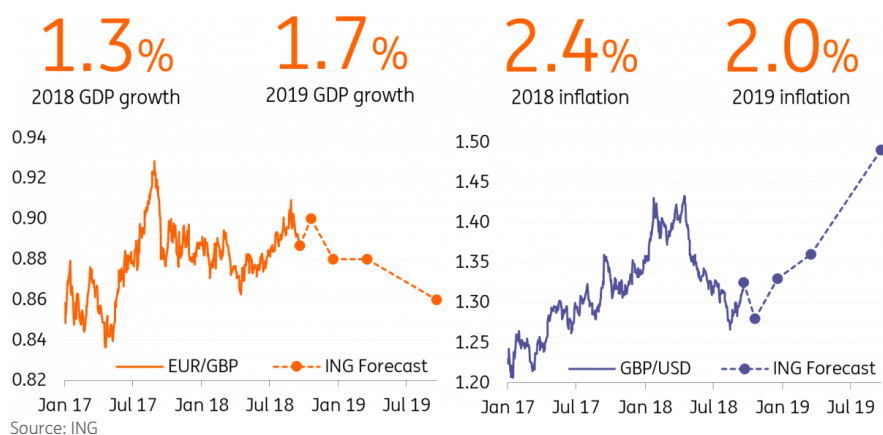
second referendum, the latter two of which could see Brexit cancelled altogether, there may be limited incentive for Conservative MPs to rebel against the government when push comes to shove.

Of course, we're unlikely to know for sure until mid-late January at the earliest, and in the meantime, Brexiteers are likely to maintain maximum pressure on the government to make concessions before a deal is agreed. This says that Brexit talks are only likely to get noisier in the near-term.

Other things to watch this week

- It's a light week for UK data, but **keep an eye on consumer confidence on Friday**. Sentiment is already weak, but it will be interesting to see if consumers are becoming more concerned in light of recent 'no deal' warnings. One of the reasons why the UK economy hasn't fallen into recession since the Brexit vote is that employment has held up. But as the warnings about the practical, day-to-day risks get louder, there's a risk workers begin to get more anxious about job security and personal finances. We therefore think there's a risk the economy loses more momentum over the winter. Even now, confidence is flirting with multi-year lows, which is particularly stark when compared to the level of optimism in the US and elsewhere in Europe (even discounting the latest slip), both of which are near decade-plus highs.
- Having heard relatively little from Bank of England policymakers over recent weeks, **we'll hear from four speakers this week - including Governor Carney**. While it's always intriguing to see a sudden increase in Bank communication, we doubt policymakers will offer any fresh hints on rate hikes. Given the economic risks mentioned above, we think the Bank will find it tricky to lift rates again before Brexit, and we don't expect another rate rise before May 2019 at the earliest.

Key UK forecasts



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