GENERALI INVESTMENTS

Focal Point

UK snap elections may fail to ease Brexit negotiations

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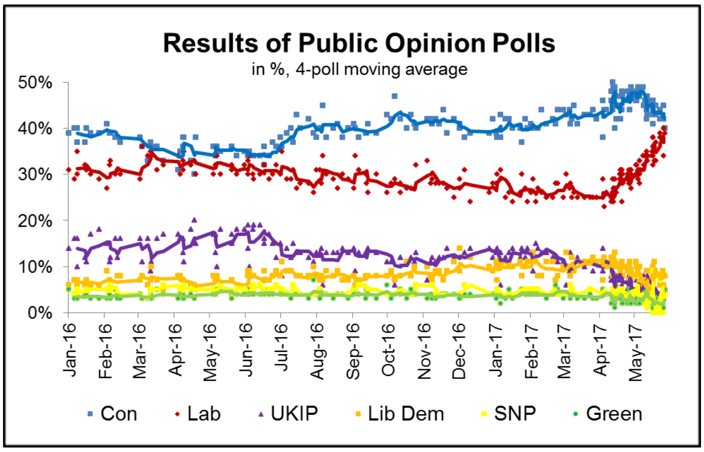
- Against the backdrop of a strong lead of the Conservative Party in opinion polls in mid-April, UK Prime Minister (PM) Theresa May called a snap election, to be held on June 8.
- Her main goal was to gain more room for maneuver for the EU negotiations, given the slim majority of Conservatives in parliament and the implied dependency of the government on Brexit hardliners.
- However, recently the Labour Party caught up in voter approval. Due to the “first-past-the-post” electoral system in the UK, the impact on parliamentary seats is likely to be substantial.
- Latest polls sent a strong note of caution. We therefore consider it now slightly more likely that the Conservatives will not be able to increase their majority substantially. Even a hung parliament or a Labour lead cannot be ruled out.
- The British pound and UK equities are particularly sensitive to the election result. An only very scarce conservative majority or hung parliament would likely weigh further on the pound while favoring the FTSE100 in a knee-jerk reaction.

On April 18, UK PM Theresa May – contrary to prior statements – called for a snap election, to be held on June 8. A general election had not been due before May 2020, but the House of Commons confirmed the date with the necessary two-thirds majority already the next day after May’s demand. In the last election in 2015, the Conservative Party had won an absolute majority of 330 seats out of a total of 650 (absolute majority at 326 seats), giving the Tories a lead over all other parties by 10 seats and a working majority with the help of smaller parties by 17 seats. The result had come as a surprise, proving opinion polls rather unreliable which had predicted a win of the Labour Party or a least a hung parliament. While polling companies have updated their models since then, some caution likely remains appropriate.



Hopes for strengthened PM’s Brexit mandate…

By the time, in mid-April, when PM May suggested the snap election, the Conservative Party had a strong lead in opinion polls of almost 20 pp. These polls were putting the share of votes for the Conservatives to around 47% while in contrast, Labour saw itself defeated with around 28%. According to models predicting the seat distribution within the House of Commons, this would have meant a landslide Conservative victory. Tories would have gained 79 seats (total of 409) seats and a lead over the other parties by 168. Labour, would have fallen to a low of 160 seats, the worst result since 1935.

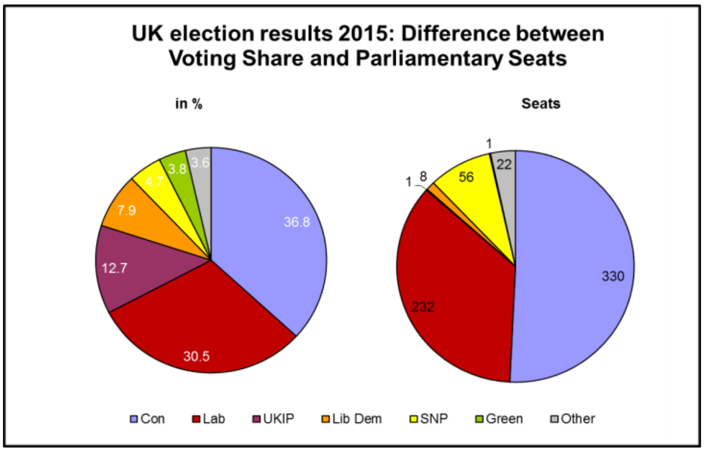
Accordingly, PM May tried to seize the opportunity for a larger majority in the House of Commons, thereby getting more independent from “hard” Brexiteers within her own party and strengthen her mandate ahead of the Brexit negotiations. In our view, this did not mean for her to drift away from her fundamentals – the “hard” Brexit – outlined in her speeches before; namely leaving the EU Single Market and likely the Customs Union, regaining full control over borders and getting independent of the European Court of Justice. However, the effectively available UK-EU negotiation period is already less than one and a half years and the EU insists on starting with the “divorce bill” including the rights of expatriates. Hence, reaching a full-fledged new free trade agreement is most probably out of reach. Thus, PM May has to prepare for a transitional agreement. Within this period, the EU will likely insist that the phase will be governed by EU rules and courts, avoiding any “cherry picking”. PM May needs to be able to compromise on these demands, without having to please Brexit hardliners in her own party too much. To this end, a larger Conservative majority in parliament is essential. Moreover, selling a compromise to voters in regular elections in 2020 would have been a big challenge. PM May would risk to have failed to unwind EU obligations like budget contributions, EU court ruling, no immigration control and thus not delivered on a factual Brexit. This would substantially reduce her re-election chances.

…but Labour significantly on the rise

However, since the end of April the Labour Party caught up significantly in voter preferences. Important public discussions sparked from the so called “dementia tax”, the terror attacks in Manchester and London as well as to some extent the slowing economy. In particular, the notion of “Dementia tax” covered plans to force elderly people to pay more for their social care under certain circumstances. (The reforms have been dubbed a 'dementia tax' because people with dementia living at home would be obliged to pay while for instance people with cancer in hospital would be spared.) While May publicly backtracked, the topic nevertheless cut significantly into the Conservatives’ opinion poll lead. With regard to the devastating Manchester terror attack on May 22, Labour leader Jeremy Corbyn linked Britain’s participation in foreign wars to incidents such as the Manchester suicide bombing and the London attack. Moreover, PM May was accused to have reduced police forces significantly in her time as interior minister. Similar accusations were made after last weekend’s attack in London. Finally, the British economy had a soft start into the year with a (downward revised) growth rate of just 0.2% qoq in Q1 2017, mainly driven by weak private consumption amid rising inflation. The latter reduced real income growth to almost nil. Neither of the two big parties aim to re-open the Brexit decision, but PM May repeatedly announced that she would be ready to walk away from the negotiations if a deal was not good enough, while Corbyn insisted that there “is going to be a deal”.

Only a small Tory majority is increasingly likely

By the time of writing, opinion polls (4-polls average) had lifted Labour’s share in votes within four weeks from 28% to slightly above 37%. Conservatives fell back to about to 42.5%. Using these shares in the parliamentary seat model of electoral calculus (www.electoralcalculus.co.uk), the Conservative Party would gain only 9 additional seats to 340, while Labour would remain unchanged. In this case, the lead of the Conservatives above all other parties would increase to 30 seats, which still seems comfortable, but constitutes a strong setback compared to the time of PM May’s election call. Models from various survey firms differ, but generally (with the exemption of YouGov) they still predict the Conservative Party to win.
However, Labour may well be able to capitalize on the current momentum. Due to the British first past the post electoral system, a small further shift of only 0.5 pp in favor of the Labour Party may be enough to reduce the Conservatives lead to only 22 seats. A slightly higher shift by 1 pp could already lead to a gain in seats by Labour, reducing the Conservative lead to 10 seats. A recent YouGov suvey – using a different model – already predicted PM May to lose the majority.



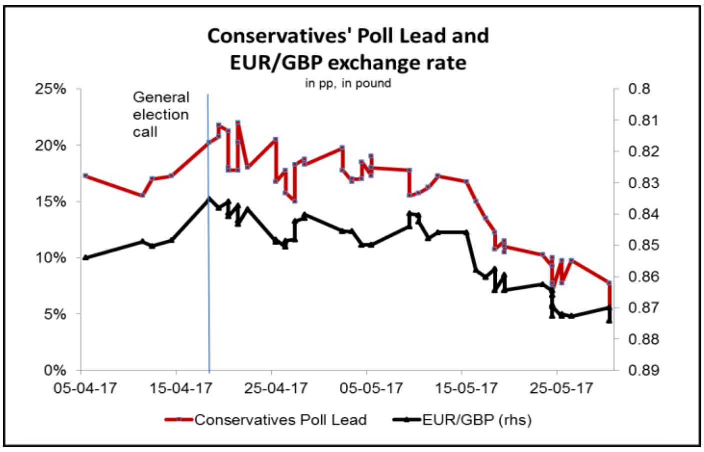
In sum, the election result remains highly uncertain. Currently, most surveys still predict the Conservatives to win the election but with a small and decreasing majority. However, a hung parliament as well as a Labour majority cannot be ruled out. This implies that PM May’s strategy to increase the Conservatives’ share in parliament is also likely to fail, which is bad news for the smoothness of the Brexit process.

What happens in case of a hung parliament?

If the election produced no majority, PM May would have difficulties to find a coalition partner as the Liberals opted for a second Brexit referendum and the Scottish National Party (SNP) want to avoid a Brexit at all. However, as incumbent, PM May has the right to make the first coalition attempt and the cabinet would remain in place, until a new government would be formed. She could also try to form a minority government, but it is doubtful – given the important Brexit negotiations and implied legislation, e.g. to convert EU into British law – whether such a solution would be lasting. Labour’s chances to form a new government could be higher, as with regard to the Brexit they are closer to the Liberals and other small parties. Labour could also try to form a minority government. Beyond Brexit, Labour plans a substantial change in Britain’s fiscal policy including raising taxes on large firms and on ”wealthy”, through a higher corporate tax (from 19% to 26%) and higher taxes on top 5% of income earners. Such a maneuver is intended to compensate for higher public spending on education, healthcare and police. At the same time, Labour still aims at reducing national debt, which to some extent contradicts the pledge of a large infrastructure investment fund (GBP 250 bn over 10 years, 12% of GDP).

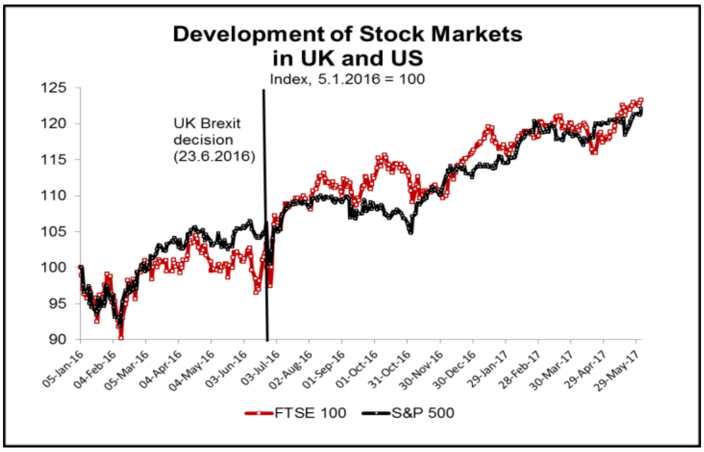
Pound proved sensitive indicator to Brexit woes

In the recent past, the pound-euro exchange rate has proved a sensitive indicator to the Brexit woes. The date PM May announced her general election call, the GBP/EUR appreciated, showing markets expected a smoother Brexit process and transition period. However, with the Conservatives’ lead shrinking over the recent weeks, the pound depreciated again. A very slim conservative majority would raise concerns about a hard Brexit, as PM May would remain dependent on the party’s euro-sceptic wing. This would be also reflected in her cabinet. A hung parliament and the implied difficulties to form a government would likely even hinder the scheduled start of the Brexit talks on June 19. In both cases, we would

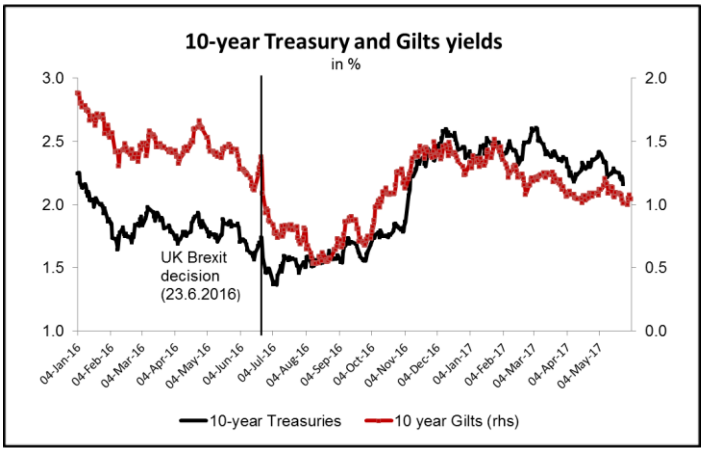


expect as a knee-jerk reaction the pound to depreciate slightly further, with a hung parliament the worst case. By contrast, in case of a large Conservative majority but also an outright Labour majority (due to its generally softer Brexit stance), the pound could initially take back some of its recent losses. However, fundamental factors (like UK's large current account deficit) would soon come to the fore again.

The UK stock market index FTSE 100 strongly increased after the Brexit decision in June 2016. The main reason was the sharp depreciation of the pound, as UK's large companies have a high share of foreign earnings, which benefitted via the exchange rate development. This mechanism still holds at the margin. Thus, the expected small depreciation together with valuations, which show some discount to euro area (EA) ones, could let UK equities experience a short term relief. However, a less upbeat economy following Brexit uncertainties and shrinking real household incomes amid declining earnings in relative terms, still make us favor EA equities over UK ones. Overall, UK and US stock market indices moved very much in line.



Finally, in case of a narrow Conservative majority of even a hung parliament, we would expect 10-year Gilt yields to recede visibly. After the Brexit shock, Gilts rallied pushing yields down to about 0.9%. However, by late autumn last year UK long-term bonds started to move again in line with their US peers but with a more pronounced downward trend. Indeed UK yields responded to the "hard" Brexit scenario of PM May and in general to an increased uncertainty (as also stated recently by the Bank of England). We would expect yields in a hung Parliament to drift again towards the 0.9% level. A small majority would probably produce less of a move. In case of a clear conservative majority, uncertainties could recede again. Generally, we expect Gilt yields not to be able to fundamentally decouple from the international yield development. Therefore, as we expect US long-term yields to rise, so will Gilt yields but to a much lesser extent.



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