



May's mandate for Brexit?

How the UK election could shape Brexit, Bank of England policy and the outlook for markets



Britain votes again: May's mandate for Brexit?

Having previously promised not to call an early election, huge opinion poll leads proved to be too tempting for Prime Minister Theresa May to ignore. Britain goes to the polling booths again on June 8, the third national vote in three years, with the Conservatives looking to potentially win the largest parliamentary majority since Tony Blair's landslide victory in 1997.

The Conservative party mantra is that "strong and stable leadership" is required for what could be a tumultuous period for the UK and this is resonating with the electorate. However, the Conservatives are also helped by a lack of a strong opposition. Support for the Labour party is languishing, attributed to a lurch to the left, an unclear plan for Brexit and voter antipathy towards its leader, Jeremy Corbyn.

Other parties are also performing badly. The fact that the UK has triggered Article 50 and Brexit has become a reality has seen UKIP's relevance questioned and its support collapse. Meanwhile, the Liberal Democrats' tactic of putting a second referendum on Brexit as its core policy has failed to generate the support imagined. Surveys suggest that those who voted for the UK to remain an EU member are increasingly reconciled to the view that the will of the people must be respected and Britain will leave the EU (so called Re-Leavers). The Scottish nationalists (SNP) will remain a very strong regional force, but they too could lose seats to the Conservatives.

Theresa May has suggested a larger parliamentary majority will boost Britain's chances of winning a good deal in Brexit negotiations. This looks like wishful thinking. We consider it more likely to be electoral spin to help convince wavering voters to opt for her party. The size of the Conservative's majority in parliament will make little if any difference to the EU's demands of a substantial divorce payment, nor its stance of making sure that they win the best deal possible for their own constituents.

Nonetheless, it will make passing what could be very contentious Westminster legislation easier. The current majority of just 17 MPs ran the risk of government defeats on key votes in coming years. A majority, potentially well in excess of 100, would give Theresa May much more breathing room with new Conservative MPs keen to show their loyalty and back the Prime Minister in parliament.

It also allows Prime Minister May to pursue her own policies rather than be beholden to the 2015 election manifesto that carried David

Cameron to victory – although there appears to be few major differences between the two prospectuses. She also has more freedom to select a cabinet of ministers of her own choosing – she followed convention last year by giving key jobs to the defeated candidates who stood against her in the leadership election that followed David Cameron's resignation.

Where calling the election provides Brexit benefits is that Theresa May has more scope to agree a transitional period that could help smooth Britain's exit from the EU. Facing the electorate in 2022 rather than 2020 gives more time and flexibility to make sure it is the best possible "new arrangement" before she faces the voters once again. This reduces the chances of a "cliff edge" in 2019 which could be potentially very damaging. We remain optimistic on the potential for a mutually beneficial deal, but getting a transitional arrangement is of critical importance.

We can't discount the possibility that the opinion polls have got it completely wrong and the Conservatives fail to win a majority, but it looks very remote at this stage. The most likely scenario would be a multi-party coalition including Labour, Lib Dems and the Scottish, Welsh and Irish nationalists.

Labour would likely acquiesce to demands for a second Brexit referendum on the final deal from the smaller parties. But starting from scratch on a new strategy for Brexit would be challenging given that nearly two of the 24 months set aside for negotiations have already passed. Moreover, any thoughts that this outcome would yield a "softer" Brexit could be quickly dispelled if the parties start disagreeing on what they want to achieve. This could make failure in Brexit negotiations more likely.

Alternatively, what would happen if Labour reverts to being an enthusiastic supporter of ongoing EU membership? They are unlikely to stop Brexit given their election manifesto (plus it would require EU approval). However, there may be little incentive to negotiate Brexit properly. This pro-EU government could simply say that they failed to get a deal that satisfies the UK interests. The electorate would be left with a second referendum choice of severe economic dislocation (but "freedom" from European rules) versus staying in the EU. Given 52% of the population had voted for Brexit first time round, this would be a high risk game that could see wild swings in market sentiment and economic expectations.

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May's mandate for Brexit

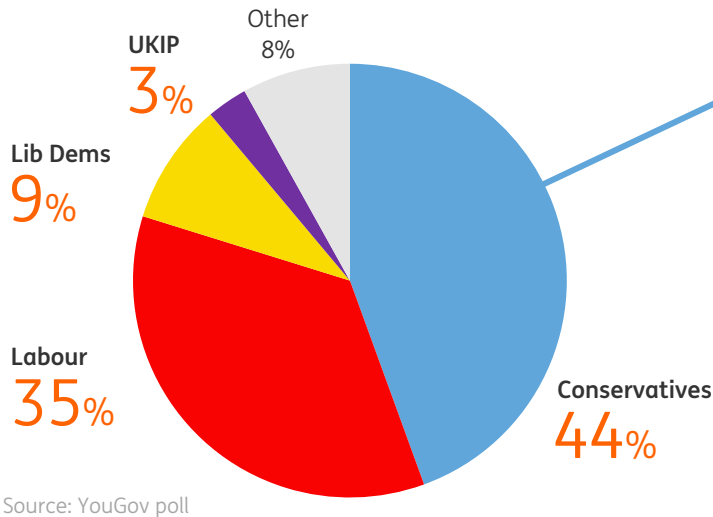
Having previously insisted she would not call an election, Theresa May "reluctantly" decided that the British people must vote again on 8 June. The rationale is that her Conservative party were doing so well in opinion polls that she should take advantage and secure a huge mandate for her own policies. Currently her government has a majority of just 17 and this may not be big enough to pass what could be very contentious legislation over

coming years. With the opposition Labour Party having shifted to the political left and its leader, Jeremy Corbyn, viewed unfavourably by many voters, the Conservatives look set to make sweeping gains across the country. Now Brexit is happening, UKIP's support has collapsed, while the Liberal Democrats pledge of a second referendum is failing to gain traction with a population that is increasingly reconciled with the idea of Brexit.

Where the major UK parties sit on key issues...

Conservatives	Labour	Lib Dems
<ol style="list-style-type: none"> 1. Brexit to be fulfilled 2. Reduce and control immigration 3. Continue with austerity 4. Reform of social care for elderly 	<ol style="list-style-type: none"> 1. Reject "no deal" Brexit 2. Higher taxes for corporates & high earners (£80k+) 3. Nationalisation of key industries 4. More spending on social care 	<ol style="list-style-type: none"> 1. Referendum on final Brexit deal 2. 1p income tax rise for to fund extra healthcare spending 3. Increased corporation tax 4. More spending on education
Scottish National Party (SNP)	UK Independence Party (UKIP)	Green Party
<ol style="list-style-type: none"> 1. Scotland to get "special status" and remain in single market 2. Second Scottish independence referendum 	<ol style="list-style-type: none"> 1. Brexit to be fulfilled 2. Cut net migration levels to zero 	<ol style="list-style-type: none"> 1. Referendum on final Brexit deal 2. Raise top rate of income tax & nationalise some industries 3. Tackle climate change

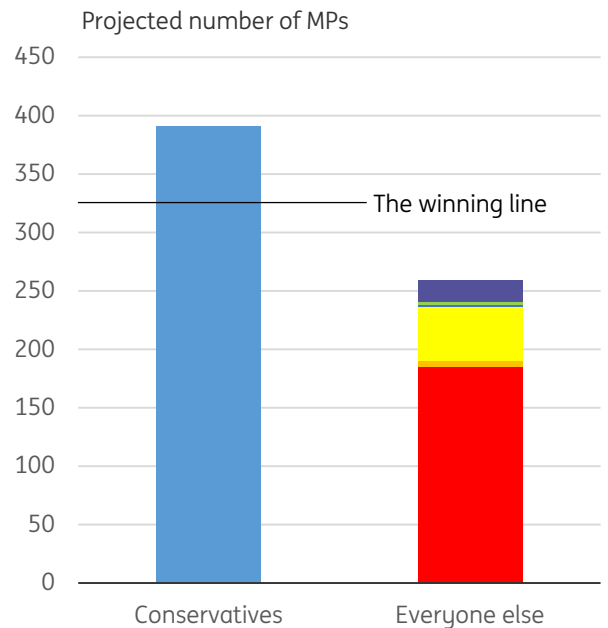
The latest opinion polls and what they could mean...



Predicted Conservative majority

132 Based on latest polls (current majority is 17)
Source: Electoral Calculus

Theresa May set to win biggest government majority since Tony Blair in 1997...



Source: Electoral Calculus

The UK operates on a "first past the post" parliamentary system. The candidate with the most votes in each of the 650 constituencies becomes the MP for that seat. The party (or parties) that win more than 50% of the seats then forms the government.

Smaller parties tend to suffer because their support is often spread nationally without the critical mass in individual constituencies. This means that looking at who is leading in national opinion polls can be very misleading when estimating which party will get the most MPs.

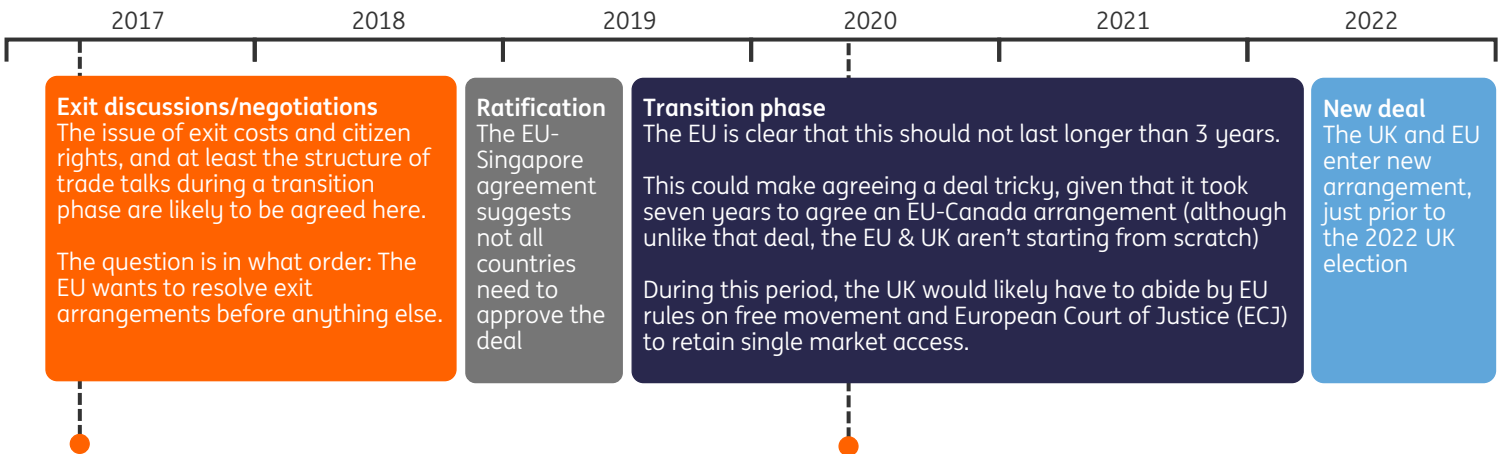
Regional polling offers better insights and suggests the **Conservatives will win a huge majority**

Election is no Brexit game-changer, but helps foster a smoother process

It's not completely true to say that this election has no impact upon Brexit, given the low likelihood of a leadership change. Without a 2020 election hanging over it, the government will be able to tackle the Brexit talks without having to worry so much about short-term political popularity. That might mean PM May can be more open with the British people about Brexit's

challenges. It also gives her more flexibility to negotiate an extended transition period. At the margin, it might alleviate some pressure from the hard-line Brexiteers within her party (this possibility gave the pound a boost back in April). But this election is unlikely to herald any major differences to the final trading arrangement or outcomes, barring a surprise Conservative loss.

The transition phase: Election makes it politically easier to agree to a three year period



Brexit negotiations looks set to start very soon after the 8 June election. The EU reportedly wants to start talks on **19 June**.

Original date of next election (2020) meant arranging a transition phase would have been politically tricky, given single market access and free movement will be temporarily retained.

Skewed incentives? What could happen with Brexit if the Conservatives lose the election

There aren't many people who seriously think the Conservatives will lose, but given the recent record of opinion polls ahead of such votes it would be foolish to completely discount the possibility. The most likely scenario would be a multi-party coalition.

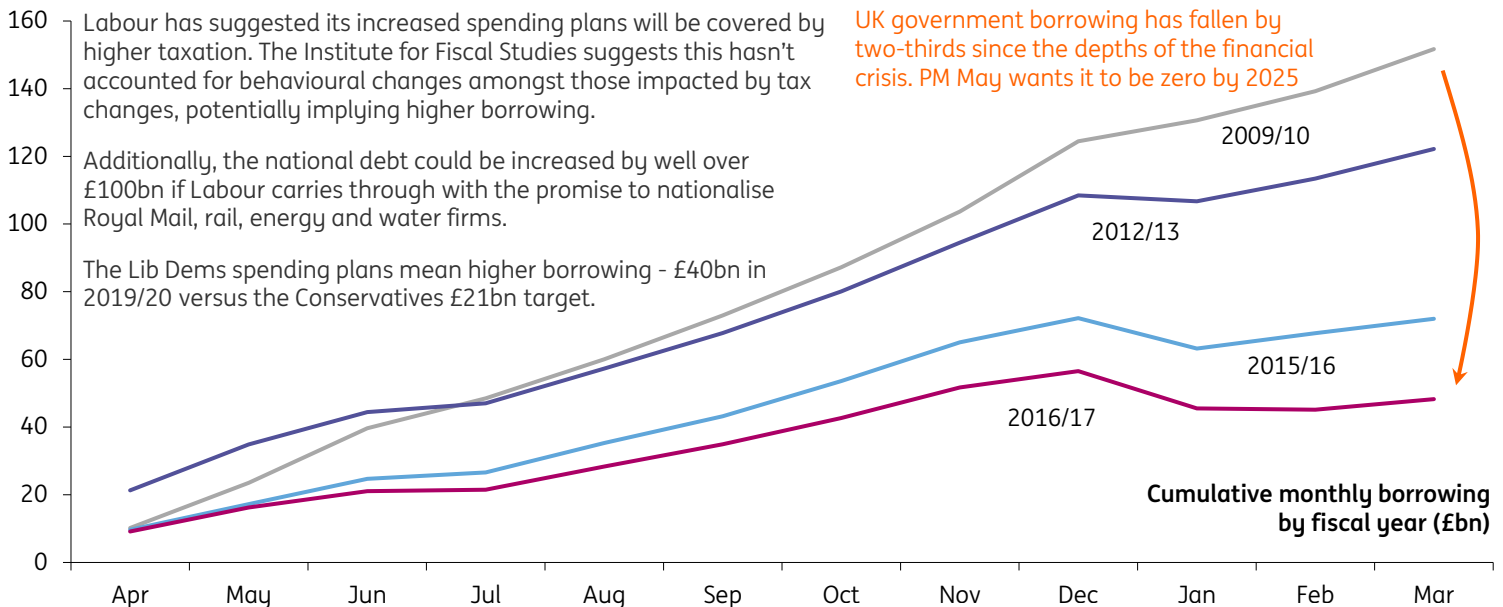
One SNP condition would be a second Scottish independence referendum, which would extend UK political uncertainty. We would also see demands for more devolvement of political powers.

This would be a government that is split on Brexit - Labour is respecting the "will of the people" while the Lib Dems and SNP want ongoing EU membership. Anyone thinking this could lead to a "softer Brexit" will be let down if internal coalition disagreements make it more challenging to agree a deal with the EU by 2019.

Alternatively, Labour could revert to being pro-EU leading to a very pro-EU government. While they probably wouldn't be bold enough to stop Brexit straight off, they would offer a second referendum.

However, the incentive to properly negotiate Brexit would be compromised as they may hope a "bad deal" would mean people vote to stay. This would be a high risk gamble that could easily fail.

How fiscal policy could change post-election: Conservatives targeting balance in 2025



The Brexit deal: Positive signs, but toxic politics are still a big risk

Huge EU-UK trade ties are often cited as a reason for optimism that a good trade deal can be agreed. But the lesser discussed issue of population dynamics and the potential for EU budget contributions are clear negotiation incentives. The big question now is whether anti-EU sentiment, most notably in Italy, could prompt the EU to take a tougher line in UK trade talks. But

regardless of whether good or bad prevails, the EU principle that “nothing can be agreed until everything is agreed” means that a period of prolonged uncertainty looks inevitable. Whilst a transition phase helps avoid a “cliff-edge” scenario, limited clarity on trade before 2022 means businesses may opt to hold off on investment for several years, leading to slower jobs growth.

Trade, population and budget: Three reasons why we think a positive deal is possible

Trade

More than €600bn of trade occurs between the UK & EU. Millions of jobs are tied to this, so disruption will hurt incomes & tax revenues for both sides.

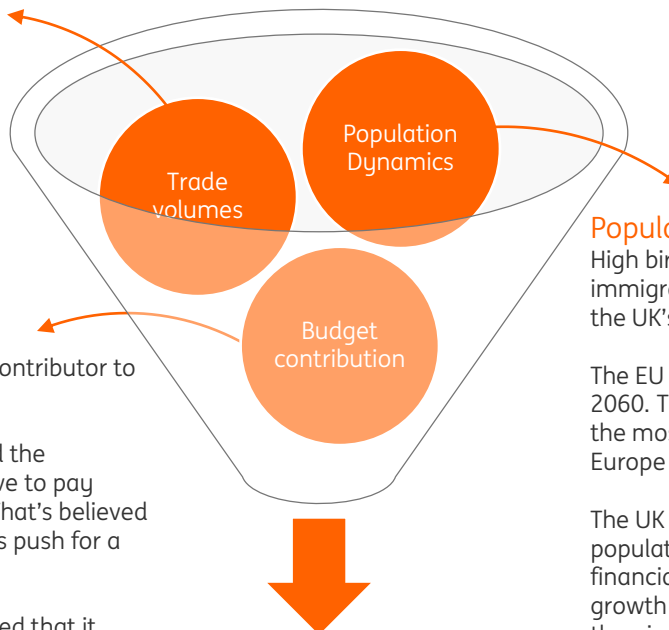
A bad deal risks higher prices for consumers/businesses, and also disruption to the frictionless trade many modern supply chains rely on.

Budget

The UK has been a major net financial contributor to EU funds.

Brexit means that France, Germany and the Netherlands, amongst others would have to pay more, or poorer countries receive less. That's believed to be one of the reasons behind the EU's push for a larger, €100bn “exit bill”.

The UK government has already indicated that it could make ongoing contributions to maintain some market access. This was confirmed in the Conservative party manifesto.



Population dynamics

High birth rates, driven partly by immigration over previous years, means the UK's population is growing.

The EU however is expected to shrink by 2060. The EU estimates that the UK will be the most populous nation in Western Europe within 30 years.

The UK will have a growing working age population and will be less impacted by the financial cost of ageing. That means UK growth should be structurally stronger than in Europe.

On that basis, the UK will be an increasingly attractive market to export to.

Positive trade deal

How it could go wrong: Toxic politics and economic/financial contagion combine

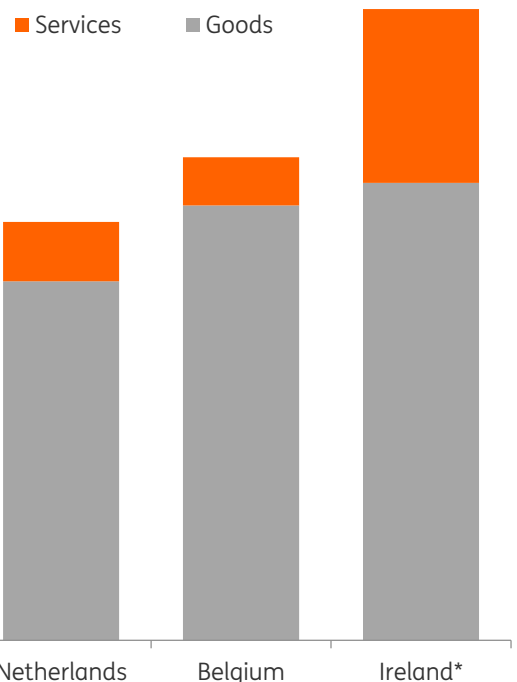
Arguments about the timetable and the mooted €100bn “divorce bill” highlight how fractious discussions will be. Brexit Secretary David Davis has again talked about the potential of the UK “walking away”. This would likely mean the introduction of WTO rules and tariffs, that could increase costs and bureaucracy – hurting trade and economic growth.

Another key issue is the uncertainty surrounding the Italian election planned for the first quarter of 2018. The concern is that the first and third place parties in opinion polls are both decidedly anti-EU.

Should the next Italian government decide that they want a referendum on leaving the EU (this will require constitutional change), then the EU could be inclined to take an even tougher line in Brexit negotiations to make leaving look as unattractive as possible.

In a worst-case scenario, fears of EU break-up could see toxic politics combine with economic dislocation and financial contagion, which would spell disaster for the European economy – not just the UK economy.

Exports to the UK (% of each country's GDP)



Source: Macrobond

*Irish exports to the UK by value are equivalent to 11.3% of Irish GDP

The outlook for the Bank of England and markets

Despite some hawkish comments of late, we don't expect a Bank of England rate hike before 2019. That's because rising inflation is likely to hit spending and growth through this year and next. This could be compounded by weaker investment, as firms sit tight until the Brexit path becomes clearer. Neither of these factors are likely to drastically change as a result of the General Election.

A narrative that the pound will react positively to a Tory landslide is overly simplistic – especially after the recent short positioning adjustment. The election run-in has been a catalyst for markets to return to a more neutral Brexit level, but this means that there are greater two-way risks. What matters is May's post-election moves and this is where GBP's perseverance could show cracks.

The Bank of England outlook: No rate hikes before 2019, regardless of election outcome

There are two reasons why we aren't expecting a Bank of England rate hike before Brexit talks end in 2019 – neither of which are likely to change significantly as a result of the election.

Firstly, households are feeling the squeeze from higher inflation and slower wage growth. Given that consumption is already slowing, any fiscal pledges during this election campaign may only offset this at the margins. Note the poor 1Q GDP growth of just 0.2%QoQ.

Secondly, as we noted earlier, Brexit uncertainty is likely to persist for several years, potentially limiting investment/hiring. Regardless of who wins the election, and their respective plan for Brexit, this uncertainty is unlikely to dissipate fully. This slowdown in growth will more than offset any BoE concerns about above target inflation

14%

Source: Bloomberg

Probability of a rate hike by the end of 2017 (based on the UK OIS Curve)

51%

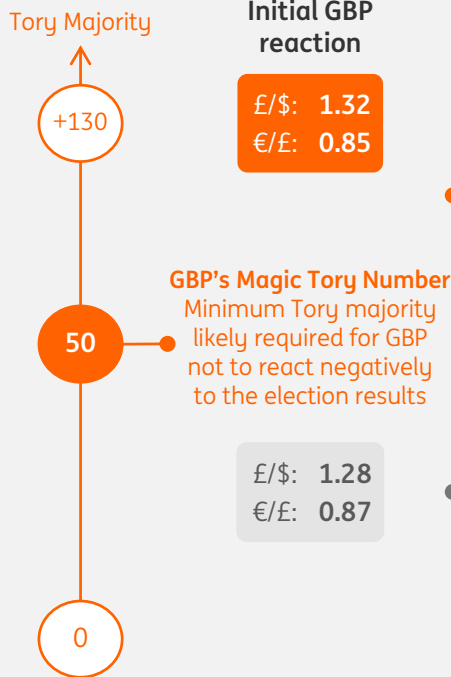
Source: Bloomberg

Probability of a rate hike by the end of 2018 (based on the UK OIS Curve)

GBP & #GE2017: A one-stop guide to how the pound will react to the UK General Election

Phase 1: GBP's knee-jerk reaction

Assuming a Tory win, GBP's initial reaction will be based on the size of May's majority. Anything less than a 50 seat margin will be seen as a disappointment for GBP markets.



Initial GBP reaction

£/\$: 1.32
€/: 0.85

£/\$: 1.28
€/: 0.87

£/\$: 1.25
€/: 0.89

Phase 2: What matters for GBP once the dust settles

Markets are adequately priced for a solid Tory win and the key for GBP is what happens next. The composition of the new UK Parliament could influence PM May's cabinet line-up and the tone of Brexit talks. Visible steps towards a transition deal are needed to lift GBP higher.

	Cabinet Reshuffle	Transition Deal Hopes	
PM May's 'Army of Brexiteers'	Pro-Brexit MPs dominate May's new cabinet	Tough UK Brexit stance delays transition talks	£/\$: 1.27 €/: 0.87
May moves to centre ground	May opts for more centrist & 're-leaver' MPs	A diplomatic Brexit style lifts transition odds	£/\$: 1.33 €/: 0.84
Lab keeps a strong foothold	Status quo on cabinet with a mix of Tory MPs	May's Brexit bargaining hand weaker	£/\$: 1.28 €/: 0.87
Anti-Brexit Lib Dems gain seats	PM May could opt for more moderate MPs	Transition & softer Brexit hopes possible	£/\$: 1.30 €/: 0.86
'Cor-by'n Blimey' Lab-Lib-SNP coalition	While one could see a softer Brexit being the goal of a working Labour government, political uncertainty – GBP's Achilles Heel in recent times – is likely to prevail in the short-run		£/\$: 1.25 €/: 0.89

Spot reference: 1.2950 (£/\$); 0.8630 (€/:)

Our key 2017 UK forecasts

1.5%

2017 Real GDP Growth

0.85

4Q17 EUR/GBP (eop)

2.7%

2017 Headline CPI

1.35

4Q17 GBP/USD (eop)

	2017F					2018F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
GDP (% YoY)	2.0	1.7	1.5	1.0	1.5	1.1	1.0	1.2	1.4	1.2
CPI headline (% YoY)	2.1	2.8	2.9	3.0	2.7	2.8	2.7	2.7	2.7	2.7
BoE official bank rate (% eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
BoE Quantitative Easing (£bn)	435	435	435	435	435	435	435	435	435	435
GBP/USD (eop)	1.24	1.32	1.31	1.35	1.39	1.41	1.46	1.51	1.51	1.51
EUR/GBP (eop)	0.87	0.85	0.88	0.85	0.83	0.85	0.83	0.83	0.80	0.80

As of 25 May 2017

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