



## UK Elections End In Dismay

UK voters have caught investors off guard again – the UK is headed for a hung parliament, defying market expectations for the Conservative Party to maintain its majority. Market reaction has been swift – on the currencies front, the British Pound (GBP) has weakened significantly against its peers. In this note, our Chief Economist Megan Greene looks at what could happen next and how it might affect upcoming Brexit negotiations, the UK economy and markets.

It turns out polling company YouGov got the polls right this time around when it predicted a hung parliament in the UK's general election<sup>1</sup>. From here-on-out UK politics – and therefore economics and markets – turn into a veritable “choose your own adventure” book. Here's a quick guide to help get you through it.

### What Will The Next Government Look Like?

#### Conservative Rule:

As the largest party, the Conservatives will be given first dibs on forming a government. At 5pm BST, the Conservatives and the Northern Ireland Unionists (DUP) had a combined 328 seats in parliament – just two seats more than the requisite 326 for a majority<sup>2</sup>. It is possible the two parties could garner additional support from “other” parties to form a very slim majority, but much more likely is a minority government with either a formal Conservative-DUP coalition or an informal partnership.

This minority government would require the support of opposition parties to pass pieces of the domestic preparation legislation for Brexit, complicating an already difficult negotiation process further. A minority government would also be fairly unstable, and as a result, the probability of early elections is higher. We believe a collaboration between the Conservatives and the DUP would probably continue to pursue a ‘Hard Brexit’, particularly given that the DUP is closely aligned with the right-wing section of the Conservative Party in favor of Brexit. But if the UK government had no real mandate to negotiate a ‘Hard Brexit’ before, it has even less of one now and this would significantly weaken the UK's hand in the Brexit negotiations.

The leader of the Labour Party has already called for Theresa May to step down as Prime Minister. The pressure on her to step down will be immense, even though she has vowed to carry on in the role<sup>3</sup>. If Mrs. May does cave to pressure to leave, it is difficult to guess who would replace her as party leader and PM. Former Mayor of London and ‘hard Brexiteer’ Boris Johnson, Chancellor of the Exchequer Philip Hammond or Home Secretary Amber Rudd seem potential candidates<sup>4</sup>. Regardless of who may replace Mrs. May, having ‘the face

<sup>1</sup> Independent: [YouGov Explains Shock Hung Parliament Prediction](#), May 31, 2017

<sup>2</sup> The latest results can be found [here](#)

<sup>3</sup> Bloomberg: [May Vows To Stay On For Brexit After Forging Loose Alliance](#), June 9, 2017

<sup>4</sup> Bloomberg: [Who Could Be New Conservative Leader With May Under Fire?](#), June 9, 2017



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of Brexit' for the past year and her negotiating team change could shift the UK's interaction with the EU in Brexit negotiations – and potentially in a positive way.

### Labour Rules:

If the Conservative Party cannot form a government – with either a majority in parliament or a minority government – the baton will be passed on to the Labour Party. We think this is an unlikely scenario, but it is far from an impossibility. So far, the Labour Party has indicated that if given the chance, it would opt to form a minority government rather than attempting to form a formal coalition with the Liberal Democrats (Lib Dems) and the Scottish Nationalist Party (SNP). However, one should never rule anything out. According to the latest figures, this coalition would hold 308 seats in Parliament, short of the 326 required for a majority. Once again a minority coalition would complicate the Brexit negotiations and would increase political instability.

But even at a theoretical level, there are already challenges. Labour campaigned in favor of a 'Soft Brexit', though this seems difficult to achieve in reality. Labour Party leader Jeremy Corbyn has indicated that the party feels strongly about the UK controlling its borders<sup>5</sup>. Given that the European Union has been clear that no country can pick and choose which of the four freedoms it wants to embrace as a Single Market participant, either Labour will have to accept the free movement of labor or it will have to pursue a 'Hard Brexit'. The Lib Dems campaigned on the UK remaining in the EU, so Labour may have to accept free movement of labor to appease its potential governing partner.

In addition, a Labour-Lib Dem-SNP coalition would first need to devise a Brexit negotiating strategy and staff its negotiating teams. This would no doubt delay the Brexit negotiations, which are currently due to start in Brussels in just over a week. This government would also be a completely unknown quantity when it comes to its negotiating partners in other European capitals. But this needn't be a bad thing – it seems likely that Labour leader Jeremy Corbyn could go into Brexit negotiations with a more conciliatory tone than Mrs. May, whose approach has been described by some as being akin to a "bull-in-a-China-shop"<sup>6</sup>. In my view, this could shift how the EU approaches the negotiations, which in many ways is far more important than what the UK's strategy is. It could also reduce the chances of the UK stumbling out of the EU with no agreement at the end of the two-year negotiating period.

### No Coalition:

If neither the Tories nor Labour manages to form a government, a new election will be called. The trouble with this is that there is little reason to believe the result would be much different. A second election would mainly just waste precious Brexit negotiating time.

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<sup>5</sup> The Party's [manifesto](#), published on May 16, 2017, notes that "freedom of movement will end when we leave the European Union"

<sup>6</sup> Guardian: [Brexit Briefing: A Tale Of Two Bills And A 'Bull In A China Shop'](#), March 7, 2017



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### What Does This Mean for the Markets?

It is hard to think of a scenario in which the British Pound doesn't weaken further relative to the US Dollar. There will be some uncertainty while a government is formed, which could cause GBP weakness. In my view, the GBP is likely to fall further if the Conservative Party proceeds with plans to form a minority government and likely pursues a 'Hard Brexit'.

If Labour leads a government, there will be an even longer period of uncertainty as the new coalition works out its Brexit negotiating strategy. It is possible investors will be more bullish on the GBP on the assumption that a Labour-led government can pursue a 'Soft Brexit'. However, a 'Soft Brexit' seems unlikely to me given that Labour would like to limit the free movement of labor. There could be, however, some opportunity for the GBP to recover later if a Labour government proves to be more constructive in negotiations with the EU, and the chance that the UK stumbles out of the EU with no deal diminishes.

As for the other asset classes, it's worth highlighting – as already noted by others in the media – that this UK election is not a global event. It therefore seems likely that the impact of the UK election result on other markets may be muted. Gilt yields are based primarily on rate expectations. They may rise moderately to reflect a risk premium, but the operative word here is modestly. There is also likely to be a further divergence in equity prices for internally versus externally-facing UK companies.

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