

June 8th UK snap election ends in hung parliament; a period of political uncertainty lies ahead

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Conservatives win but surprisingly lost majority

Just a week before Brexit discussions are due to start, Theresa May's Conservative party has surprisingly lost its majority in the House of Commons. With 649 out of a total of 650 seats declared so far, Tories came first gaining 318 seats down from 330 in 2015 and 8 short of an absolute majority, the Labour Party 261 seats up from 232 in 2015, the Scottish National Party (SNP) 35 seats down from 54 in 2015, potentially implying less risks for a second Scottish referendum, Liberal Democrats 13 seats up from 9 in 2015, the Democratic Unionist Party (DUP) 10 seats up from 8 in 2015 and the UKIP no seats from 1 in 2015. In terms of popular vote share, Conservatives won 42.4% up from 36.9% in 2015, the Labour Party 40.0% up from 30.4% in 2015, the SNP 3.0% down from 4.7% in 2015, Liberal Democrats 7.4% down from 7.9% in 2015, the DUP 0.9% up from 0.6% in 2015 and the UKIP 1.9% down from 12.7% in 2015. Turnout reached 68.7%, up from 66.4% in 2015.

The main winners and losers from the general elections

Undoubtedly, the election outcome is a disappointment for the Conservative Party. This followed a controversial campaign including, among others, the abandoning of a previous pledge to not raise national insurance and/or VAT as well as a U-turn on adult social care reform (the so-called "dementia tax"). Increasing evidence over slowing UK economic growth over the last few weeks and criticism to Prime Minister Theresa May in the wake of the recent terrorist attacks that under her leadership as Minister of Internal Affairs (2010-2016) the number of police officers was reduced, had also a negative impact on the party's performance. On the flip side, the Labour Party, which has moved further to the left-wing of policies under the leadership of Jeremy Corbyn, was among the main gainers performing much better than expected and increasing the number of seats and vote share. The party 2017 manifesto released a few weeks ahead of the June 8th general elections envisions, among others, increased borrowing for public investment, higher corporate and household income tax along with plans for the nationalization of energy companies, railways, buses and the Royal Mail.

Hung Parliament: fears over a period of political uncertainty

The election outcome is a blow to the Conservative Party and PM Theresa May taking into account that a major reason behind her decision back in April for early elections was an increased majority in Parliament that would give her a strong hand in upcoming Brexit negotiations. Bear in mind that, when snap elections were called, opinion polls suggested an average lead of c. 20% for the Conservative Party over the Labour Party that was translated to a majority in the House of Commons of more than 100 seats. PM Theresa May's position has undoubtedly weakened as the election outcome implies a rejection of the government's hard Brexit strategy. Though the Prime Minister publicly stated that she does not intend to resign, she will likely face pressure to leave her post as Conservative party leader in the coming weeks/months opening the way for a Tory leadership challenge. Adding to political jitters, the prospect of a new Conservative leader opting to hold new snap elections in the coming months to secure a fresh mandate, cannot be ruled out.

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Securing the biggest number of seats in the House of Commons, the Conservatives will likely try to form a minority government, probably with the support of the pro-Brexit DUP, on the basis of a confidence and supply deal.¹ However, it is questionable whether a minority Conservative government can make it through the full five-year term especially considering the complexities of the Brexit process. If Tories and Northern Ireland's DUP fail to reach some form of cooperation, then it would be hard to see how an alternative government could be formed as Labour, Liberal Democrats and the SNP fall short of a majority.

Potential implications for UK Brexit strategy

If Theresa May retains her post as Prime Minister and Tories reach a deal to form a minority government with the DUP relatively quickly, Brexit negotiations are likely to start on June 19th, as planned. Pro-Brexit DUP is unlikely to challenge the Conservatives' hard Brexit strategy. Under such a scenario, the Eurosceptic wing of the Conservative party could end up with increased influence in upcoming Brexit discussions, raising the risk for a hard and probably disorderly Brexit, the worst case Brexit scenario. However, opposition to such a scenario will become louder with Labour, SNP and the Liberal Democrats, taken together, increasing their seats in the House of Commons. If Theresa May resigns, the start of Brexit negotiations will likely be delayed due to the leadership contest.

All things considered, it is too early to tell whether the hung Parliament makes a "soft" or "hard" orderly/disorderly Brexit scenario more likely than before. A Conservative minority government suggests a weaker mandate to negotiate Brexit with the EU, raising questions over whether the Tories will eventually advance with their Brexit plan. As such, a Conservative minority government may eventually opt to cooperate with the more pro-EU political parties in Parliament. This would inevitably result to the redefinition of the government's Brexit strategy as there are significant differences between the Conservative Party and all other majority parties to Brexit and immigration. Tories' 2017 manifesto vows reduction in net immigration post-Brexit to the "tens of thousands" even if that would imply less access for the UK to the Single Market and the Customs Union as part of the deal with the EU. Adopting a clearly different approach, the Labor Party favors a softer approach to Brexit with the UK "retaining the benefits of the Single Market and the Customs Union" while it does not propose a cap on net immigration inflows. As far as the Liberal Democrats and the Scottish National Party are concerned, both are in favor of the UK remaining in the EU. However, whether a minority Conservative government will eventually decide to soften its Brexit strategy or not, will take time to become evident.

Knee-jerk market reaction to the UK election outcome

Favored by their safe-haven appeal and increased uncertainty about the potential impact of the political uncertainty on the UK's growth outlook, UK Gilts rallied in the aftermath of the election result. The 10-yr yield retested levels slightly below 1.0% in early European trade on Friday, before reversing the trend and hitting a multi-session high close to 1.07% a few hours later mainly on the back of higher inflation risk due to the weaker sterling. Elsewhere, after closing at a three-week low in the prior session, the FTSE100 index was firmer in early trade on Friday on the view that the hung Parliament may force the Conservative party to adopt a softer approach to Brexit. The GBP reacted negatively coming under pressure across the board. GBP/USD dropped to 1.2630 in early European trade on Friday (June 9), the lowest level since mid-April, before stabilizing around 1.2700/1.2710 a few hours earlier. Along these lines, EUR/GBP marked a fresh year-to-date high of 0.8860, before retreating modestly to levels around 0.8770/75 in late European trade, remaining c. 3% higher so far this year. Looking ahead, GBP volatility will likely rise further with market participants focusing on political headlines hitting the newswires. Unless, the Conservative Party manages to form a government swiftly, PM Theresa May retains her post and Brexit discussions commence as planned, the likelihood of further GBP weakness in the coming sessions cannot be ruled out.

¹ Confidence and supply deal is determined as an agreement between political parties that is less formal than a full-blown coalition but one that allows a minority party to hold power.

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