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Parliament rejects May's Withdrawal Agreement

Below, we provide some thoughts regarding last night's political developments. As noted, the result was largely expected, although the scale of the government's defeat was a surprise. In terms of the impact on portfolios, we do not intend to make any large-scale changes on the back of these events, and we remain comfortable with the current positioning, and with the changes already made. Given the opacity of the situation, we feel that positioning parts of the portfolios to potentially benefit from different outcomes is sensible. Within Levitas B, we have recently been adding to gilt positions and to US Treasuries (denominated in US dollars), as well as building up the cash weighting. Within Levitas A, we have maintained our underweight to UK equities, with a corresponding preference for overseas exposure. These positions should benefit if we see an increase in the likelihood of a 'no deal' or 'hard' Brexit. The UK exposure in both portfolios has a higher weighting to mid-cap, and within Levitas A the exposure to UK small-cap is also overweight - these domestically focussed positions should benefit if we see a softer Brexit, or indeed no Brexit at all.

As had widely been expected for some time, the Government's Withdrawal Agreement was rejected by Parliament in the meaningful vote on Tuesday evening. However, the size of the defeat was greater than most had expected, with 432 votes being cast against the Government and just 202 in support (118 Conservatives and 10 Democratic Unionists appear to have voted against). Although this is the largest defeat suffered by a UK government on record, Theresa May has signalled her intention to stay on as Prime Minister. Nevertheless, her ability to do so will be determined by a vote of confidence in the Government, which was called by Labour leader Jeremy Corbyn after the result was announced and will take place on Wednesday. If the no confidence motion carries it could lead to a general election, but we would expect it to fail as dissenting members of the Conservative European Research Group faction and Democratic Unionist Party have already indicated that they will support the Government.

Sterling came under pressure ahead of the vote, as investors priced in its failure and the chance of a deal being signed immediately being missed. Despite these fears being crystallised by the result, sterling staged a sharp recovery after the Prime Minister delivered a speech indicating that she will now listen to Parliament on how they would like to continue the Brexit process. This could include cross-party talks and indicative, non-binding votes on the best way forward. There is little appetite for a no-deal scenario within Parliament, with most MPs appearing to favour a soft Brexit and a delay of the secession date, and sterling's recovery shows that investors have begun to price these eventualities into asset markets. Overall, sterling ended the day stronger on a trade-weighted basis, with UK equity futures also making gains on the day amid volatility driven by the swings in foreign-exchange markets.

Despite these developments, the UK is still set to leave the EU with no deal on 29 March until Parliament votes for another course of action. However, another course is likely after the Prime Minister provides her revised plans to MPs on Monday. We see four possibilities in this regard:

- A no-deal scenario
- A compromised version of the current Agreement
- The whole process being delayed
- A second referendum resulting in a remain vote

Although it is uncertain what will happen next, what we do know is that current market pricing is incorrect for any of these outcomes individually; rather, it is reflecting the combined probabilities and likely effects of each. It is rare for a political event to have such large and diverse near-term consequences for an economy and as the ramifications are so large, developments in the process will likely generate significant market volatility.

No-deal scenario

As it stands, the UK is set to exit the EU on 29 March with no agreement in place. It is clear that there is little appetite for a no-deal secession within Parliament, given that MPs recently voted to reject the Government's proposed annual Finance Bill for the first time since 1978. This revoked the Government's ability to raise taxes to finance emergency spending in the event of a disorderly secession, which is indicative of MPs attempting to persuade the Government not to progress with a no-deal secession.

It is likely that another option will be found to avoid a no-deal scenario, but the Prime Minister may try to use the threat of a no-deal secession to force dissenting MPs to accept her deal in a second vote. As such, investors will increasingly price a disorderly secession into asset markets until clarity is gained as to exactly how such an event will be avoided.

Compromise on current agreement

In the days leading up to the vote, the Government offered MPs the chance to amend the current Agreement in the hope of bolstering its chances of passing the meaningful vote. Although its efforts were in vain, it is possible that Parliament will be allowed further chances to pass amendments before a second vote is held. However, even in the event that the Agreement is amended by Parliament and passes a vote, we see little chance of it being accepted by EU leaders who have continually reaffirmed that the current deal is the best available.

It appears that there are simply too many obstacles to overcome for an agreement to be reached that will satisfy both the UK and EU using the current process. However, we cannot rule out a capitulation on the EU side as the secession date approaches. This could lead to the negotiation of a passable Agreement or changes to the accompanying Political Declaration. Nevertheless, we would attribute only a low probability to this scenario playing out within the current Brexit timescale.

If the Government attempts to take the route of renegotiation, we would expect markets to be sceptical of a near-term resolution. Commensurate with this, investors would begin to price a greater probability of a hard Brexit into markets, as long as politicians affirmed that the UK will exit the EU as scheduled on 29 March. However, it is likely that both the Government's opposition and dissidents from within the Conservative Party will now push for the secession date to be delayed, given a lack of appetite for a hard Brexit within Parliament.

Process delayed

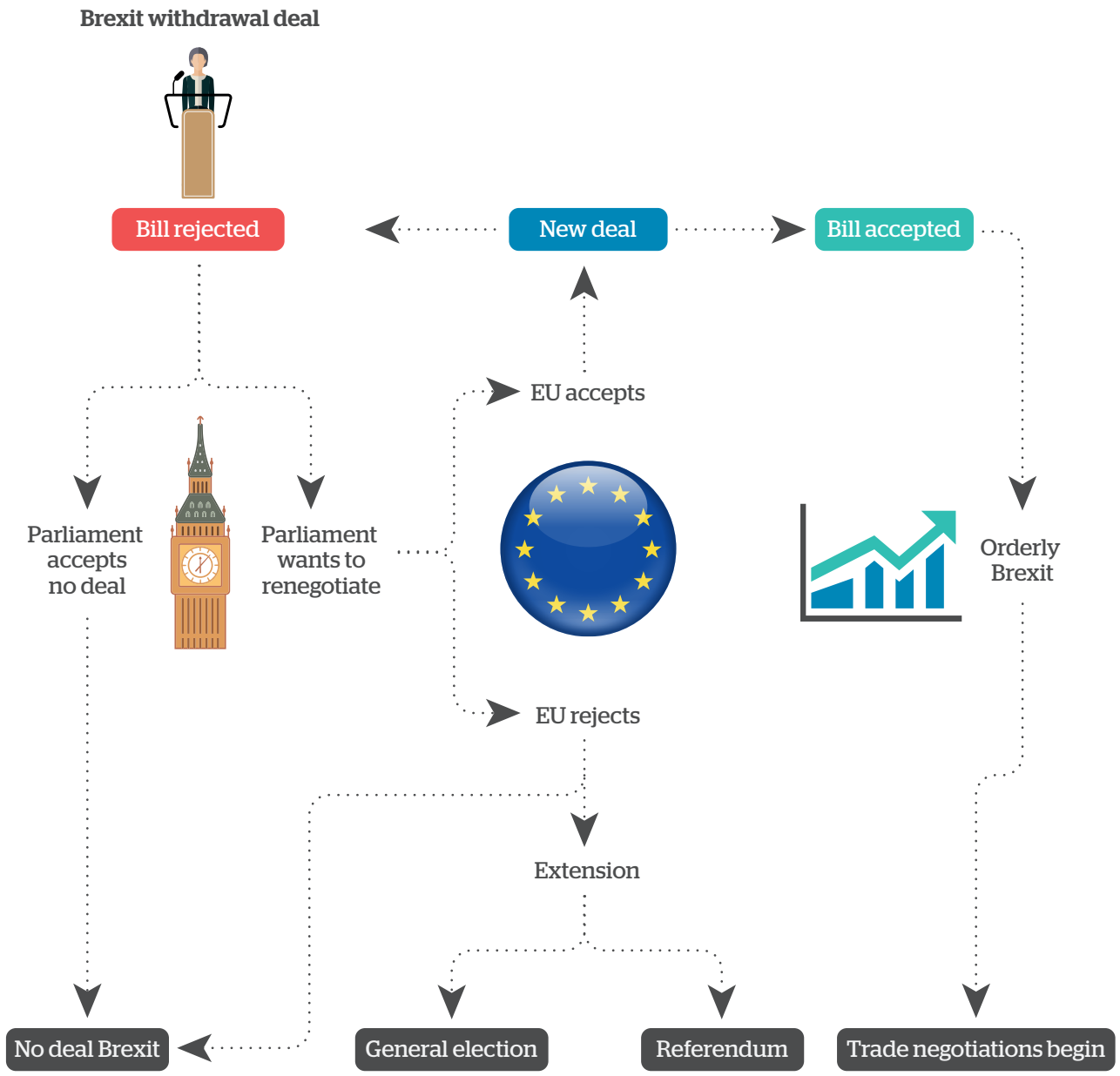
The European Court of Justice (ECJ) has ruled that the Article 50 deadline can be extended if both the UK and EU agree. Indeed, there had already been calls to delay the secession date prior to Tuesday's vote, for various logistical reasons. While a delay may not be politically palatable for the Government, it may now be unavoidable; the Prime Minister effectively lost control of the Brexit timetable after being defeated in a vote which forces her to provide her Brexit 'plan B' within the next three days.

If the Brexit deadline is delayed, we would expect investors to judge the chance of a no-deal scenario to have lessened, as any delay would be specifically to avoid such a scenario. Subsequent to a delay, it is possible that the Government will be able to put another process in place to find an agreeable deal for both sides over a longer timeframe. This may ultimately result in a soft Brexit in the future, although there would still be significant uncertainty as to how the process will progress. Overall, we would expect a delay to reflect positively in UK asset markets, although any improvement in sentiment would be restrained by ongoing uncertainty.

A second referendum resulting in a remain vote

The Government may seek to hold a second referendum, with a 'remain' result one of the possible options (we note that ECJ has ruled that the UK can unilaterally decide to remain within the EU). A second referendum has broad support within Parliament and large number of Labour MPs have suggested that they will switch their stances towards pushing for a second referendum if they cannot force a general election.

If a second referendum was announced, the market's reaction would likely be determined by the terms under which it is held. It would likely mean a choice between the current deal, no deal, or remain. Such an event would likely generate significant volatility within asset markets given the diverse consequences of each outcome.



Market reaction

The market's reaction to Brexit developments will continue to follow the lines of how 'hard' (disorderly) or 'soft' the secession will be. A harder Brexit is generally associated with greater uncertainty, weaker investment, a cheaper sterling, slower real wage growth and lower consumption, and greater pressure on the UK's economic growth in everything but the very long term. Conversely, under a softer Brexit investors expect less political uncertainty, more investment, sterling appreciation, stronger real wage growth and consumption, and faster overall economic growth.

Under a hard Brexit, the Bank of England will be faced with a tough choice between using policy stimulus to support growth and not stoking inflation, which would rise as a result of sterling weakening. UK equities would be very likely to come under pressure, with domestically-orientated stocks underperforming UK-based multinationals. It is also possible that a no-deal Brexit could drive broader risk aversion in Europe, or on a global scale. Gilts could benefit from expectations of slower growth, more accommodative monetary policy and safe-haven demand. Global multi-asset investors would be able to benefit from overseas diversification and, taking a long-term view, a hard Brexit would likely present opportunities to acquire attractive assets at favourable valuations.

With the UK's labour market currently strong and inflation close to the Bank of England's mandate target level, policymakers would likely raise interest rates in the event of a soft Brexit. This may cause additional sterling strength. The UK government would benefit from what the Chancellor has labelled a "deal dividend", releasing the reserves it had built into its finances in case of a hard Brexit in the form of higher fiscal spending. UK equities could experience a relief rally, with domestically-orientated stocks outperforming UK-based multinationals. Gilts would likely come under pressure as risk appetite increased and investors began to price in tighter monetary policy.

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