

A very British affair

Following the UK snap elections, we are entering another uncertain period in British politics. Market implications look limited, however.

Conservatives are largest party but fail to secure majority - hung Parliament

With 326 seats needed for a majority of the House of Commons, the lower chamber of the UK parliament, it is now certain that the Conservatives failed to achieve this goal. Theresa May, as the incumbent Prime Minister, now has to try to form a government. The Conservatives (Tories) may be able to rely on the 10 members of parliament (MPs) of the Democratic Unionists (DUP), the main pro-British protestant party in Northern Ireland, to support them in a 'confidence & supply' arrangement. In our view, an informal arrangement seems more likely than a formal coalition under which DUP MPs might actually take seats in the UK Cabinet.

Too early for a full assessment and plenty of risks ...

- Like her predecessor David Cameron with the Brexit referendum, Theresa May seems to have bet her career on the snap elections – and lost. While she may try to carry on, surviving for very long might prove another matter entirely.
- The timing of the vote, just days before Brexit talks were supposed to start, makes the outlook pretty murky. Had this election taken place before Article 50 was triggered, an exit to the Brexit would have been a viable scenario – and a welcome one from a market perspective.
- As things stand, the UK's decision to leave the European Union (EU) looks technically irreversible under Article 50 (although the European Court of Justice (ECJ) may have to rule on this). Legally, extending the Article 50 process requires a unanimous vote of EU countries. Britain's European partners may not want the resource-intensive process to drag on for longer, though as always there may be scope for compromise.
- Certainly, the UK's bargaining position may have been weakened, both by the vote and the triggering of Article 50. The two-year negotiating period was always likely to prove very short for such a complex set of negotiations. Now, the UK finds itself in a very uncomfortable situation of the first talks with Michel Bernard Barnier, the European Chief Negotiator for Brexit, being scheduled in ten days, while its negotiating position is up in the air.
- It would be premature to conclude that a softer Brexit is the logical consequence of this vote, although it is the most likely scenario. With such a narrow majority in the House of Commons, every single MP counts, and every single vote has the potential to bring down the government (opening the door to yet another round of voting). This, along with

Expectations in a nutshell

- Theresa May seems to have bet her career on the snap election – and lost. While she may try to carry on, surviving for very long might prove another matter entirely.
- The timing of the vote, just days before Brexit talks were supposed to start, makes the outlook pretty murky.
- Risks remain from a market perspective. However, the new Conservative government supported by the Northern Ireland unionists, might take a more pragmatic approach in the Brexit talks.

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another contest for the Tory leadership, would create even more uncertainty.

... but also the possibility of a more pragmatic approach on Brexit

- However, there is also the possibility of a more favorable outcome from a market perspective. The new Conservative government supported by the Northern Ireland Unionists, and potentially under a new prime minister, might take a more pragmatic approach in the Brexit talks.
- The Conservatives mitigated their electoral meltdown by winning 12 additional seats in Scotland. Those new Scottish Tory MPs are likely to press for a softer version of Brexit. Similarly, the DUP, while in favor of Brexit, is also keen to keep the border to the Irish Republic open. Together, the two groups alone would account for 22 votes – more than enough to block any "hard-Brexit" deal not to the liking of their voters.
- Meanwhile, Tory euro-sceptics might be loath to risk a fresh round of voting and accept significant concessions (perhaps even on immigration). From their perspective, any Brexit might be better than no Brexit.

Economic and market implications of a very British affair: increased and prolonged uncertainty to weigh on the British pound and potentially on Gilts, but limited fall-out beyond the UK

As first market indications confirm: this is very much a national event. Global markets took little notice of what in British eyes was another dramatic night. We therefore concentrate on assessing the impact on UK assets. Although chances of a softer Brexit and less fiscal tightening are now higher, the main outcome of the vote is to increase uncertainty, potentially for a prolonged period of time.

- **Gilts:** It is hard to assess where Gilts will move from here on. In a bull case we would assume a flight to quality on the back of a weakening economy. The bear case would be that a weaker pound, political uncertainty and a leadership vacuum would push overseas investors to ask for a higher risk premium, pushing Gilt prices down. The Bank of England could be more inclined to follow a more accommodative stance.
- **UK equity markets:** The major short-term impact for equities stems again from the pound. Its weakness is lifting stock prices, especially for companies with foreign exposure. Other than that, we would see little short-term effects as the two forces might neutralize each other: on the negative side, increased and prolonged uncertainty doesn't bode well for corporate investment decisions. On the positive side, a softer Brexit could have less of a negative impact on UK businesses.
- **British pound:** The pound lost more than 2 cents against the U.S. dollar as a result of the elections. At current levels we see few factors that could support the pound in the mid-term and remain cautious on the currency.

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Concluding thoughts:

- In our view, the Labour Party is too far behind to form a credible minority government. Given the many unexpected twists and turns in British politics in recent years, however, we would not be surprised if new forms of cross-party cooperation were to emerge on particular issues.
- From a European perspective, it is certainly noteworthy that despite the majority vote in the Brexit referendum, the House of Commons emerging from this general election is likely to look more, rather than less, Europe-friendly than the previous one.
- Along-side the European question, an even older one is likely to return to the forefront of Westminster politics, namely the Irish one. Following the suspension of Northern Ireland's power-sharing government, coming to a new arrangement will be both an urgent and a tricky task for the new government in London. In particular, Sinn Féin, the main pro-Irish catholic party has nearly doubled its number of seats in the House of Commons, to a total of 7, while continuing to boycott the Westminster parliament. In coming years, Irish republicans might begin to ask themselves if this is still the best use of their electoral strength.
- This is a reminder to continue to expect the unexpected – the sort of things Westminster politicians, let alone financial markets, might fail to see coming. In our view, this partly reflects the United Kingdom's ever altering constitutional arrangements. And, as Walter Bageshot wisely noted in his 1867 study on the topic, the "constitution is like an old man who still wears with attached fondness clothes in the fashion of his youth: what you see of him is the same; what you do not see is wholly altered."

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Glossary

Article 50 of the Lisbon Treaty

Article 50 of the Lisbon Treaty governs the withdrawal of a member state from the European Union.

Bank of England (BoE)

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

Brexit

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

Conservative Party

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

European Court of Justice (ECJ)

European Court of Justice (ECJ) the highest court in the European Union in matters of European Union law.

European Union (EU)

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

Gilts

Gilts are bonds that are issued by the British Government.

Pound sterling (GBP)

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

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