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Boris and his very fragile government

23 July 2019

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GBP: The immediate hurdles for Boris as PM

The Deputy Prime Minister (Tanaiste) of Ireland, Simon Coveney, has been very clear in recent days in stating that that while we are about to confirm a new Prime Minister here in the UK, the Brexit facts have not changed at all. In all likelihood, Boris Johnson will be confirmed as PM at around 12 noon today and will immediately set about proving Simon Coveney wrong. Certainly, we expect Ireland's Tanaiste to be correct from an EU perspective but what is about to change is the attempt by the UK government to push the UK to the brink of a 'no-deal' Brexit. Our GBP/USD Rates model shows one of the largest divergences from current spot, highlighting the increased Brexit risk premium priced in the market. Based on the divergence, we can assume roughly 6%-7% of risk premium is priced.

But there is certainly scope for that to extend further from here but perhaps not imminently. There is still a three-month period ahead and market participants may be content with the current degree of risk premium for now. But further out, we maintain our view of little leeway by the EU in negotiating the Withdrawal Agreement or the backstop. That points to a failure in negotiations that we believe will ultimately lead us to a probable general election and some form of additional extension to allow for

BREXIT RISK PREMIUM ESTIMATED TO BE 6%-7%

Source: MUFG GMR

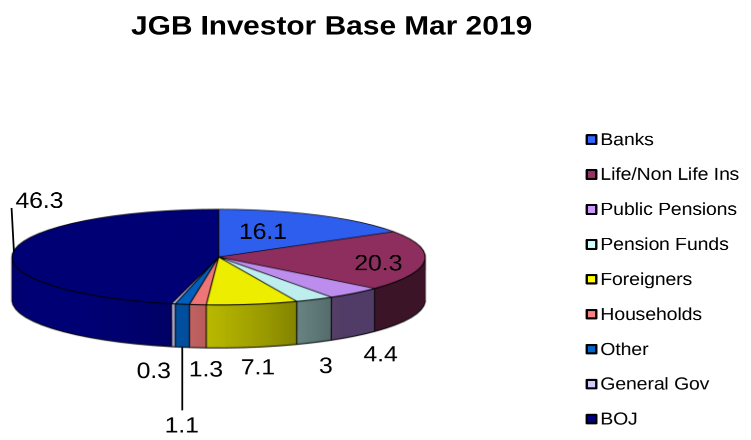
that. The complete failure of the Labour Party to offer a coherent policy stance on Brexit makes a general election a more viable option for the Tory government after the negotiations with the EU break down.

But more immediately, there are a number of important factors that will shape the start of Boris Johnson's premiership. Firstly, the extent of his victory over Jeremy Hunt in today's announced result will be important. ConservativeHome ran three polls of Tory members during the voting period and the results of those polls had Boris Johnson gaining 67%, 71% and 73% of the vote respectively. A separate YouGov poll had Boris on 74%. So by some margin Boris is expected to win. If these polls are to prove wrong and the result was say close to or under 60%, that would from the outset create some uncertainty over the support of his Brexit stance and would embolden the anti no-deal Tory MP faction.

Secondly, yesterday, Tory MP Charlie Elphicke was charged with sexual assault and lost the Tory whip. Technically that takes the government's working majority to three (although Elphicke as an independent will probably still support the government). Thirdly, there is a by-election on 1st August and there is a strong likelihood the Tory incumbent will be defeated. That would take the government's majority to just two. There are continuous rumours of MPs departing and/or defecting. Finally, Alan Duncan yesterday resigned as a minister in protest of there being no vote of confidence in a PM who may not command the support of parliament. Chancellor Hammond and Justice Secretary Gauke will resign today. Will there be other resignations as well?

The new Boris Johnson government will be so fragile, it could be over before it's barely begun. We don't expect much in the way of GBP FX volatility today – much of what unfolds today appears discounted. But a political crisis like no other looks to be on the way and a general election looks the likely end game to all of this and we believe further pound depreciation is inevitable.

BOJ CLOSE TO OWNING 50% OF JGB MARKET



Source: Ministry of Finance, Japan

JPY: Kuroda provides no sense of change in policy outlook

BoJ Governor Kuroda gave a speech in Washington at the IMF yesterday and once again reiterated the determination of the BoJ to maintain "powerful monetary easing" in order to achieve the inflation target of inflation above 2%. He added that the BoJ would pay "close attention" to the effects of uncertainties regarding the global economy. But again, like before, there wasn't anything meaningfully different in terms of communication from the BoJ at a time when we are witnessing meaningful changes in communication and/or actions from other key central banks. We are predicting ECB action this week, the Fed will follow for sure next week and other central banks – the RBNZ and the RBA – have already eased.

It's clear that the options for the BoJ are pretty limited from here. The BoJ as of the end of March 2019 holds 46.3% of the JGB market and continues to purchase JGBs on a monthly basis, albeit at a slower pace. The government, following its election victory in the Upper House elections at the weekend, will move forward with its plan to increase the Sales Tax from 8% to 10%, which undoubtedly places near-term downside risks on the economy.

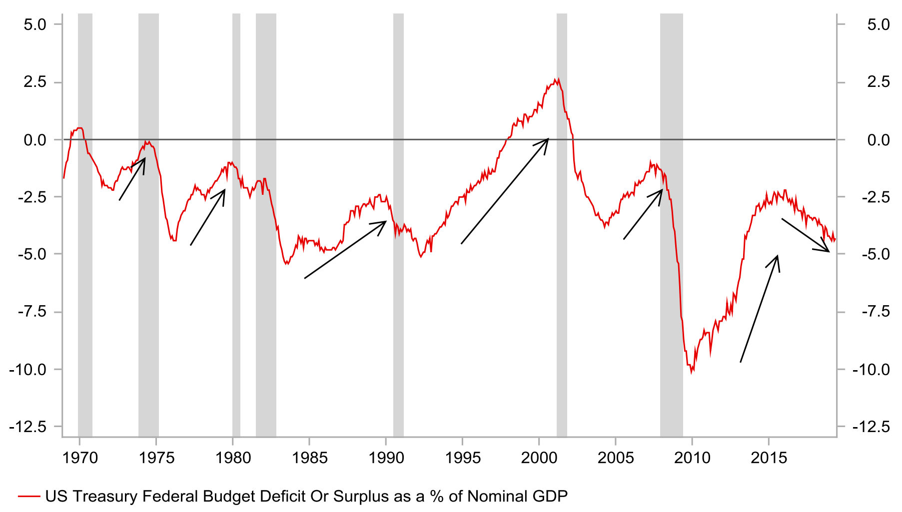
We suspect yen appreciation will add another. With monetary easing a global phenomenon and the BoJ reluctant to join in, yen strength is likely. The best the Japanese authorities can hope for is that Fed easing lifts risk appetite and global equities which will help to slow yen appreciation.

USD: Dollar support as one Fed downside risk removed

In Fed Chair Powell's semi-annual testimony he spoke of "government policy issues" – there were three to be precise – trade policy uncertainty; Brexit uncertainty; and US debt ceiling uncertainty. That final uncertainty now looks to have been removed following the deal announced yesterday that suspends the debt ceiling until 31st July 2021.

This has understandably helped lift the dollar and we could see further gains in the coming days into the ECB meeting on Thursday. The removal of the debt ceiling given this was cited by the Fed has diminished the prospect of the Fed being more aggressive with monetary easing. Two rate cuts and done is looking more feasible. The deal avoids a cut in domestic spending of USD 55bn and military spending of USD 71bn. The spending caps rise in 2020 and 2021, ensuring the fiscal deficit will now be larger than projected before. A USD 1trn deficit next fiscal year is now more likely. The deal will soften the blow from the fading of government spending and tax cuts announced by Trump's tax deal that was legislated for in December 2017. How the extra funds are spent still need to be agreed, so the risk of a government shutdown on 1st October remains.

THE US DEFICIT IS WORSENING BEFORE A RECESSION HITS



Source: Macrobond

KEY RELEASES AND EVENTS

Country	BST	Indicator/Event	Period	Consensus	Previous	Mkt Moving
UK	11:00	CBI Trends Total Orders	Jul	-15	-15	!!
UK	11:00	CBI Trends Selling Prices	Jul	--	4	!
UK	11:00	CBI Business Optimism	Jul	-20	-13	!
UK	12ish	Tory Leadership Election Result				!!!
IT	14:00	Italy's Di Maio, Geraci Speak in Naples				!
US	14:00	FHFA House Price Index MoM	May	0.30%	0.40%	!
US	15:00	Richmond Fed Manufact. Index	Jul	5	3	!
EC	15:00	Consumer Confidence	Jul A	-7.2	-7.2	!
US	15:00	Existing Home Sales	Jun	5.33m	5.34m	!!

Source: Bloomberg

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