23 July 2019

BREWIN DOLPHIN

What will Boris mean for the markets?

The UK's new prime minister will be Boris Johnson, who has insisted he will take the country out of the EU on 31 October "do or die". What could his appointment mean for the economy and investment markets?

Five takeaways

1. Boris Johnson's appointment as prime minister makes a no deal Brexit seem like a closer prospect than ever – but we still think it unlikely to occur
2. Mr Johnson's rhetoric leaves room for both the UK government and EU to make concessions that could result in a deal
3. While we think it unlikely to happen, if there is a no deal Brexit UK government bond prices would be expected to rally
4. The pound would also likely fall, benefiting the large internationally-focused companies that dominate the FTSE100
5. Other companies would suffer, but as long-term investors we will be looking for attractive opportunities to invest in great companies cheaply.

The Conservatives' preference for a new leader has been confirmed by the party membership and Boris Johnson will now be asked to lead the government.

As this appointment has looked like a formality for several weeks the financial markets have not reacted noticeably. They have, however, been paying close attention to what Mr Johnson's administration might mean for the UK economy, and the investment implications.

Chief amongst these, almost to the exclusion of all others, is whether the new prime minister can resolve the Brexit negotiations.

What happens next?

In principle the new prime minister's approach is very similar to his predecessor's, Theresa May. Both have emphasised that they would seek a deal but have employed variations on the theme of no deal being better than a bad deal. So far that approach has not yielded a deal which will be approved by Parliament. This raises the obvious question, why should the new prime minister be more successful?

There are two stages to a classic negotiating strategy. The first is to show that you are willing to walk away. Negotiators call this improving your best alternative to a negotiated agreement (known as a BATNA). If your opposite number believes you will suffer greatly through failing to agree a deal they will compromise less.

Hence the apparent willingness of Mr Johnson to embrace no deal. As one of the leaders of the Leave campaign, Brexiteers may be hoping that the new prime minister is more willing to countenance a no deal outcome than Mrs May was. He will however have far less time to make no deal preparations, which slightly weakens his hand.

How will the EU react?

At each successive Brexit deadline the possible outcomes have been deal, no deal or deferral. But while Parliament ruled out no deal, that only left deal or deferral. For the EU, who don't want the UK to leave, deferral of Brexit was a reasonably attractive alternative to any deal. If the choice truly becomes between deal or no deal, then it may prompt the EU to concede more.

Where might discussions focus?

The deal which was repeatedly and decisively rejected by Parliament aspired to a future relationship of frictionless trade in goods, including on the border between Northern Ireland and the Republic of Ireland.

However, in order to get to that future relationship, it would be necessary to enter a transitional period during which the final negotiations would take place. To guard against the failure of those negotiations it was deemed necessary to incorporate a "backstop arrangement", which remains a significant point of controversy.

The backstop is deemed necessary because, in the absence of a significant trade deal, Brexit will re-establish the border between Northern Ireland and the Republic. That border will need to be substantial enough to form the outer limit of the European Union and yet unobtrusive enough not to undermine the economy, or the Northern Ireland peace process which the absence of a visible border has greatly facilitated.

Finding a solution to the proposed backstop arrangement would seem to be the most likely path through the Brexit stalemate and a compromise such as a time-limited backstop or longer transition period are the most commonly proposed potential resolutions.

So far, rather than reconsider the backstop, the EU and Ireland have preferred to repeatedly defer Brexit. If the new prime minister can make "no deal" the realistic alternative, the equation changes dramatically.

How could the new PM turn this to his advantage?

A no deal outcome would irrationally condemn Ireland to the hardest and most obvious of mainland borders which would need to be hastily erected from the beginning of November and with economic disruption to the EU, UK and Ireland.

If Mr Johnson can persuade the Irish government to, at the very least, accept a time limit to the backstop, it would provide some space for a deal to be negotiated which might mean the backstop would never be implemented. Technically the backstop is only meant to operate as a last resort. It is through this strategy that we assume he will try to redress the balance of power in these negotiations.

Before such an agreement is made, Mr Johnson may rule out changes to the backstop and instead insist that it needs to be abolished altogether. This most likely represents the second part of a negotiating strategy. This is called anchoring and means establishing a position from which you can make concessions that will ultimately leave you with the deal you want.

The incentive for the Irish government and the EU to enter into new negotiations stems almost entirely from the desire to limit the risk of a hard border on Ireland, or at least to delay its implementation. Therefore, claiming he wants to eradicate the backstop altogether may make Mr Johnson seem eminently pragmatic if he were eventually to concede the need for a time limited one.

However, a big uncertainty remains whether the House of Commons would agree to play ball and back such a deal. The EU has repeatedly stated that before making concessions it needs to know those concessions will have the support of Parliament – which cannot simply be assumed.

What are the chances of a no deal and what could it mean for the economy and markets?

It still seems most likely that both the UK and EU will avoid the mutual harm of a no deal Brexit outcome. However, given the complexity of the competing factions in the House of Commons, no deal now seems to be a more realistic prospect than ever.

In the event of no deal, we cannot tell how severe the economic disruption might be. Recognising that even official studies on the subject seem to reflect some form of partisan lean, accompanied by the lack of accuracy economists usually display when forecasting economic adversity, nobody really knows the degree of economic harm that would follow.

Should it prove particularly dire though, then UK government bonds would benefit in price and that in turn should benefit the corporate bonds issued in sterling.

The pound will also be expected to fall. That means for those companies that buy their wares overseas and sell them in the UK profit margins would be squeezed. This is often the case for retailers. However, for most of the large companies we invest in, the opposite is true. Their sales will normally be global and so a decline in the pound means their value rises for UK investors.

When a known deadline like this has occurred in the past, we have seen the market act irrationally in the first instance. This is because the fastest to react are the shortest-term speculative investors. Therefore, we could see attractive opportunities for long-term investors like ourselves to invest in great companies cheaply. We will be on alert for those opportunities.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.