UK Watch

Group Economics
Financial Markets Research

25 November 2019

Last chance for Remain?

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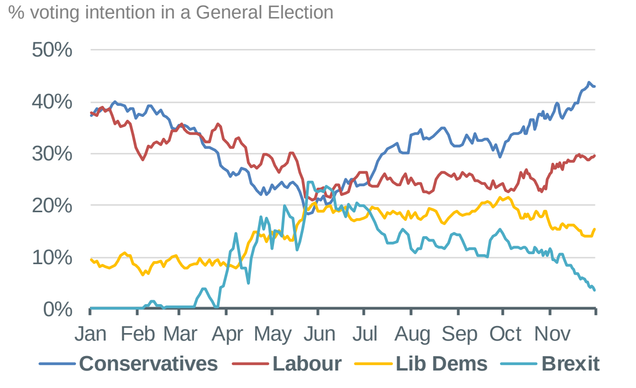
- **The UK votes in a general election on 12 December. Polls point to a Conservative victory, but another hung parliament is also possible**
- **In any case, the risk of a disorderly Brexit is now very low**
- **With a Conservative majority, Brexit will take place as planned on 1 February. With another hung parliament, we expect a new referendum before end-2020**
- **Growth is likely to remain subdued in the near-term, before picking up later next year on the back of higher government spending**
- **We expect the Bank of England to keep policy on hold, but with the risk of a near-term 25bp cut**

Disorderly Brexit comes off the table

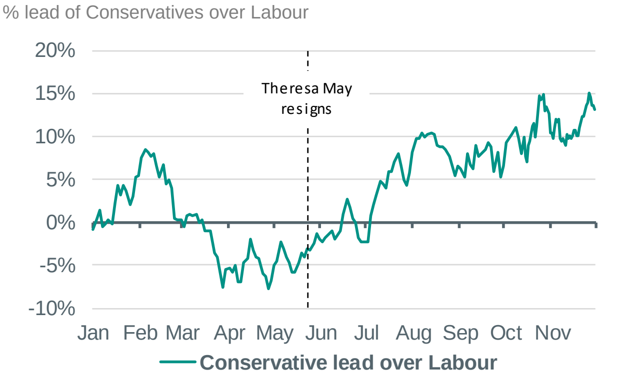
Cutting through the noise of the many recent developments in the UK, by far the most important for the economic outlook has been the significant fall in the chance of a no-deal, disorderly Brexit. This occurred because of two things: first, the so-called 'Benn' Act which forced the government to request a delay to Brexit at the end of October. Second, PM Johnson managed to secure a deal that his hard Brexit cabinet could support. This has narrowed the likely outcomes of the looming election to Johnson's new deal on one side, and a soft Brexit or Remain outcome on the other side. While risks remain, the tail risk of a disorderly Brexit is significantly lower. In this note, we will explore the likelihood of each of these outcomes, and the implications for the UK economic outlook.

Polling suggests a Conservative majority…



Source: Various polling organisations, ABN AMRO Group Economics

…with the party leading by 10-15 points



Source: Various polling organisations, ABN AMRO Group Economics

An election like no other?

The UK will go to the polls on 12 December in what could yet prove to be a highly unpredictable election. The Conservative Party currently enjoys a 10-15 point lead in opinion polls over the nearest rival, the Labour Party. However, the party enjoyed a similar lead over Labour in the period leading up to the 2017 election, and this proved disastrous for the Conservatives, with the party losing its majority in parliament. The coming election's predictability is further complicated by the UK's first-past-the-post electoral system – a 'winner takes all' system where parties can win seats with a minority of the vote share in a given constituency, so long as they have the most votes. This did not pose problems when elections in the UK were two-horse races between right/left, Conservatives/Labour. However, the Liberal Democrats (pro-remain) and Brexit Party (pro-no deal Brexit) have both attracted voters from the main parties, and so extrapolating national polling to the constituency level could yield misleading predictions of the actual outcome. With that said, of the likely scenarios – a Conservative majority, or another hung parliament (similar to now) – all lead to relatively benign outcomes for financial markets. The Conservatives are campaigning on the basis of their deal (whereas the risk before was that they would campaign for a no-deal Brexit), and another hung parliament would likely lead to another referendum pitting PM Johnson's deal (or some soft Brexit variant) against Remain. In any case, the risk of a no-deal, disorderly Brexit is substantially lower than it was previously.

Conservative majority or another hung parliament the likely outcomes

The election is still over two weeks away, but opinion polls have already shifted, with support from the smaller parties leaking back to the two main parties. Most significantly, the Brexit Party has decided not to field candidates in the 317 constituencies the Conservatives won in the last election. On the surface, this looked to be a game changer, as the presence of the Brexit Party was splitting the leave vote, reducing the chance of pro-Brexit candidates getting into parliament (see box). However, the decision to continue fighting the election in other Conservative-Labour marginal seats means that it is still a significant uphill struggle for Conservatives to win a majority. With that said, a Conservative majority still looks more likely than a Labour majority. For Labour, the likely best case scenario would be having the largest number of MPs but not an absolute majority, meaning they would need the support of the SNP and/or Liberal Democrats to form a government.

Box: How the UK electoral system complicates predictions

Unlike in most European countries, the UK does not have proportional representation as its electoral system, but instead the 'First Past the Post' system. Because of this, it is better to think of UK elections as 650 mini elections rather than one national election. To illustrate with an extreme example, if the current polling were distributed evenly across the country, the Conservatives would win all 650 parliamentary seats with only c.40% of the vote share. In reality, the distribution is much less even, with the Labour vote share tending to be concentrated in the big cities, and the Conservatives dominating in rural areas.

For more on the First Past the Post system, and a comparision with eg. Proportional Representation, see: https://www.electoral-reform.org.uk/voting-systems/types-of-voting-system/first-past-the-post/

What comes after the election?

We see two main likely outcomes to the election: 1) A conservative majority, or 2) another hung parliament (similar to now). Below we lay out how each of the two scenarios would pan out, and the implications for the economic outlook.

Scenario 1: Conservative majority

On current polling, this outcome looks more likely than a hung parliament. In this scenario, we expect PM Johnson's deal to be passed with relative ease before the 31 January Brexit deadline. Following the UK's formal exit from the EU, the UK will start negotiations on a post-Brexit free trade deal with the EU, and enter the so-called 'implementation', or transition period, during which for practical purposes the UK remains essentially an EU member – with no change to trading arrangements or laws. The key question in this scenario – and something that may come to vex financial markets – is whether the government ends up requesting an extension to this transition period, which is currently due to end at end-2020. Under the terms of the Withdrawal Agreement, the government has the option of extending this period by up to two years if it looks as though a post-Brexit free trade deal is not negotiated in time. So far, PM Johnson has committed *not* to extend this period, which in theory could mean the UK leaving with no trade agreement in place.

Renewed risk of 'no deal', but not as we know it

This would not be as bad as a disorderly Brexit, as the UK would be leaving on good terms with the EU, and there would therefore be ad-hoc agreements covering for instance aviation. This would reduce the disruptive impact of such an outcome. However, it would still be economically damaging, as it would significantly raise barriers to trade. As such, we doubt the government would ultimately follow-through on this promise, and in the probable scenario that negotiations on a free trade deal are not concluded in time, we expect the government to seek an extension to the transition period. However, the request for this may not come by the official deadline of mid-2020, but probably closer to the actual end of the transition period towards the end of 2020. Uncertainty over this will therefore continue to weigh on investment and the economic outlook, keeping growth relatively subdued.

Scenario 2: Another hung parliament (or a minority Labour government)

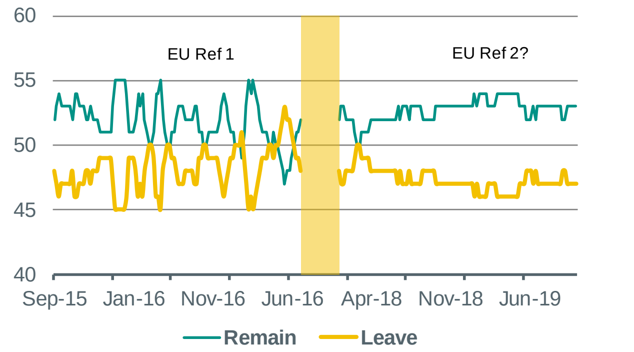
In this scenario, no single party wins a majority of seats in parliament, and given the lack of a natural partner for the Conservatives (the DUP are no longer an option given their opposition to Johnson's deal), this would lead Remain-leaning parties to form a temporary alliance with the primary purpose of putting Brexit to another referendum. Alternatively, a minority Labour government could be formed, with support from other parties dependent on what is being put to parliament. Either way, we expect another referendum to result from this. Labour's policy is to negotiate a soft Brexit, which would involve a customs union and regulatory alignment with the EU – essentially amounting to European Economic Area membership – and to put such a deal vs Remain in a new referendum. It has promised to do this within 6 months of the election. While such a timescale looks tight, a referendum before the end of 2020 looks likely in this scenario.

Brexit-in-name-only, or Remain? Same difference

A new referendum is likely to lead to a Remain outcome. While polling on a simple 'Leave' vs 'Remain' question gives Remain the same narrow margin it had prior to the last referendum, other polling – for instance, on whether the UK was right or wrong to vote to leave the EU – suggests a more pronounced shift in favour of Remain may have happened below the surface. Naturally, opinion can change in the course of a referendum campaign, and it is possible Leave could still win. But given the very soft Brexit that would be on the ballot versus Remain under Labour's proposal, the economic implications of such an outcome would be rather small; there would still be frictionless goods trade, and potentially continued Single Market membership, supporting services trade (where the UK has a comparative advantage). Essentially, it would amount to a 'Brexit in name only', with the only major change being the loss of political influence the UK currently has on EU regulation.

A more stable - but still narrow - lead for Remain

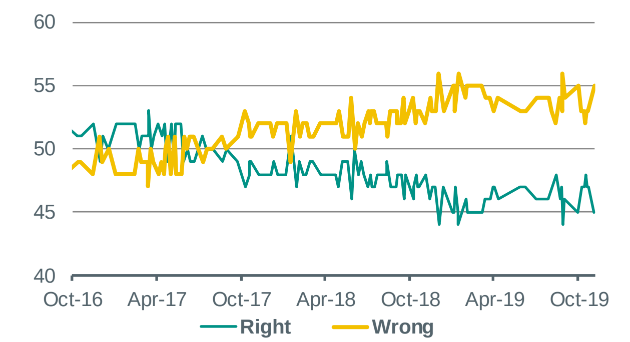
% voting intention in a new EU referendum



Source: What UK Thinks: EU, ABN AMRO Group Economics

Is hindsight 20/20?

% response to 'Was the UK right or wrong to vote to leave the EU?'



Source: What UK Thinks: EU, ABN AMRO Group Economics

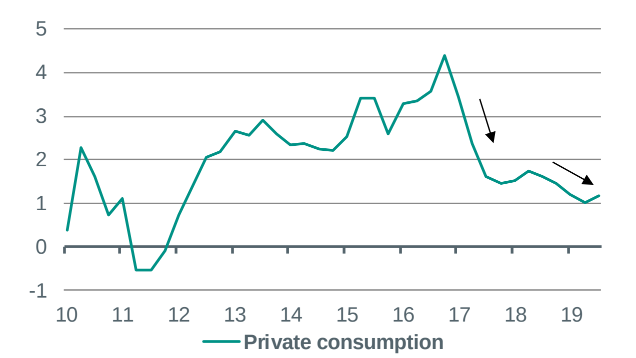
Labour majority looks unlikely, but could be negative for markets

The main risk scenario for financial markets in the election is a Labour majority, which on present polling looks unlikely. This may seem counter-inuitive, given that Labour favours a closer relationship with (if not remaining in) the EU, and if Labour were to form a majority government, we would initially expect events to broadly follow scenario 2. The difference would be that Labour would have much more freedom to implement its radical leftwing agenda, including renationalising parts of the economy that had been privatised (such as the railways), and immediately raising the minimum wage by over 20%. This would likely have a negative impact on financial markets and business confidence, though it would also – at least in the short term – be stimulatory to growth and inflation.

Macro outlook: Growth has slowed significantly since the 2016 referendum

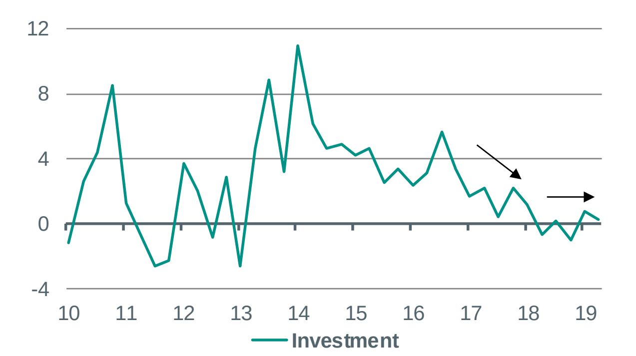
As the political stalemate over Brexit has dragged on, so the economic damage has increased and become harder to reverse. While avoiding predictions of a recession in the post-referendum aftermath, the threat of a no-deal, disorderly Brexit has hit both consumption and investment. The initial victim was disposable household incomes, as the fall in sterling drove higher inflation, without a corresponding increase in wage growth. To some extent, consumers dipped into savings to make up the shortfall in income growth, driving the savings rate to historically low levels. However, since the referendum, consumption growth has fallen from an average 3.3% pace in 2015-16, to 1.7% in 2017-19. A stagnation in investment has followed; while initially holding up after the referendum, investment has essentially flatlined since mid-2017. After contracting -0.1% in 2018, our forecast is for zero investment growth in 2019 – this compares with the average 3.0% growth pace over 2015-17. Taken together, weaker consumption and investment have driven overall GDP growth down from 2.1% in 2015-16 to 1.4% in 2018, and our projection of 1.2% in both 2019-20.

Consumption has slowed significantly…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…while investment has flatlined for the past two years

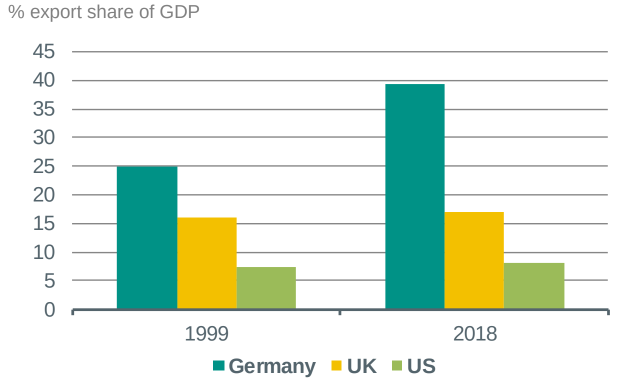


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Brexit to be a structural growth drag, regardless of how it is resolved

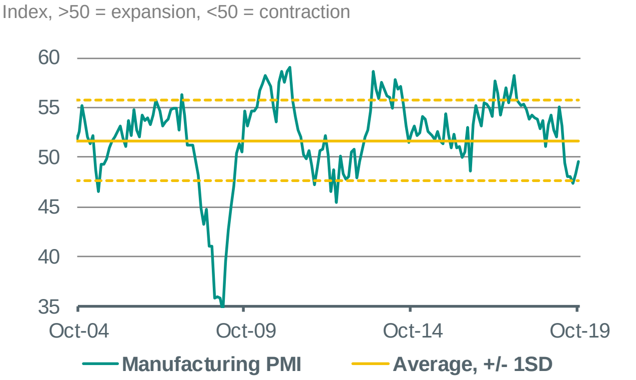
In our note last year, *The macro impact of Brexit scenarios*, we presented three scenarios – deal, no deal, and Remain – each of which leading to differing economic outcomes. Since then, we have come to the view that both Brexit with a deal and Remain outcomes would be quite similar in their macro effects, at least on our forecast horizon of 1-2 years ahead. Why is this? First, the external environment has changed. The global industrial slowdown that started in early 2018 persisted for far longer than we anticipated back then, and has since intensified in 2019 on the back of the escalating US-China trade war, turning into an industrial recession. While the UK is not as export-dependent as some other European economies, and its manufacturing sector smaller as a share of GDP, the global slowdown has nonetheless played a part in the UK's economic weakness – and this drag looks set to persist over the coming quarters, regardless of any resolution to Brexit.

UK is not as export dependent as some…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…but global weakness has still hit manufacturing



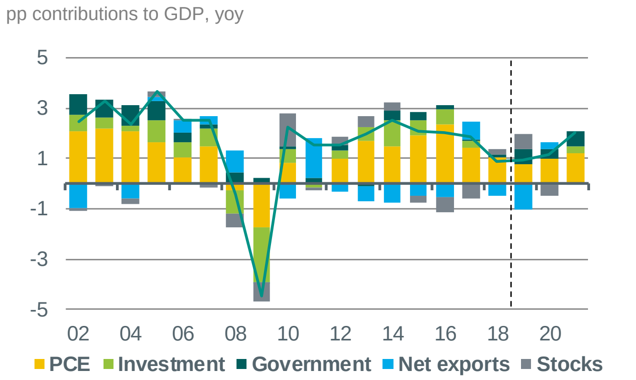
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Second, we think the intensifying polarisation of UK politics will mean uncertainty over future trading arrangements will persist for some years, even in the most positive scenario of 'Remain' winning a new referendum, particularly if it is again by a narrow margin (as would be likely). The pro-Brexit movement would not disappear overnight, and the risk of a pro-Brexit government coming to power again in future will mean a semi-permanently higher risk premium on UK investments. In short, the Brexit genie would be hard to put back in the bottle, and as such, our previous assumption of an immediate sharp rebound in investment in a 'Remain' scenario looks less likely than it did previously.

Near-term growth subdued, with a fiscal boost from H2 2020 onwards

Growth in Q3 was somewhat stronger than expected, with consumption growth picking up a notch, but fixed investment contracted for a second consecutive quarter. With Brexit delayed at least until January, and uncertainty probably persisting for much of next year, we expect only a mild recovery in investment and solid, if unspectacular growth in private consumption. Key risks for the near-term outlook will be 1) whether recent signs of labour market weakness develop into a more significant downturn, and 2) how quickly planned government spending increases might come on stream. The latter naturally will depend on the election outcome, but both Conservatives and Labour are promising big spending increases, despite high levels of government debt – with Labour promising to outspend the Conservatives, perhaps significantly. This should lift growth later in 2020 and into 2021, by which time we expect growth to be closer to trend.

Growth to see support from government spending…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…despite still-elevated government debt

Source: Bloomberg, ABN AMRO Group Economics

The medium term outlook is less positive, given how weak UK macro fundamentals are. With businesses paralysed by Brexit uncertainty and investment flatlining for the past two years, productivity growth is suffering. Things are scarcely better on the household side; while consumer confidence has held up better than business confidence, and real wage growth has picked up, household balance sheets are in a parlous state, with household debt not far off pre-recession highs at 90% of GDP, and the savings rate just shy of historically low levels. This makes households highly vulnerable to any downturn.

High household debt…

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

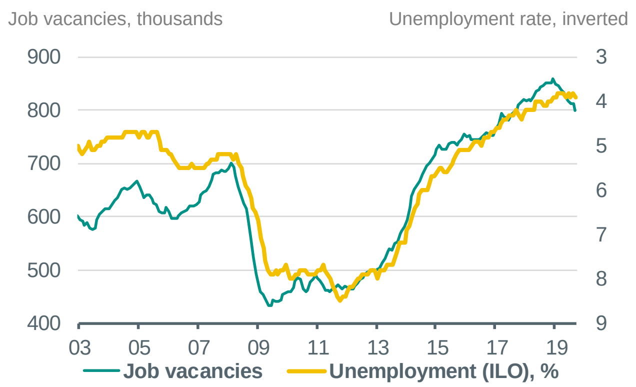
…and low savings leave households vulnerable

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

BoE to keep policy on hold, with risk of a near-term cut

The Bank of England has kept interest rates at 0.75% since raising them twice by 25bp (in August 2018 and in November 2017). Until relatively wecently, the BoE looked to be comfortably on hold for the time being. However, a dovish shift on the MPC – notably by ex-hawk Michael Saunders – suggests a higher risk of a cut in the near-term. Accompanying Jonathan Haskell, Saunders dissented at the November meeting in favour of a 25bp cut, with both citing falling job vacancies as a sign that the labour market is turning. Vacancies have indeed fallen from historically elevated levels, as has employment, though the labour market overall remains strong – with wage growth and unit labour cost growth continuing to accelerate. Indeed, while inflation has fallen back of late, we expect higher ULC growth to drive a pickup in inflation next year. In the election meanwhile, both main parties are promising minimum wage hikes in the coming years, which should keep upward pressure on unit labour costs. It is possible that companies choose to cut jobs rather than raise prices in response to higher labour costs, but inflation expectations are relatively high in the UK, perhaps giving more leeway for businesses to pass on higher costs than in other advanced economies.

Falling vacancies could point to turn in labour market



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

But labour cost growth continues to accelerate

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Further complicating the decision of the MPC is the aforementioned looming increase in government spending, which also looks likely regardless of the election outcome. In the absence of this we think the Committee might have opted to cut rates, and we still think the policy bias will be towards an easing of policy rather than a tightening. But a cut to us looks likely only if signs of weakness in the labour market prove to be more significant than in our base case.

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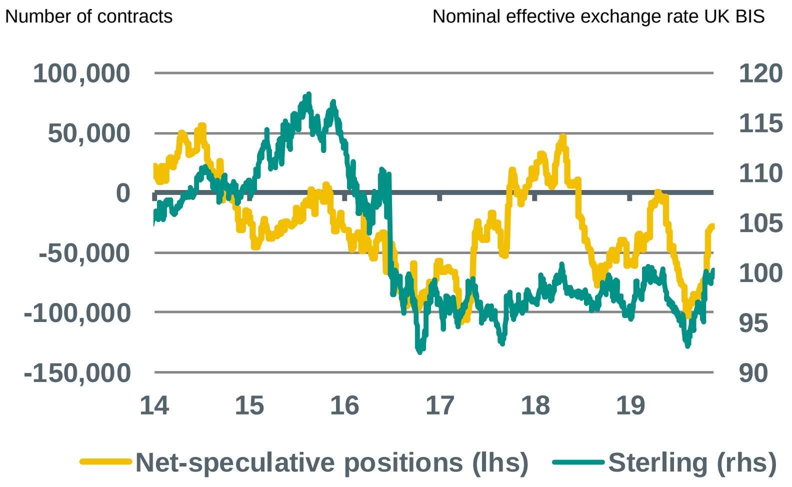
Sterling outlook

This year sterling has been very volatile. Back when investors feared a disorderly Brexit in August 2019, GBP/USD was close to 1.20 and EUR/GBP was above 0.93. Since then, sterling has recovered and the excessive net-short speculative sterling positions have been reduced. We think that sterling has room to recover further for the following reasons. First, the risk of a disorderly Brexit is now very low, but uncertainty about the upcoming elections still make investors somewhat cautious. In general, investors are cautious about important upcoming elections, but all likely outcomes of the election are benign for financial markets, with minimal risk of a disorderly Brexit. Speculators are still overall short sterling, and these trades will likely will be closed when the election uncertainty is over. Sterling has probably the most upside potential if parties supporting Remain/another referendum get a majority, but sterling will likely be more volatile because of the uncertain path to get to a Remain. A Conservative majority will also be positive for sterling in the near-term as it reduces both political uncertainty and Brexit uncertainty in one go. However, towards the end of 2020 sterling will likely experience some weakness on the risk that the government does not extend the transition period. A Labour majority will likely lead to the smallest upside potential for sterling, as investor expectations on the implementation of Labour's agenda will dampen the positive impact on sterling of a potential soft Brexit/Remain.

Speculators are still net-short



Source: Bloomberg, BIS

Second, the economy will perform relatively well (no recession) and a BoE rate cut is not in our base scenario. Third, from a technical point of view the longer-term outlook for sterling has become positive and this will continue to support sterling. Ahead of the Brexit referendum in June 2016 GBP/USD, was above 1.45. Our economic outlook and BoE view are constructive for sterling, but not overly bullish. So, our new forecasts show some upside in sterling, but we don't expect GBP/USD to rally above 1.45 on our forecast horizon. Our year-end forecasts for GBP/USD for 2019 and 2020 are 1.30 and 1.35 respectively.

Key forecasts for the UK

	2016	2017	2018	2019e	2020e	2021e
Economic outlook (% yoy)						
GDP	1.9	1.9	1.4	**1.2**	**1.2**	**2.0**
- Private consumption	3.6	2.2	1.6	**1.2**	**1.5**	**1.8**
- Fixed Investment	3.6	1.6	-0.1	**0.0**	**-0.2**	**1.6**
- Government consumption	1.0	0.3	0.6	**3.3**	**2.1**	**3.1**
- Net exports (pp contribution)	0.0	0.3	-0.8	**-0.4**	**0.0**	**0.0**
Inflation	0.7	2.7	2.5	**1.8**	**1.7**	**2.0**
- Core inflation	1.3	2.4	2.1	**1.7**	**1.9**	**2.2**
Bank of England Bank Rate	0.25	0.50	0.75	**0.75**	**0.75**	**0.75**
GBP/USD	1.23	1.35	1.28	**1.30**	**1.35**	**1.42**

Source: ABN AMRO Group Economics

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