

Brexodus heaps pressure on May

A slew of ministerial resignations and the probability that enough of her MPs will look to trigger a no-confidence vote leave PM Theresa May's Brexit plan in tatters. The biggest loser is the UK economy



PM May's proposed EU exit deal was never likely to please everyone and in the end, it pleased no-one. Ministers queued up to hand in their resignation and Conservative Brexit hardliners vocally rallied to the cause of ousting Theresa May as Prime Minister. They have since been joined by some remainers who have lost faith in the Prime Minister's leadership. As such it looks increasingly likely that the threshold of 48 MPs (15% of total Conservative MPs) writing letters of no-confidence in the PM will be achieved today. This then will trigger a full no-confidence vote in a secret ballot of all Conservative MPs.

The process of no-confidence

Such a vote is likely to be early next week given that many MPs will already be back in their constituencies. If a majority backs her, then she cannot face another leadership challenge for 12 months. That is why this is such a gamble for the Brexit hardliners. They want someone in charge that can deliver a "true" Brexit, but risk being stuck with the status quo if they cannot convince 158 of the 314 Conservative MPs to do the same. If she loses the vote then she is forced out and there is a leadership election in which she cannot contest.

Under this scenario, a contender has to be nominated by two MPs. If there is only one name put forward then that person will become leader of the party and Prime Minister. If two candidates are put forward then this goes to a ballot of Conservative party members who decide which of the two becomes leader and prime minister. If three or more are nominated then a vote is held amongst MPs and the one with the least votes withdraws. If there are more than three nominations then this process is repeated until only two candidates remain to put before the broader party membership.

What might happen?

Political analysts suggest that Theresa May (at this stage) is likely to win. As former Chancellor and pro-remain MP Kenneth Clarke stated yesterday, she is likely "doomed to carry on leading us through this mess because there isn't anybody else." However, bookmakers are not so sure. Indeed, the pressure is likely to continue building and if her leadership looks doomed this could see momentum build for a change. This could accelerate if the DUP withdraw their "confidence and supply" deal with the Conservatives – headlines this morning suggest they "could review it".

PM May has been resolute and determined and lasted much longer than most analysts might have expected, but even if she wins a confidence vote, this latest twist may have been a step too far. Her mandate may be too heavily damaged and there is clearly a risk she eventually steps down. Indeed, if she puts her EU withdrawal plan before a vote in parliament it seems certain to fail. The EU shows no sign of being willing to rework the plan and it would be difficult to see where she could make progress from here.

So who could take over?

If Theresa May is forced out then according to bookmakers the favourite to take over is Dominic Raab, the former Brexit Secretary who resigned yesterday, triggering the chaos. He is then followed by former Foreign Secretary Boris Johnson, current Home Secretary Sajid Javid and the (for now) Environment Secretary Michael Gove, who reportedly turned down the Brexit Secretary role yesterday. But again, we come back to the point – what can they achieve that Theresa May couldn't?

The EU's prerogative is to look after itself and its members and to protect the integrity of the single market. If a new UK leader was to be installed they are unlikely to achieve any meaningful concessions. At best, we make get a slightly looser wording, but that is it.

Despite growing calls for a second referendum, Theresa May is adamant it won't happen if she remains leader and given that all the other contenders are to varying degrees pro-Brexit, it is unlikely to happen under them before March 29. Article 50 could be extended in theory, but the process is not easy, nor guaranteed. If Micahel Gove wins through though there could be a possibility that the UK slips seamlessly into the European Economic Area, but again there would be resistance from the hardline Brexiters as this is not "true" Brexit.

Where next?

Our view, as it has been for a long time, is that this is going to go down to the wire – British MPs feel that there are several months before the “hard” deadline in March 2019 and as such there is no impending pressure to get a deal done right now. However, there is no majority in the House of Commons for a “no-deal” Brexit and that is why the most likely route of success is to put a simple choice of the UK leaving without a deal or the UK progressing into a smooth transitional arrangement as late as possible to help focus minds. This is obviously at odds with the EU timetable and will anger EU leaders, but it is difficult to see much of an alternative at this stage.

This will be economically damaging for everyone due to the uncertainty and worry it causes for businesses and individuals, but it will be the UK that is hit hardest. Some notable manufacturers in the UK are already warning of plant shutdowns over the Brexit period and others are likely to follow suit. After all, there is a very real fear that components could be trapped on motorways as ports grind to a halt under the burden of customs and regulatory checks at a time when there aren't enough qualified staff available to deal with it.

There are also warnings of food and medicine shortages. The UK only produces 60% of the food it consumes and there are major questions over what will happen in supermarkets. Hungry voters tend to be quite angry voters and MPs will not want to risk the wrath of the electorate. As such, we keep coming back to the point that the most likely scenario remains we get an 11th hour deal to allow the UK to go into a transitional arrangement that effectively keeps things as they are until December 2020.

What about the future arrangements?

Where we go from there remains even more uncertain. It has taken 29 months to get to the current juncture following the June 2016 referendum. I simply cannot see how an all-encompassing deal on the UK's future arrangement with the EU and non-EU countries can be agreed in the 20 months the transitional arrangement currently allows. As a benchmark, it took Canada seven years to agree a trade deal with the EU.

On the positive side, the UK would be starting negotiations from a point of full regulatory alignment, which may make things a little easier. But on the other hand, we assume that the eventual deal should be deeper and broader than the Canada deal given the massive amount of trade in goods and services.

Brexiters disagree and suggest that only a Canada plus style deal will allow the UK to “break free” from the EU and enable the UK to fully develop trade deals with other non-EU countries. However,

in an environment of global trade protectionism, there are serious questions about the type of trade deals the UK may eventually win. Hammering out what the UK actually wants could well eat up most of the transitional period in itself.

As such, the transitional arrangement probably won't be long enough and there is already talk that it may be extended by 12 months. Even this may not be long enough. The technology required to allow rapid assessment on the customs and regulatory standards that could generate "frictionless" trade at UK ports is not something that can be bought off the shelf. We could be talking years of implementation and testing in the knowledge that UK governments don't have a great track record on huge procurement contracts.

Economic pain to continue

This all means that we will not have clarity on the UK's economic situation for a protracted period of time. When asked about the economic impact of Brexit so far, I use the rough rule of thumb that UK growth should be half-way and three-quarters of the way between eurozone and US growth. After all, the UK has a labour market, tax system and enterprise culture tilted more towards the US than Europe. If we have a eurozone economy growing 2% in 2018 and a US economy growing at 3%, I would have thought the UK should be growing around 2.5-2.7%. Instead, we are looking at 1.3% growth this year.

With sterling's sharp post-referendum fall still pushing up inflation and squeezing spending power, consumption has been hit while the uncertainty from Brexit has led to a much weaker path for business investment. At the same time, the fact is that the UK has a relatively small manufacturing base these days so it has not seen a meaningful bounce in economic activity caused by the competitiveness boost from a weaker currency.

Obviously, we are in a significant state of flux right now and with a lack of clarity, the situation is likely to get worse before it gets better. UK asset prices will remain under pressure in the near term – our FX team sees the risk of a 3-4% decline in sterling from here. Moreover, the latest Brexit developments suggest the risks to growth are increasingly skewed to the downside. Confidence will be hit and with sterling set to fall further, the upside risk for inflation and the squeeze on spending power look set to continue. Indeed, the prospect of a Bank of England rate rise in May is looking less likely, with markets now barely pricing in two rate rises over the next three years.

Could Britain change its mind?

This remains the most frequently asked question we get. It remains possible, but at this stage, the political mantra from the two major parties remains "we must respect the will of the people". Moreover, opinion polls suggest support for Brexit remains strong, so if there was another referendum held before 29 March there is no guarantee we would get a different outcome.

However, opinion polls such as those done by Survation suggest that Britain is becoming more polarised by age with the under 45s looking increasingly in favour of "remain" and the over 65s even more certain that Brexit is the best course of action. There also appears to be growing support for a referendum on the "final" deal, which could open the door to a reversal of the decision in time. This won't happen soon though. The most likely scenario for a change in opinion polling and a reversal of Brexit involves a prolonged transitional period with the UK economy underperforming key trading partners, which is not particularly

palatable for the economy, or jobs either. It is also highly doubtful that Theresa May would be in power to deliver such an outcome.

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