

OVER TO YOU, BRUSSELS

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IN A NUTSHELL

- _ Against the odds, Boris Johnson has won a landslide victory.
- _ Since the 2016 referendum on EU membership, the chances of "getting Brexit done" reasonably quickly and smoothly have never been better.
- _ However, that will also depend on the EU's willingness to be less legalistic and more pragmatic in the next phase of the negotiations about the future relationship. We are cautiously hopeful on that.

Even for veterans of British politics, it was a stunning election victory. Contrary to our expectations, Boris Johnson's Tories were able to secure their biggest majority in the House of Commons since 1987 with more than 360 seats (out of 650). This result will likely reshape the UK's electoral landscape, potentially for many years to come. Perhaps even more importantly from a market perspective, we think that the new political realities in Westminster will subtly change the dynamics in the next phase of the negotiations about the future relationship with the remaining 27 member states of the European Union (EU).

That does not necessarily mean it will all be smooth sailing from now onwards. In Scotland, the Scottish National Party looks set to gain 48 out of 59 seats. And in Northern Ireland, Johnson's former allies of the Democratic Unionist Party suffered heavy losses. For the first time, Northern Irish members of parliaments (MPs) inclined towards a unification with Ireland will outnumber those in favor of staying in the UK.

Even these potential flies in the ointment, though, might offer opportunities for Johnson. Opposition to his very hard version of Brexit in Scotland and Northern Ireland offers a good excuse to seek a slight softening in the next phase of negotiations (not least to mitigate the risks of customs border checks down the Irish Sea). During his short tenure in Downing Street, Johnson has already shown himself famously flexible in ditching commitments to friend and foe alike. Having secured a convincing majority in the Commons, he will no longer be constrained in his ability to do so. (Checks and balances familiar in other Western democracies are largely absent in the UK, as long as the prime minister of the day commands a Commons majority and can rely on the support of his party.)

As of today, Boris Johnson will be the politically strongest Tory prime minister since Margaret Thatcher. For the remaining EU 27, that means the UK's exit will likely take place by the end of January 2020. More subtly, Johnson's revived political fortunes look set to change the dynamics in the next phase of the negotiations about the future relationship. No longer as reliant on the euro-skeptic wing of his party, he would, for example, probably be able to ask for an extension of the transition period, if necessary to secure a satisfactory trade deal. Alternatively, Johnson can now credibly threaten to implement a range of tax-cutting and de-regulatory measures if no deal is reached. Fearful of such a race to the bottom right at its doorstep, we would expect the new European Commission and the remaining 27 members to be less legalistic and more pragmatic in the next phase of the negotiations, out of sheer self-interest. The eventual outcome could well be better – for both sides – than seemed plausible even a few weeks ago.

For once, market enthusiasm in the early hours of trading appears justified. Indeed, both the pound and equity markets had already been pricing in a conservative victory. As a result of the actual results, British domestically-focused stocks have been even stronger, while globally-exposed ones suffered from the stronger pound. In part, this also reflects the empathetic rejection of Labour's radical economic proposals, such as nationalizing a wide-range of companies, by the British electorate. From a macro-economic perspective, recession risks have receded further and we could even see an investment revival. The probability of an interest-rate cut by the Bank of England has fallen. All of which could be modestly favorable for risk assets more broadly.

After all, this was a victory against the odds. Having spent quite a bit of time since spring analyzing the Conservatives' prospects in each of the 650 constituencies, we were acutely aware of how easily Boris' Johnson's snap-election gamble might misfire. Based on our take of the data so far, there are probably three main reasons why it did not.

First, and most importantly, Labour's position was probably even weaker heading into Election Day than even its mostly weak polling figures suggested. An early clue – which we were too dismissive of – could be gleaned from the detailed weighting assumptions of several of the UK pollsters. When prompted by pollsters in recent months on how they had voted in 2017, about one in five of Labour's voters failed to recall their previous decision correctly.¹ We should have taken it as a strong hint of "buyer's remorse", with the potential to depress Labour turnout, especially in its erstwhile heartland. This is exactly what happened on Election Day in England, and to a lesser extent, in Wales. (By contrast, past campaigns would have suggested a late tightening in these Labour leaning areas).

Second, and relatedly, missteps by Labour and the Liberal Democrats (Lib Dems) probably made Johnson's task easier. The two main opposition parties in England and Wales failed to reach even a tacit understanding of the sort that greatly helped both in 1997 – the last time there was such a strong anti-Tory mood in much of the country. Instead, both concentrated much of their fire on each other. Moreover, the new and soon to be former leader of the Lib Dems Jo Swinson unwisely promised to revoke Brexit altogether in case of winning an absolute majority. That rash promise probably did not help when meeting voters on their doorsteps. But it almost certainly led the Lib Dems to spread their resources too thinly. Indeed, Ms. Swinson narrowly lost her own seat in Scotland.

Third, and most impressively, the Tories did surprisingly well even in seats where neither weak opponents nor luck can be credited. One of the best examples of this was in East Devon, where an inexperienced Conservative candidate easily saw off what had looked like a strong challenge by an independent candidate with plenty of experience in local government.² Even in Scotland, where Johnson and Brexit remain deeply unpopular, the Tory vote held up surprisingly well. Plainly, the Conservatives ran an extremely skillful campaign across the country.

¹ <https://capx.co/why-are-the-polls-telling-such-different-stories/>

² <https://www.newstatesman.com/2019/11/who-win-election-east-devon-tory-brexiteer-rural-revolt-independent-rebellion>

GLOSSARY

The **Bank of England (BoE)** is the central bank of the United Kingdom.

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

The **Conservative Party**, also referred to as "Tories", is a center-right political party in the United Kingdom.

The **European Commission (EU Commission)** is the executive body of the European Union (EU) which represents the interests of the EU.

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

The **House of Commons** is the lower chamber of the United Kingdom's parliament.

The **Labour Party** is a center-left political party and one of the three biggest parties in the United Kingdom.

The **pound sterling (GBP)**, or simply the pound, is the official currency of the United Kingdom and its territories.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

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