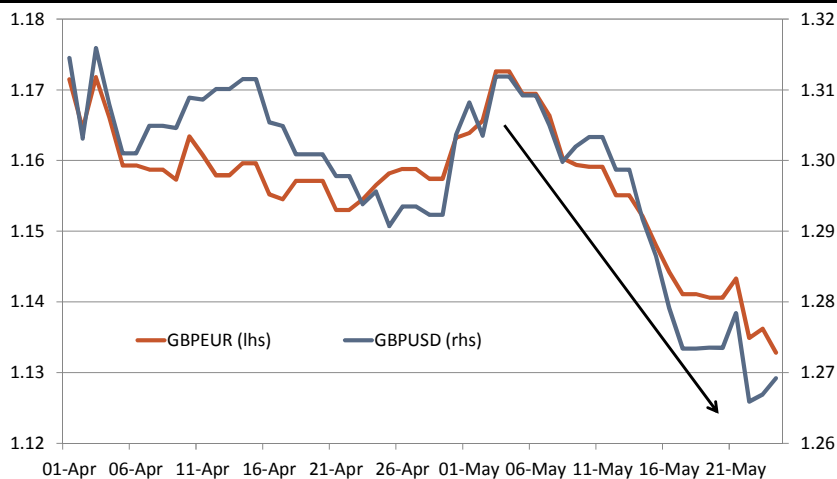


29 May 2019

## UK: Political tail risks edge higher

### Rising hard Brexit risk and political uncertainty weigh on sterling



Daily data. Source: Financial Times

- A watershed moment:** The results of the European elections have set the UK's major political parties in drastically different directions. After hemorrhaging support to the Brexit Party, the Conservatives look set to harden their stance on Brexit as the party searches for a new leader and prime minister. The Labour Party, which suffered big losses to the pro-EU Liberal Democrats, looks set to fully back a second EU referendum shortly. Strong support for the Scottish National Party has renewed its drive for a second Scottish referendum. Altogether, this lowers the odds of a compromise semi-soft or soft Brexit while increasing the likelihood of the more extreme outcomes. The latest sterling selloff reflects the heightened political uncertainty and rising tail risks – see chart.
- Making plans for Nigel:** Opinion polls for the next general election suggest that frustrated Brexit voters are switching to the newly formed Brexit Party led by eurosceptic Nigel Farage. This hurts the Conservatives the most, whose support has fallen from c40% in March to 24% (last five polls), while support for the Brexit Party has risen to 17%. Despite economic risks, the next Conservative leader may benefit politically by taking a hard line on Europe.
- Hard Brexit risk rises:** According to the bookmakers' implied odds, the next PM is likely to be a Brexiteer: Boris Johnson (38% chance), Michael Gove (18%), or Dominic Raab (18%). On its own, this would raise the hard Brexit risk. The impact of the Conservatives' drubbing in the European elections and their slide in the opinion polls suggest the hard Brexit tail risk has risen significantly. We now put it at 35%, from 25% previously.
- Raab is the one to watch:** A genuine hardliner, Raab pushed for a harder stance when he headed the UK side of the UK-EU negotiations. The hard Brexit risk could rise further if he becomes PM. Johnson and Gove are more pragmatic. Instead of going head first for a hard Brexit, they will likely try to pass a deal. With luck, they might have the pro-Brexit credentials to unite their party and pass the Withdrawal Agreement (WA). However, we now only see a 40% chance that the UK will pass the WA plus a compromise for future UK-EU trade eventually, down from 55%.
- Second referendum and Corbyn risks up:** Even though a majority in parliament is against a hard Brexit, it remains the default option on 31 October unless the UK passes the WA or changes its mind on Brexit. The chance that the EU would agree to a third extension just to prevent a hard Brexit is low, in our view. However, for a snap election or second referendum that could be a different story. This could leave only the nuclear option to stop a hard Brexit, that is, for pro-EU Conservative MPs to threaten or indeed to back opposition parties in a vote of no confidence against their own government. This jointly raises the snap election risk and the chance of a second referendum (it also feeds into the higher hard Brexit risk). We thus raise the probability of no Brexit to 25% from 20%. We also nudge up the risk that far-left Labour leader Jeremy Corbyn eventually becomes PM to 25% from 20% previously.
- A noisy summer ahead:** The Conservatives will probably use up most of the time from now until parliament is due to head for summer recess on 24 July to find a new leader. We might thus have to wait until parliament returns on 4 September before MPs can address any serious Brexit business. That would leave just two months to sort out Brexit. Unless the first act of the new PM is to cancel summer recess (not impossible), markets, business and households now face the prospect of months ahead with all noise but no action. So what else is new?

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