Will Britain's economy rise or fall under Brexit PM Boris Johnson?

Boris Johnson has become the new British prime minister, but the stage is set for an almighty battle in October as parliament tries to stop 'no deal' Brexit, which is why we think a general election could well be inevitable. But all of this uncertainty means a tricky few months for the economy and the pound. We could see EUR/GBP touch 0.92 and GBP/USD at 1.22

In this bundle

Article | 23 July 2019 **United Kingdom**

Brexit and the next 100 days in five charts

New UK prime minister Boris Johnson will face the same hurdles as Theresa May, and crafting a new Brexit deal will be tricky. The new leader may be open...

Source: Shutterstock

In a nutshell: PM Johnson to face the same hurdles as PM May

With 100 days to go until Brexit, the UK finally has a new prime minister - former foreign secretary Boris Johnson.

Fears are growing that the UK could leave the EU without a deal on 31 October, but at least in the first instance, one of the PM's first acts will be to return to Brussels and seek a reworked deal. But with neither side willing to compromise on the Irish backstop - the mechanism designed to avoid a return to a hard border between Ireland and Northern Ireland - negotiations are unlikely to bear fruit.

This sets the stage for an almighty battle in October as Parliament tries to stop 'no deal' from happening - and a no-confidence vote in the government is likely to happen in the run-up to the Brexit deadline. A general election is getting more likely - perhaps even inevitable. Recent polling suggests that an election might not actually be a bad thing for Mr Johnson -

but given that an election would almost certainly require another Article 50 extension, his party's renewed popularity could falter by the time the vote occurs.

All of this uncertainty makes for a tricky few months for the economy, and this has sparked talk of a UK rate cut later this year. Markets see a 50% chance of easing in 2019, although we're yet to be convinced. Even so, the risks for the pound are intensifying - we could see EUR/GBP hit 0.92 over the summer.

Our updated Brexit scenarios

	ING probability	How scenario could materialise	Article 50 extension?	Market reaction
Parliament forces a general election	40%	Parliament stops 'no deal' by passing no confidence motion. General election takes place as early as December	✓ At least 3 months	EUR/GBP: **0.95** GBP/USD: **1.18**
Revamped deal	25%	To avoid election at all costs, pro-Brexit MPs reluctantly back tweaked deal given there's a Brexiteer in place for next stage of trade talks	✓ Possibly (for legislation)	EUR/GBP: **0.85** GBP/USD: **1.34**
Second referendum	10%	Parliament may struggle to force a 'People's vote'. But can't fully rule out PM triggering one as "least worst" option versus an election	✓ At least 6 months	EUR/GBP: **0.82** GBP/USD: **1.40**
No deal	20%	If EU rejects further A50 extension, or a new leader pushes for a hard Brexit, Parliament may lack the legislative tools to stop it	X	EUR/GBP: **1.00** GBP/USD: **1.10**
Revoke Article 50	5%	Parliament may prefer this over a 'no deal' exit, but like a 2nd ref, MPs could lack a legislative tool to force the new PM's hand.	X	EUR/GBP: **0.78** GBP/USD: **1.47**

We also wouldn't rule out Mr Johnson asking for a further extension simply to buy more time to break the deadlock – although his recent comments suggest he is highly averse to doing so

Source: ING

Finding a tweaked deal that both the EU and Parliament can agree to will be challenging

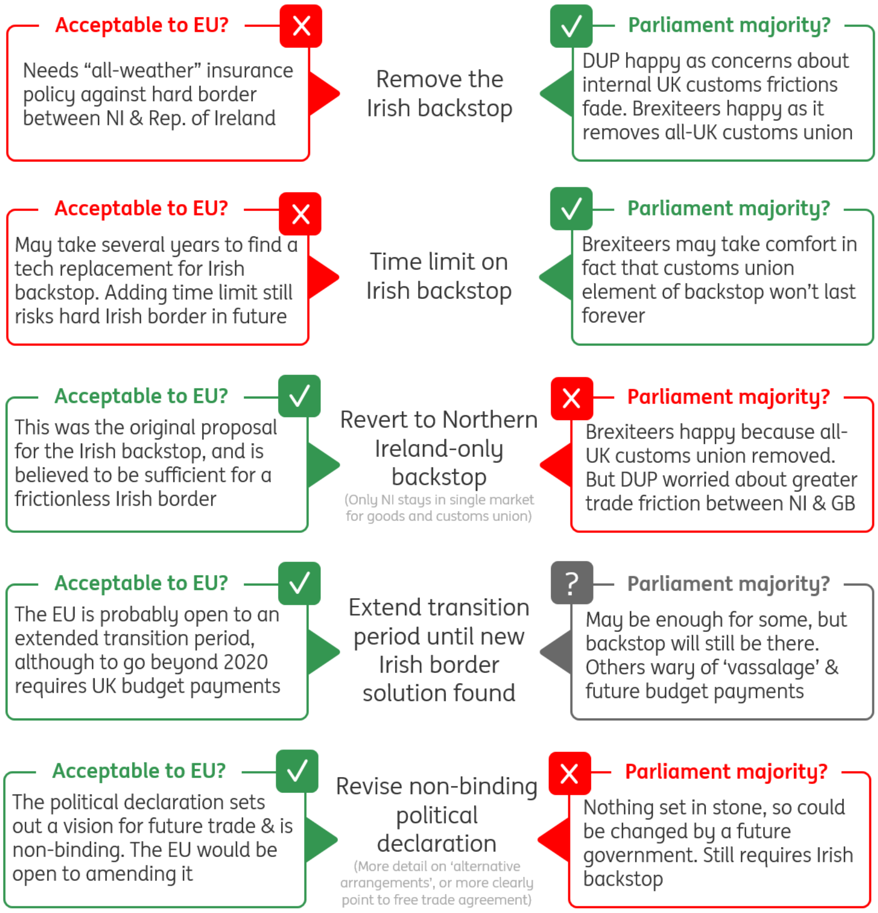
Despite all the 'no deal' rhetoric, we assume the new prime minister will initially head to Brussels in September to attempt a renegotiation of PM May's existing deal. But seeking a meaningful change to the agreement from the EU – and then getting enough MPs to support it – will be seriously challenging.

Brussels has ruled out removing, or time-limiting, the contentious Irish backstop – something which Mr Johnson has repeatedly said is a red-line in talks. So what could the new prime minister do? The chart below shows how most proposals would be unacceptable to either the UK or the EU, although one particular idea looks interesting.

One way the new PM might be able to command a majority is if he can convince sceptical MPs that the Irish backstop will never come into effect - and the most obvious way of doing that is to ask for a long transition period with the EU. In theory, that could allow time to find a different - perhaps technological - solution to preventing a hard border on the island of Ireland.

In reality, it could be several years before such technology becomes available (if it becomes available at all), but in principle the EU would probably be open to a more prolonged transition period. The current deal leaves the door open to a transition until the end of 2022, assuming both sides agree.

What are Mr Johnson's options for a revised deal?



Source: ING

If a deal is to get a majority in Parliament, the devil might not be in the detail after all

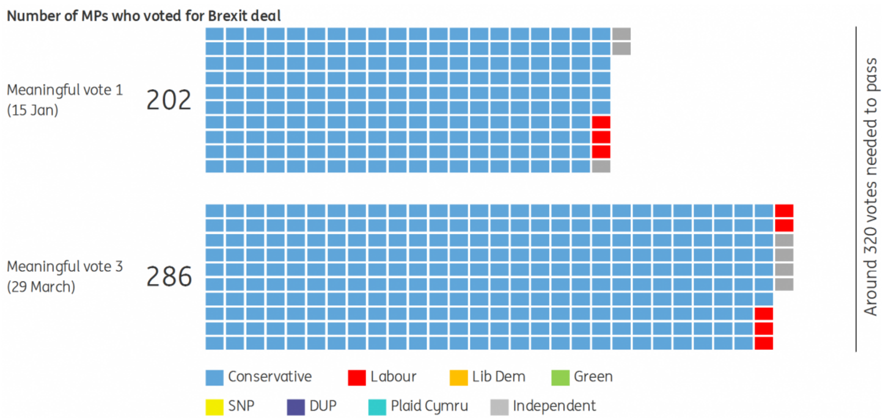
So is the 'long transition deal' a strategy that could work for Mr Johnson? We see three reasons why it probably won't.

1. While it is probably the PM's best chance of demonstrating the Irish backstop will not be needed, the backstop will nevertheless remain a part of the deal. And as long as the backstop stays, leaving open the possibility of regulatory diverge between Northern Ireland and the British mainland at some point in the future, the Democratic Unionist Party (DUP) are unlikely to back the agreement.
2. Secondly, an extended transition period will require fresh budget commitments for the next EU multiannual financial framework (MFF), which begins at the start of 2021. The idea of paying more money, rather than less, to the EU is unlikely to go down well with the domestic UK audience.
3. Thirdly, for many pro-Brexit MPs, an extended transition period would present too much 'vassalage' – staying within the single market but without a say in the rules.

All of that means it's hard to see pro-Brexit Conservative/DUP lawmakers backing such a deal. But as always, the politics matters. If MPs don't back a revised deal, opposition lawmakers may well succeed in forcing an election to avert 'no deal'. Some Brexiteers may conclude that it's safer to 'swallow' a lightly-amended deal, and take the fight to the next stage of talks where the ultimate trading relationship will be agreed than it is to fight an election and risk losing control of Brexit altogether.

Unlikely as that may sound, something similar actually happened back in March, when a number of pro-Brexit Conservatives voted for the deal in the third meaningful vote, on the basis that Mrs May had committed to resigning her post if the agreement passed. The chart below shows that 81 additional Conservative MPs – including Mr Johnson himself - voted for the deal third-time around at the end of March, than in the initial vote in mid-January.

A number of Brexiteers voted for Mrs May's deal on the third vote



Source: BBC, ING

The election numbers look good for Mr Johnson - but can they last?

Our base case is that new negotiations will not prove successful, and this could set up an almighty battle in October as Parliament races to try and prevent the new government pursuing a 'no deal' exit. While a 'no deal' is possible (we see a 20% chance at the moment), all of this is more likely to culminate in a no-confidence vote in the government. One way or another, a late 2019 election is getting increasingly likely.

Predicting the outcome of an election is very challenging. But as the polls stand, things are looking good for Mr Johnson. His repeated commitment to get the UK out of the EU one way or another has resonated with many voters.

A recent YouGov survey found that around 51% of Conservative voters at the 2017 election (64% if you exclude those that aren't sure/wouldn't vote etc.) would vote for Mr Johnson's party at an election, assuming Brexit is done by then. While that is still a sharp fall compared to the last election, polls suggest Labour would fare worse. Less than half of 2017 Labour voters said they would vote for the party again in a post-Brexit election.

A failure to live up to the promise of achieving Brexit by October would undoubtedly dent Conservative support

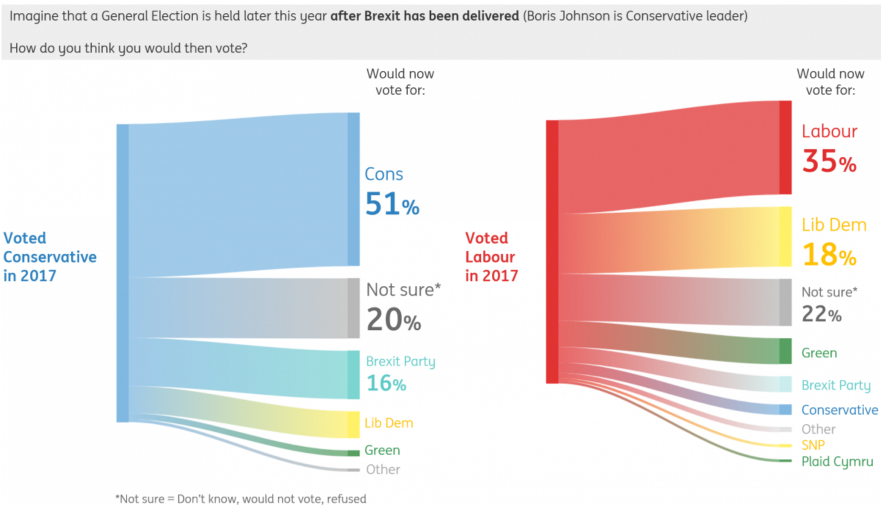
Translating all of this back into the UK's first-past-the-post electoral system is not straightforward, but in theory a Conservative share of the vote of around 30% could translate into a decent result for Mr Johnson. Some commentators have gone as far as to suggest he himself could trigger an election to run on a 'no deal' ticket to 'cash in' this advantage.

We think that's unlikely – not least given the lessons of the 2017 election where Mrs May's polling (which was significantly stronger than Mr Johnson's is now) failed to translate into a Conservative majority when the public had their say.

But the bigger issue for the new government is that an election – however it comes about – would almost certainly require a further article 50 extension. A failure to live up to the promise of achieving Brexit by October would undoubtedly dent Conservative support. And while the new PM may make a 'no deal' Brexit a formal campaign pledge - potentially shoring up support in key Leave-supporting areas - polling from Hanbury/Politico suggests this could alienate the more centrist Conservative voters in swing seats in areas such as London and Scotland.

It's also worth noting that, while the main opposition Labour Party may not do so well either, the party arguably has a wider pool of potential coalition/confidence and supply partners than the Conservatives. This means a Labour-led coalition is not an inconceivable outcome of a 2019 election, should the Conservatives fail to gain (or come close to) a majority.

Polls suggest a more divided Labour Party than Conservatives at an election



Source: YouGov/Britain Elects poll (7-8 July 2019)

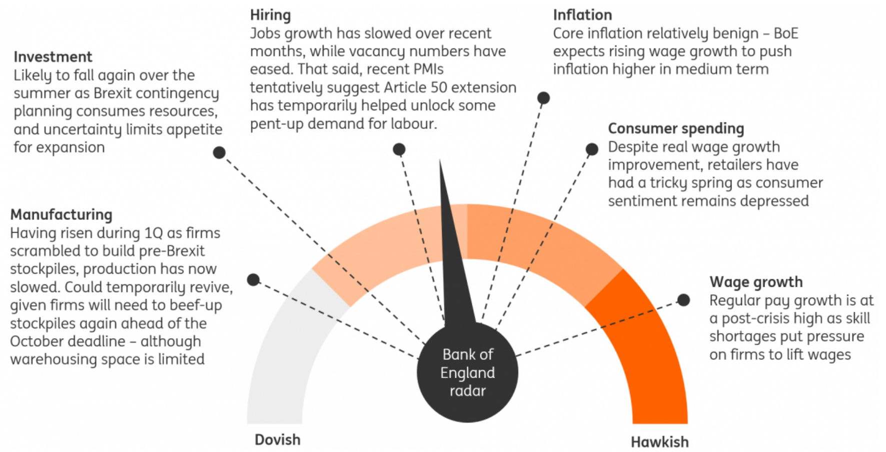
Uncertainty to take its toll on growth, although rate cuts not yet on the horizon

All of this uncertainty will continue to take its toll on growth. The prospect of further declines in investment, coupled with the recent lacklustre retail spending numbers, suggests underlying quarterly growth (once volatile production/inventory numbers are stripped out) will remain capped at around 0.2/0.3% for much of the rest of the year. Benign inflation projections and the prospects of monetary easing abroad have sparked talk of a UK rate cut - markets are pricing a 50% chance of one happening by the end of 2019.

At this stage, we aren't convinced. Wage growth has reached another post-crisis high, and this has been a key a hawkish factor for policymakers over the past couple of years. A lot will depend on Brexit of course, but if an election takes place, or Article 50 is extended to allow more time to break the deadlock, we expect rates to remain on hold for the time being.

However, a further deterioration in UK growth, a significant escalation of global trade tensions, or a 'no deal' Brexit in October, could be catalyst for fresh easing from the BoE.

BoE radar: Investment set to remain a drag on economic activity



Source: ING

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Watch: Boris, Brexit, the Bank and Britain's pound

Boris Johnson is to be the UK's next Prime Minister. With 100 days to go before Britain is due to leave the European Union, ING's James Smith...

Boris, Brexit, the Bank and Britain's pound

Exactly 100 days until Britain leaves the European Union, how will the markets react?

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Article | 17 July 2019 **FX | United Kingdom**

GBP: The pressure is building

Sterling continues its descent as concerns about the Brexit outlook intensify. While there is already a 3% risk premium in EUR/GBP, this is still below...

Source: Shutterstock

More negative news ahead

In the month ahead, we expect headline news to continue to negatively impact sterling. First, the likely confirmation of Boris Johnson as the next Conservative leader and thus prime minister next Tuesday won't be helpful for GBP. The Conservative party conference in late September will also add pressure to GBP, with peak pressure building in October ahead of the 31 October Article 50 extension deadline.

While the outlook for GBP does not look great, sterling has already moved considerably. Below we look at the technicals such as risk premium, positioning and the option market and conclude that despite the bad news already being reflected in sterling, there is still scope for further GBP decline. This is consistent with our forecast of EUR/GBP 0.92 and GBP/USD 1.22 this summer. Risks to our GBP forecasts remain on the downside, stemming from both risks of a hard Brexit or early elections.

If elections are called early, we see EUR/GBP approaching the 0.95 level.

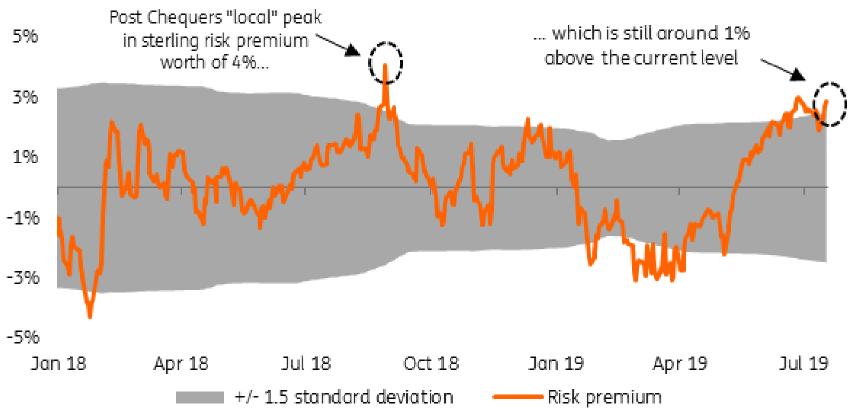
Risk premium

Following the recent sterling decline, a fair degree of risk premium is priced into sterling. Based on our short term financial fair value model, we estimate the risk premium is currently worth around 3%, which is elevated and outside of the usual 1.5 standard deviation band – as the figure above shows. However, the same chart shows, this is still below the GBP risk premium highs observed in 3Q18 after the Chequers cabinet meeting, which was followed by the resignation of Boris Johnson. At that time the risk premium was worth 4%, suggesting another 1% decline in GBP could be still on cards and consistent with our forecast of 0.92 this summer.

In the case of early elections (a meaningfully rising probability), we can see EUR/GBP at 0.95 as the prospects of a potential Labour government or a hard Brexit are unlikely to go down well with global investors.

GBP risk premium on the rise

The estimate of EUR/GBP risk premium. A residual between EUR/GBP fair value and spot.

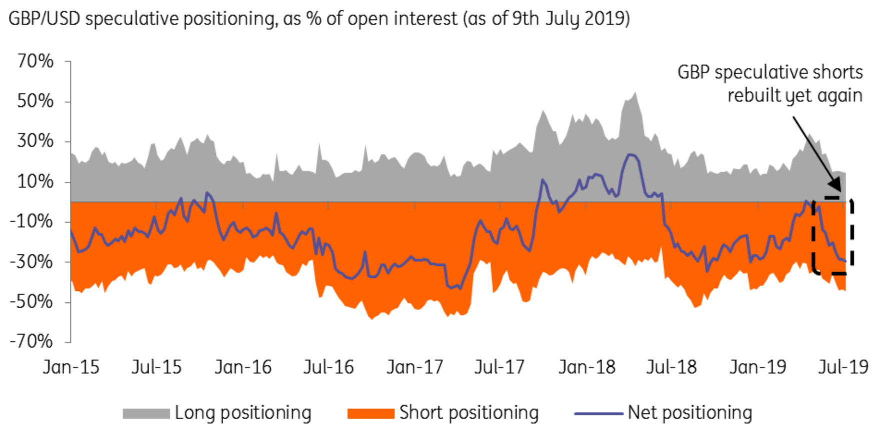


Source: ING

Speculative positioning

Market concerns about the Eurosceptic prime minister have led to a meaningful build-up / re-building of speculative sterling shorts, 30% of open interest currently, as the figure above shows. This exceeds the level of speculative shorts in January this year and has been only surpassed by the level of speculative shorts in the post Chequer's period (around 35% of open interest at the time). As the figure below shows, only rarely have GBP/USD speculative shorts exceeded the 35%-40% level (in terms of open interest). This means that while there is still some scope for a build-up of short GBP positions, the pace of the increase in GBP shorts should slow versus the aggressive build-up over the past months. This also suggests EUR/GBP trades to 0.92 this summer unless we see meaningful news (i.e., sharply rising probability of hard Brexit or early elections).

GBP speculative shorts on the rise

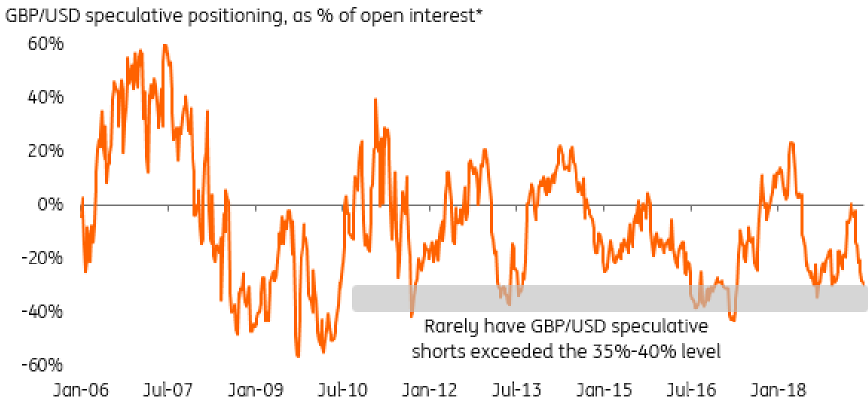


Source: ING

Option market / volatility

The rising perceived probability of a disorderly Brexit after the 31 October deadline (in response to the comments from Boris Johnson, the leading Conservative leadership candidate) is reflected in the option market, with the sterling implied volatility curve heavily kinked around the deadline date (that is the 3-4 months tenors) versus the close-to-normally upward sloping shape of the curve 2-3 months ago. This is evident in the figure below. Sterling risk reversals also surged, but are still below the March highs, suggesting a further increase over coming months

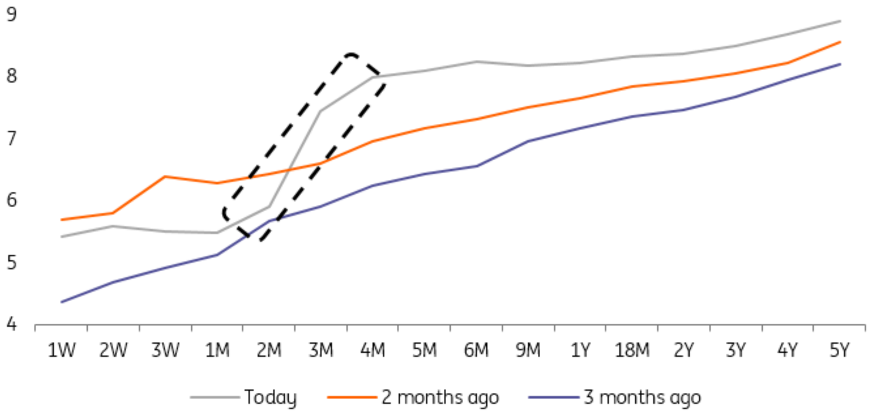
Rarely have GBP/USD speculative shorts exceeded the 35%-40% level



* As of 9th July 2019 (data are reported with a lag)

Source: CFTC, ING

Sterling volatility curve heavily kinked around the deadline date



Source: ING, Bloomberg

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