Our guide to today's crunch Brexit vote

With Theresa May's Brexit deal set to be voted down by Parliament today, our team explains what it could all mean for the pound, and why an extension to the Article 50 period is getting more likely

In this bundle

Article | 10 January 2019

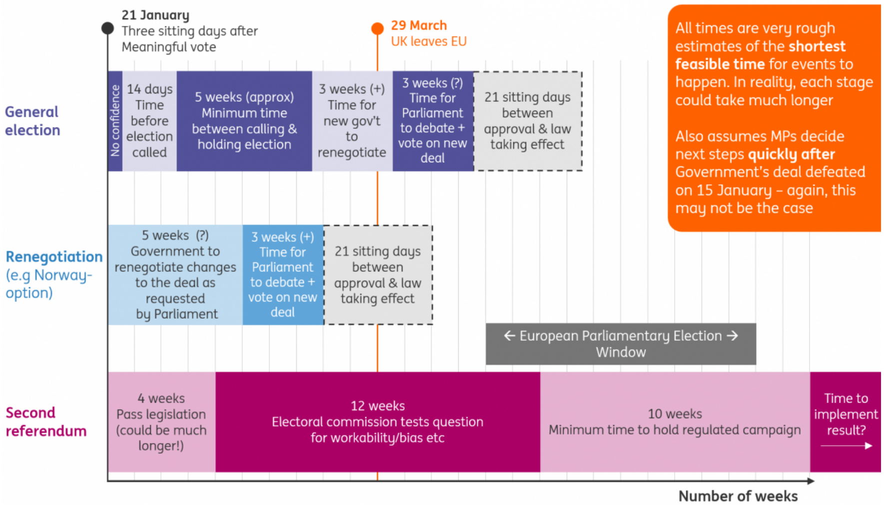
United Kingdom

Why a Brexit delay is becoming more likely

As Parliament looks set to vote down Theresa May's Brexit deal, time is fast running out to find and implement an option that lawmakers can rally...

What happens next? Alternatives to May's deal would likely take us beyond 29 March

(We emphasise these are only rough estimates of the **minimum** timings - in reality some stages could take much longer)



Source: ING

Second referendum timeline based on research from London School of Economics

On Tuesday 15 January, Theresa May's Brexit deal will finally be put to members of Parliament (MPs) to vote upon, and as things stand it looks set to be defeated by a fairly heavy margin. If that happens, the Prime Minister will have three days to bring forward a new plan, and at this point, MPs will get a say on what direction to take. The Labour Party has also suggested it will put forward a vote of no confidence in the government, in the hope of triggering an election.

Nobody really knows exactly where the next couple of weeks will take us, but time is running out – not only for MPs to find an option that commands a majority in Parliament, but also to pass a raft of legislation in time for Brexit day.

While the UK government has so far ruled it out, it looks increasingly likely that the 29 March Brexit date will need to be pushed back. The most likely way of doing this would be for the UK to apply for an extension to the two-year Article 50 negotiating period. This would require all EU member states to unanimously agree, which isn't necessarily a given, although assuming there is a legitimate reason for doing so, we suspect they would cautiously back an extension.

In this article, we take a closer look at why most Brexit scenarios now point to a delay of some kind.

The legal stuff

Even before thinking about how different scenarios might impact the Brexit timeline, it's worth noting that there are at least two ways the law-making process alone could force a Brexit delay.

Firstly, the government will have to get its skates on to pass all the necessary legislation ahead of leaving the EU in March – even if Theresa May defies the odds and gets her deal approved on 15 January. According to the Institute for Government, there are seven different bills that need to be approved in order to implement Brexit.

A Brexit deal needs to have been approved by lawmakers on-or-before 26 February

Secondly, the process for approving treaties in the UK means that the government is obliged to give MPs and Lords 21 sitting days to raise any objections before being able to formally ratify them. This 21-day process cannot begin until MPs have approved the deal.

Working backwards from 29 March, this means that a Brexit deal needs to have been approved by lawmakers on-or-before 26 February, if the UK is to formally ratify the withdrawal agreement in time for Brexit.

That's not to say the government can't go right up to 29 March to get a deal through Parliament if it has to, but going past this February cut-off point would automatically require a longer Article 50 period for formal ratification. Don't forget too that in any scenario, the European Parliament also needs to ratify the deal - the current plan is reportedly for this to take place in March (assuming the British Parliament has approved it by then).

How a general election could force a Brexit delay

If May's deal is defeated, then the opposition Labour Party has indicated it might table a motion of no confidence in the government – potentially within hours of the Brexit vote. Note this is a different process to the vote of no confidence held back in December, which related to Theresa May's position as the leader of the Conservative Party. As we've said before, there's no guarantee a no confidence vote in the government would pass, given that some Conservative or DUP MPs would have to back it.

But if it did succeed, then it would get the wheels in motion for an election, unless Parliament decides to change its mind within 14 days. After that, the current Parliament would be dissolved and an election would happen as soon as 25 working days later.

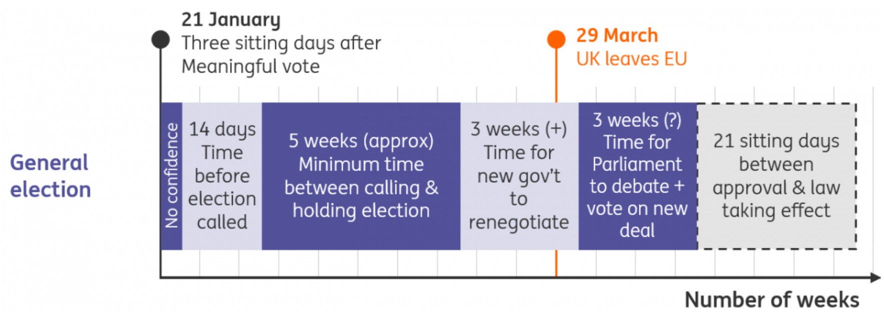
If our maths is correct, that takes us at least until early March, which automatically goes beyond that 26 February deadline we mentioned above, requiring some form of Brexit extension.

The aftermath of an election could also prompt further delays. If the Conservatives managed to cling onto power with a similar working majority, then presumably the government would still face the same old challenge of getting a deal through Parliament.

If Labour were to win the election (perhaps more likely leading a coalition of some form), then it's likely the leadership would want to return to Brussels to renegotiate. This would take time, and once a revised deal is reached, it would still need to be approved by Parliament.

Altogether, our (very) rough estimate suggests this latter scenario could require at least an eight to nine week extension to the Brexit process. In reality, this could be longer if the election date is set further out than five weeks, the new government took longer to form, or if it takes longer to renegotiate the deal and seek approval in Parliament.

The most recent YouGov poll gave the Conservatives a six-point lead over Labour



Source: ING

How a renegotiation could force a Brexit delay

If the Brexit deal is rejected, the government would be forced to return within three sitting days to inform MPs about its planned next steps. This will be done in the form of an amendable motion - which in simple terms means that MPs will get a say on what happens next (albeit, this won't be legally binding).

Many things are possible - but there is likely to be a vote on whether to pursue a softer Brexit stance, perhaps something along the lines of the so-called 'Norway Plus' model. This term is used to describe access to the European Economic Area (single market), alongside a customs union.

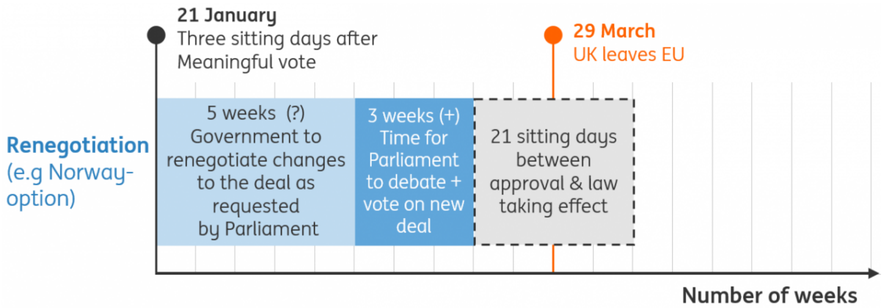
There's plenty to debate here - not least that going down the Norway-route is unlikely to see the contentious Irish backstop abolished. But sticking with the topic of time, if MPs demand some kind of renegotiation to the Brexit deal, then this would likely demand a Brexit extension. How long really depends on exactly what MPs ask for.

The easiest solution to any renegotiation would be to simply adapt the small chunk of the deal that details future trade aspirations - the non-legally binding political declaration - to reflect Parliament's wishes. That could be done quickly, although MPs have made it pretty clear that tweaked political wording alone probably won't cut it.

All of this also assumes the EU would be willing to accept revised terms - Brussels is reportedly sceptical 'Norway Plus' could work in reality.

But even assuming the Prime Minister could somehow engineer meaningful changes to her deal, there's no guarantee it would pass through the House of Commons second-time around, particularly given that the Irish backstop is unlikely to go.

Bottom line: one way or another, more time is likely to be needed in any renegotiation scenario - particularly as in reality, the chances of the government putting forward a very similar deal for a repeat vote in a few weeks' time seems fairly high.



Source: ING

How a second referendum could force a Brexit delay

Aside from re-negotiating the deal, there's a fair chance some MPs will try to force a vote on a second referendum at some point over the next few weeks. While it isn’t clear whether a majority exists for a new referendum at this stage, it could gain traction. If all other options are voted down by MPs, lawmakers may see a fresh vote as the only way to break the deadlock. Equally, if the Labour Party try and fail to trigger an election, the party leadership would be under even greater pressure to back the referendum option.

Whichever way it was to come about, a referendum would take a significant amount of time to implement.

> *It could easily take until July to arrange - or more likely after the summer*

Firstly, a consensus would need to be reached on what question to ask. Would it be a two-horse race between ‘Remain’ and May’s deal, or would Brexiteers insist on ‘no deal’ being on the ballot paper, too? Reaching agreement on this could take some time (we haven't factored this into our illustrative timeline below), although it’s possible a draft question might come pre-specified in an amendment before MPs take the decision to approve a second referendum.

Step two - pass the legislation required to hold a referendum, setting out the details (question, legal basis, date etc) of the poll. In theory, this could be completed in as little as three or four weeks given the urgency, but it could easily take much longer. In fact, according to the LSE, the legislative process took almost seven months when preparing for the 2016 EU referendum.

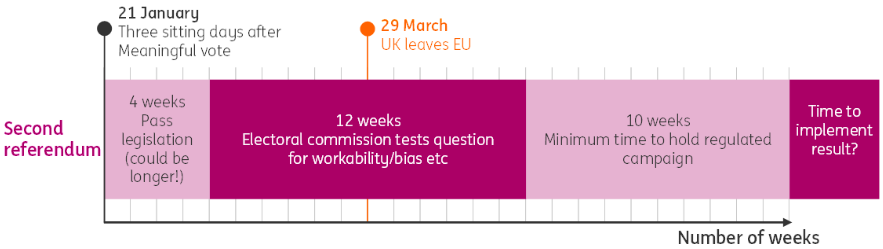
Stage three – test the question. The Electoral Commission is obliged to check the ‘intelligibility’ of the referendum question, a process which typically takes 12 weeks. Once that’s complete, there would then be a regulated campaign period, which is required to be a minimum of 10 weeks.

Add all of that together, and even assuming the swiftest timeline with no gaps, it could easily take until July to arrange – or more likely we suspect, at some point after the summer recess (September onwards).

Then there's the question of 'what next'? The polls suggest that in a three-horse race with 'no deal' and 'May's deal', remain would likely prevail. Assuming the negotiating period had been extended to accommodate the referendum, then presumably it would be a case of simply revoking Article 50. However, if 'May's deal' were to win, this would need to be formally approved by Parliament, which would take further time.

But the big unknown is what would happen if 'no deal' won (don't forget that 43% of Conservative voters would vote this way, according to a recent YouGov poll). Would the government simply allow an extended Article 50 period to elapse, or would it try to buy more time to limit the potential chaos?

Whatever the answer, a referendum could easily require a six-month extension to the Brexit process.



Source: ING, YouGov, LSE

Referendum timeline based on research by the London School of Economics

Revoke vs extend – How hard would it be to delay Brexit in reality?

There are two ways that the Brexit date could be changed:

1. **Apply for an extension to the Article 50 period**. This is probably the more likely route, although it would require all other EU member states to unanimously agree to an extension. The generally held belief is that there would need to be a strong reason for the delay for it to secure the necessary EU support. A general election or second referendum would probably tick that box, as probably would a signal from the UK side that it wants to pursue a different course on Brexit (for example the so-called ‘Norway Plus’ option). The EU is also unlikely to block an extension that simply gives the UK extra time to get all the necessary laws passed.

The conundrum comes if the UK asks for an extension simply because time has run out and 'no deal' is imminent. Here EU member states would have to weigh the risks of 'no deal' against setting a future precedent for other countries who may consider leaving Europe. It's a tricky one to call, although on balance it's hard to see the latter winning over the former given the high stakes.

There are also big question marks over how long an Article 50 extension could last. The main hurdle is the EU Parliamentary elections, which would need to take place before new MEPs gather for the first time on 6 July, potentially putting a time limit on a possible extension. The implications of not having elected representatives in place by this time aren't totally clear, although *Telegraph* editor Peter Foster suggests they may be surmountable.

2. **Revoke Article 50 altogether.** This is the more extreme option, but a European Court of Justice ruling in December confirmed that the UK has the right to unilaterally revoke Article 50. However, the ruling also suggests some kind of democratic process would be needed to go down this route, which presumably, at the very least, requires MPs' consent via a Parliamentary vote. We suspect lawmakers would be very reluctant to go down this route, although the option may come into sharper focus if the EU decides to block a UK application to extend the Article 50 period.

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GBP: Brexit and the bumpy ride to its eventual recovery

The undervalued pound still has a bumpy ride before its eventual recovery. We look at various Brexit scenarios and sterling's possible reaction....

A bumpy week for sterling

We believe there's more than a 60% chance Article 50, the treaty which began the UK's withdrawal process from the European Union will be extended. But be careful... not every scenario there will be positive for the pound, for instance, it could fall if a general election is called.

The most positive outcome for GBP is a second referendum, likely bringing EUR/GBP to or below 0.85. We still expect a market-friendly resolution by the end of the year which could see sterling stronger (GBP/USD at 1.40). While GBP is ultra-cheap (the cheapest currency in the G10 FX space), the valuation gap is unlikely to close fully as the damage to the economy has already been done.

For now, the lack of short-term risk premium priced into GBP and the potential disappointment if Article 50 isn't extended immediately may translate into weaker GBP this week

Figure 1: Six scenarios for the pound

Scenario	Probability (Rough estimates)		Market reaction
Vote passes on Jan 15	5%	May's deal is widely expected to be rejected on Tuesday	EUR/GBP: **0.85** GBP/USD: **1.38**
Modified deal passes on 2nd attempt	10%	EU unlikely to offer the compromises on 'Irish backstop' required for MPs to back revised deal on second attempt	EUR/GBP: **0.85** GBP/USD: **1.38**
Article 50 extension required			
General election	15%	Some Conservative/DUP MPs must back a no-confidence vote in the government for election to take place	EUR/GBP: **0.95** GBP/USD: **1.20**
Different deal (e.g 'Norway Plus' or permanent customs union)	25%	MPs could try to force the government to pursue a different Brexit, although more time needed	EUR/GBP: **0.86** GBP/USD: **1.35**
Second referendum	25%	Not clear if majority favour this at this stage, but could happen if MPs view it as only way to break deadlock	EUR/GBP: **0.84** GBP/USD: **1.40**
No deal on 29 March	20%	Remains the default option unless MPs can agree on alternative plan – although most MPs against no deal	EUR/GBP: **1.00** GBP/USD: **1.12**
Probability-weighted market reaction - EUR/GBP: 0.90 GBP/USD: 1.30			

Source: ING

Will the Prime Minister extend Article 50 immediately? Not necessarily

Press reports that the two-year negotiating period could be extended began circulating last Friday (coupled with market hopes that a second referendum could be in the pipeline), giving sterling a bit of a boost last Friday.

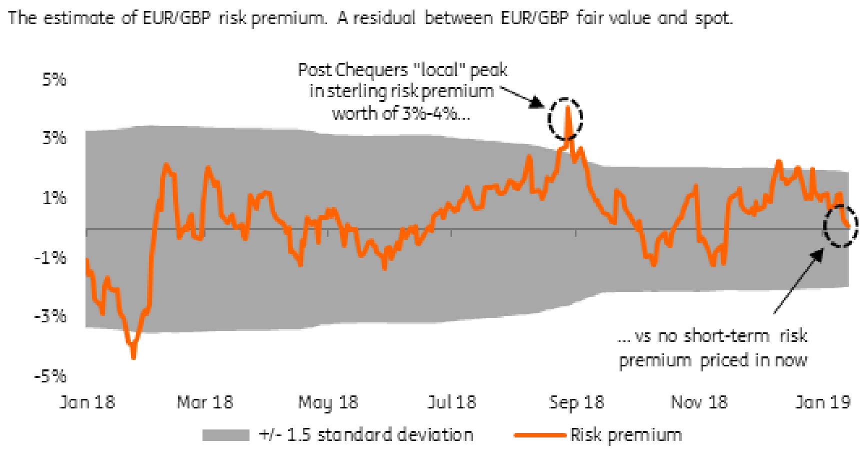
But while we think it's now more likely than not that the government will be forced to push for an article 50 extension, it seems unlikely the Prime Minister will go down this route immediately. Instead, we think 'Plan B' is likely to involve seeking further legal concessions or reassurances on the Irish backstop, although it's not clear that Brussels would be prepared to offer them.

The number of members of parliament who vote against the Brexit deal is likely to be seen as an acid test of how hard it will be for Theresa May to get a revised deal through parliament on a second attempt. A number above 100 MPs would set an extremely high bar to get a modified version of the deal approved in the next 2-3 weeks.

Market expectations are cooling, limiting further near-term GBP upside

Whatever the number, we may see market hopes for an immediate article 50 extension begin to cool, helping to push EUR/GBP towards the 0.90 level again. This is particularly likely given that our models suggest there is currently no short-term risk premium priced into GBP at this point compared to a 3-4% risk premium last autumn. Figure 2 below shows EUR/GBP trading largely in line with its short-term fair value, indicating some complacency ahead of this week's events.

Figure 2: Virtually no short-term risk premium in the pound



Source: Bloomberg, ING

A vote of no-confidence in the government?

There is a possibility that the opposition Labour Party puts forward a motion of no-confidence in the government in the aftermath of the defeat. This could potentially happen as soon as Wednesday if the government's deal is defeated, although Labour leader Jeremy Corbyn has kept his cards close to his chest so far on the exact timing. If a no-confidence motion is put forward, then this is also unlikely to be positive for GBP.

Should a no-confidence vote lead to early elections (which is not guaranteed, given that some Conservative MPs would need to get behind it), this would inevitably require an extension to Article 50. In our view, a snap election would be a bad option for the pound, as it would bring further uncertainty about the Brexit path.

The market is unlikely to react well to the potential mix of a) ongoing Brexit uncertainty and b) the perceived risk of a Labour-led government. As a result, GBP would weaken with EUR/GBP likely moving towards the 0.95 level.

Will MPs finally have their say on which Brexit path to take?

If her deal is rejected, Theresa May will have three days to return to Parliament with a new plan.

As we said above, this is likely to involve some form of renegotiation attempt on the Irish backstop. However, at this point, it is expected that MPs will also be able to table their own suggestions on the next steps (in the form of amendments). These won't be legally binding on the government, but it could mean we finally discover whether there is a majority for any alternative Brexit strategy, meaning it would be a politically significant moment.

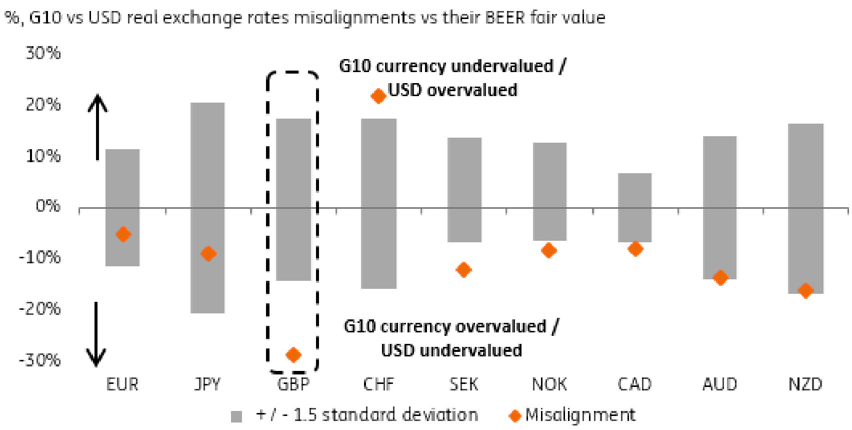
Out of all the possible options, two stand out: a second referendum, or a request to negotiate a softer Brexit stance (e.g. 'Norway Plus' or a permanent customs union). Nobody really knows if enough MPs would be prepared to get behind either of these strategies. But if they did, both options would almost certainly require an Article 50 extension.

It's important to remember that EU member states must unanimously approve an extension, and they have been clear this would require a legitimate reason to do. "We simply cannot agree" probably won't cut it.

But assuming the EU would be open to an article 50 extension for either a second referendum or a meaningful renegotiation, then we think both of these scenarios could be sterling positive:

1. **Second referendum.** In our view, this would be the most positive GBP outcome, with EUR/GBP likely to move below 0.85 as the perceived probability of remaining in the EU would rise. That said, given that a 'no deal' Brexit may end up as one of the referendum options, the initial GBP strength would be bounded. With that in mind, once a decision is taken to initiate a referendum, sterling would react to both the polls, as well as the eventual decision on the question being put on the ballot paper. The GBP upside would clearly be higher where it is a straight choice between May's deal and Remain.
2. **A different deal (e.g. 'Norway Plus' or permanent customs union).** There are two reasons why this may not be a positive for GBP as a second referendum. Firstly, even if the Prime Minister succeeded in negotiating a new deal (not a given), there is no guarantee it would be approved by Parliament as the controversial Irish backstop is unlikely to disappear. Secondly, the most positive GBP outcome – the UK staying in the EU – would not be on the cards.

Figure 3: Pound the most undervlaued G10 currency



Source: ING

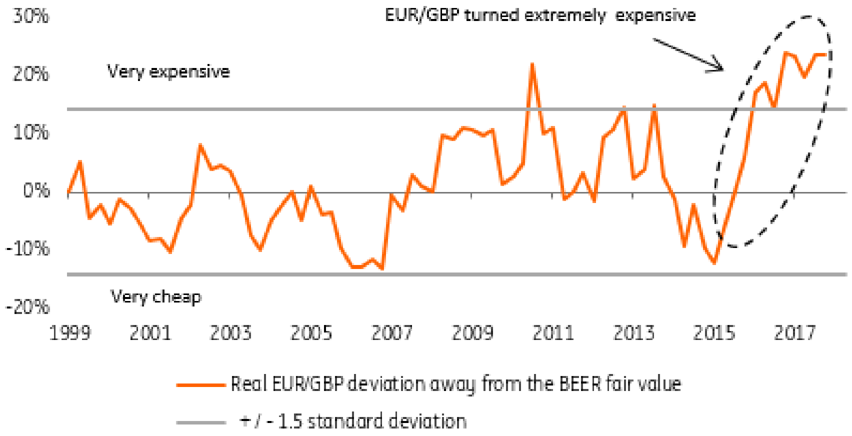
Probability-weighted outcome for GBP not far away from the current levels

In Figure 1 above, we also show the probability-weighted outcome of the various possible GBP scenarios. Interestingly, GBP is not trading materially off its probability-weighted level, largely because of the non-negligible risk of hard Brexit (around 20% in our view) which would see a large fall in the pound.

We also note that the likely Article 50 extension and the associated uncertainty would also mean a further delay to the next Bank of England rate hike, meaning that GBP would lack support from the

BoE re-pricing channel for even longer

Figure 4: The pound is still considerably undervalued according to our model



Source: ING

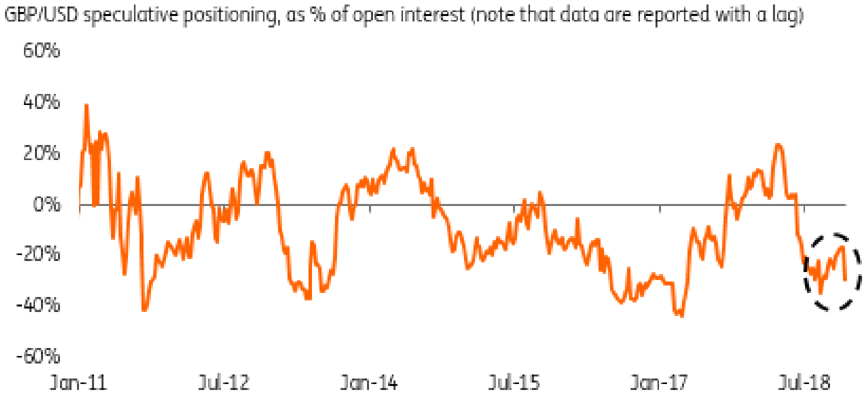
We retain a constructive medium-term view on sterling

Our base case that 'no deal' will be avoided and that there will be some form of resolution by year-end (either a renegotiated deal or a second referendum – both preceded by an Article 50 extension) makes us constructive on GBP in the medium-term. This should lead to a higher GBP by end-2019, with the scale of the GBP upside depending on the form of the resolution (ie, a large GBP rally if the UK stays in the EU vs more modest strength if some-form of softer Brexit deal is achieved – as per above and Figure 1). Coupled with our constructive EUR/USD view for 2H19, we look for GBP/USD at 1.40.

In terms of medium-term valuation, and after suffering heavily since early 2016 (the point when the market started pricing in the associated risks stemming from the Brexit referendum), sterling is currently the cheapest G10 currency by a considerable margin (as evident in Figure 3) and is undervalued by staggering 20% against EUR (Figure 4). The scenario of no Brexit (if voted through in the second referendum) would in our view lead to a compression of around half of the current mis-valuation. This would bring EUR/GBP towards the 0.80 level, particularly in light of the still very short GBP speculative positioning (Figure 5).

Still, we don't think it is likely that even in the best case scenario of the UK ultimately staying in the EU sterling would fully close the current valuation gap. This is because the damage to the economy and fundamentals has been already done over the past three years (as evidenced by the fact that the UK economy has been growing at half the speed of the US economy last year) and that all suggests less upside potential for sterling compared to what the fair value suggests.

Figure 5: Speculative shorts in GBP/USD significant



Source: CFTC

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UK economy stalling as Brexit concerns mount

The service-sector kept the UK economy crawling along in November, but recent surveys point to a further slowdown in growth both in December and the early...

Source: Shutterstock

According to the latest set of monthly UK data, the economy fared slightly better than feared in November. The economy grew by 0.2% on the month, driven primarily by another better month for the service sector. Dig a little deeper though, and the picture still looks fairly grim.

Firstly, the manufacturing sector contracted for the fifth month in a row and on a year-on-year basis, is now shrinking at the fastest rate since before the 2016 referendum. We don't expect conditions to get any easier given the recent slowdown in Europe (and elsewhere), while we also don't expect pre-Brexit stockpiling to significantly drive up production given the lack of storage capacity for inventories. The slowdown in global demand also appears to be taking its toll on the trade balance, which widened further in November.

Secondly, the most recent survey readings from the service sector suggest there was a pronounced slowdown in December, which looks set to persist into the new year. The service-sector PMI indicated that new orders growth has stalled amid Brexit uncertainty, while the recent decline in consumer confidence appears to have hit the high street hard over Christmas. The latest British Retail Consortium figures suggest it was one of the worst Christmas trading periods since the financial crisis.

The upshot is that growth looks set to be noticeably slower in the fourth quarter than the third, when activity was boosted by warm weather. We expect GDP growth in the 0.2/0.3% region in the final quarter of 2018, and something similar for the first three months of 2019.

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