

UK General Election 2017

- Highly uncertain outcome due to realignment of electorate post financial crisis
- Turnout will be key
- Increased risk of Disorderly Brexit whatever the outcome

Risks for your portfolio:

1. Disorderly Brexit risk to increase GBP implied volatility, particularly vs EUR
2. Complicates timing of first BOE rate hike
3. Stagflation risk premium for Gilts and UK small cap equity markets

The UK 2017 General Election was supposed to be the most predictable of recent political events. The past two years have sprung global surprises such as the election of candidates who have never held political office (France, the US), or where polls were significantly poor predictors of the outcome (UK GE 2015, Brexit referendum). This election was a sure thing: the Conservative Party would dominate the UK come June 9th. Former Business Secretary Vince Cable was not the only one to talk in panicked tones of a “*One Party State*”¹ in the aftermath of Theresa May’s surprise call for an election. Now, with a week to go until polling day, that could not be further from the truth.

The campaign began with a commanding lead...

The Conservative Party held a dominating lead in all opinion polls conducted since the start of the year². On the day that Theresa May made her unexpected announcement to call the election, the Conservatives were polling a vote share almost double that of Labour.

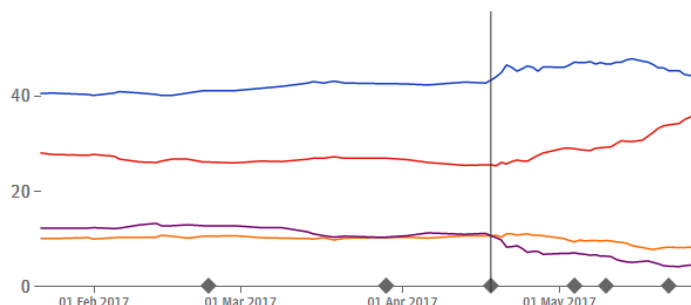
UK General Election 2017 - latest polling averages

Hover or tap for more info

18 Apr 2017

- ◆ Con: 43.2%
- ◆ Lab: 25.4%
- ◆ LD: 10.5%
- ◆ UKIP: 10.5%

Event: Theresa May calls for an early general election. MPs voted on and approved this call the following day.



The size of the Conservative lead came as no surprise. The Labour Party have been tearing themselves apart over what they actually stood for ever since the worse-than-expected performance of Ed Miliband in the 2015 General Election.

Their own MPs became so frustrated with Jeremy Corbyn that they brought a vote of no confidence in their own leader in the summer of 2016³. He easily won that second leadership vote, exposing once again the schism

¹ <http://www.independent.co.uk/voices/vince-cable-liberal-democrat-fightback-general-election-2017-heading-towards-one-party-state-a7704926.html>

² <http://www.telegraph.co.uk/news/0/general-election-latest-polls-odds-tracker/>

³ [https://en.wikipedia.org/wiki/Labour_Party_\(UK\)_leadership_election,_2016](https://en.wikipedia.org/wiki/Labour_Party_(UK)_leadership_election,_2016)

on the left of British politics. Does it want to provide an effective opposition that might need to engage with the centre ground? Or does it want to be a loud voice of protest, channelling rage but failing to change policy? This confusion had beleaguered the opposition party to such an extent that it had almost become an irrelevance.

Meanwhile Theresa May smelled an opportunity. A window was open, but closing quickly. Article 50 had been triggered on March 29th but on April 23rd the French would start their own Presidential election process, followed by the German elections in September. The EU would soon start to release their coordinate list of demands for the Brexit negotiation process. The previous four months had shown the PM how difficult it would be to pull together her own side in these negotiations. The government lost a court case on trying to trigger Article 50 without Parliamentary approval; she faced a rebellion in the House of Lords; and the Scottish National Party criticised her for hypocrisy for denying them a vote on Scottish independence even as she had never been elected as Prime Minister. An election would give her a mandate. She decided that any criticism for her U-turn would be a price worth paying to ensure her legitimacy.

...which then narrowed

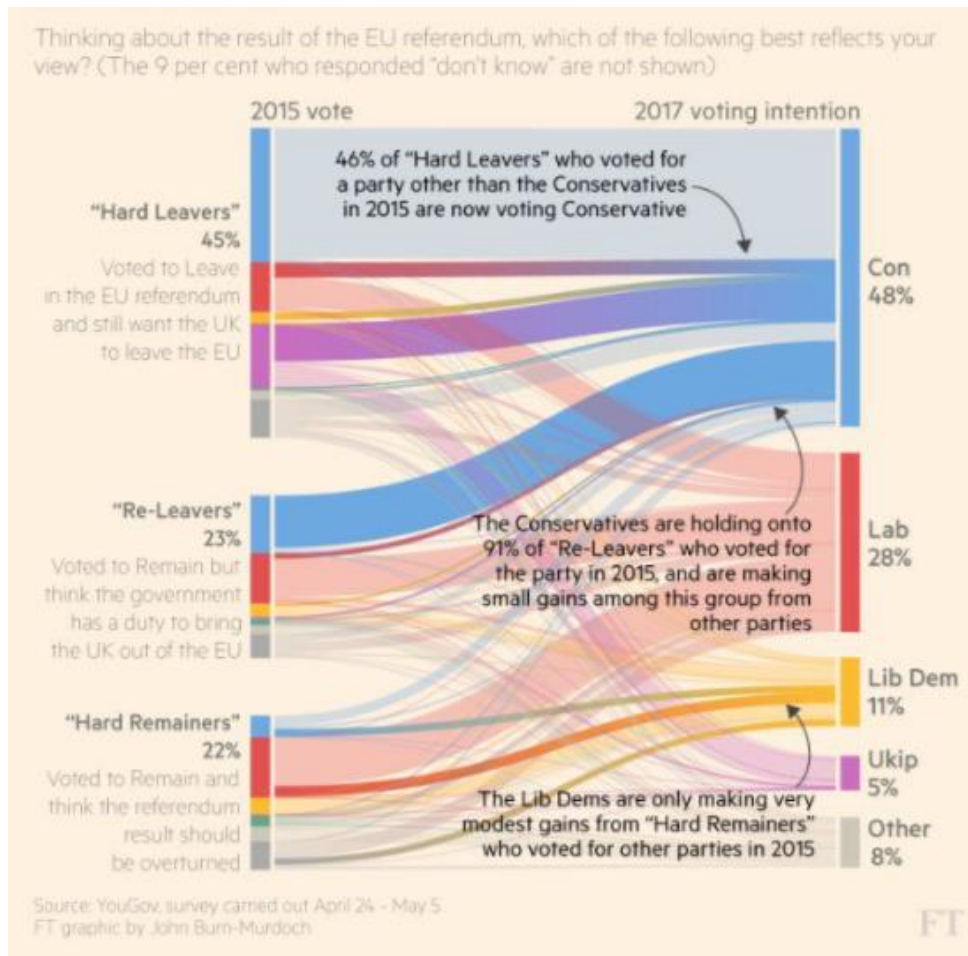
For the first few weeks of the campaign, this looked a bold move. The Conservative vote share increased, with UKIP voters returning to the fold now that the UK had indeed won its independence from the EU. UKIP constituted almost 4 million votes in the 2015 election: with much of their support, the Conservative share of the polls headed toward 50%. Who wouldn't feel confident of victory if you're polling the support of almost half of the electorate? Just nine days after calling the snap election, the Conservative party recorded a poll lead of 23 percentage points over Labour⁴, matching the record heights of Thatcher's landslide 1983 victory. The Tories openly discussed winning landmark Labour seats, such as Tony Blair's constituency of Sedgefield⁵. Hubris descended.

If this were a true Brexit election, logic dictated that the poll lead would always narrow. After all, 48% voted against leaving the EU. Some strong "Remain" constituencies could change hands. The Liberal Democrats positioned themselves to take advantage of this, formally promising a second referendum. Unfortunately for them, the logic didn't stick. A significant number of Remain voters have accepted the result, believing the government has a duty to leave. As YouGov's graphic shows⁶, only a quarter of the electorate remained Remainers:

⁴ <http://uk.reuters.com/article/uk-britain-election-poll-ipsosmori-idUKKBN17S1AS>

⁵ <http://www.chroniclelive.co.uk/news/north-east-news/bookies-say-conservatives-could-win-13072673>

⁶ <https://yougov.co.uk/news/2017/05/12/forget-52-rise-re-leavers-mean-pro-brexit-electora/>



Then in the week in which parties presented their manifestos, something shifted. This was no longer The Brexit Election. No longer an election created by the Westminster bubble to rebalance their own political equilibrium. After all, the Labour Party also had something to gain from a Conservative landslide, hoping a wipeout might bring about a more moderate leader.

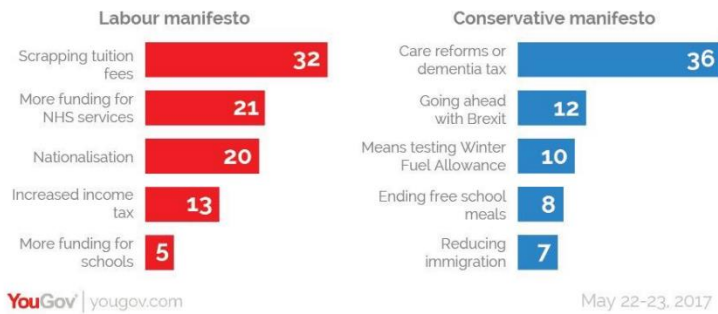
The manifestos reminded voters of their concerns beyond Brexit. Labour promised scrapping tuition fees, more money for the NHS and schools, and nationalising various industries, paid for by tax increases. Meanwhile the Conservatives also promised more money for the NHS, threw in a vote on foxhunting, promised to limit immigration to the net tens of thousands, and reduce intergenerational inequality by means testing pensioner benefits. This final point was bold. Pensioners are more likely to vote, and more likely to vote Conservative. But when you're so far ahead in the polls, why not be brave and tackle a difficult topic that will have to be dealt with one day? After all, you might pick up a few votes from the younger generation, stealing natural Labour voters as you go.

Unfortunately, this is how the public saw the manifestos, according to YouGov⁷:

⁷ <https://yougov.co.uk/news/2017/05/25/manifesto-destinies/>

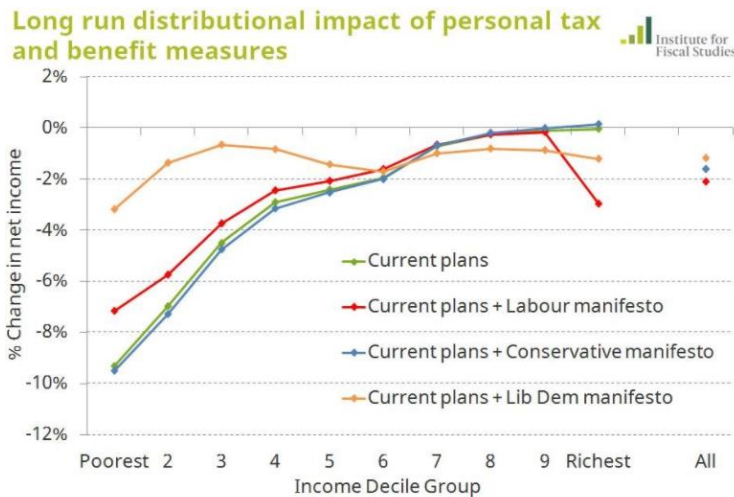
Top 5 perceived "main" manifesto policies

From what you've seen or heard, what were the MAIN policies that the Labour/Conservative Party put forward in their manifesto? %



In short, the Conservatives were taxing dementia, while Labour were handing out freebies.

In fact, the Labour and Conservative manifestos were not much different in terms of how they would affect people's incomes. This chart from the Institute for Fiscal Studies shows how income changes as you move from the poorest to richest members of society⁸:



As this demonstrates, the only party really doing anything wildly progressive to income distribution were the Liberal Democrats. Despite this, their poll lead languished at low levels.

In politics, perception is everything. Spin is a much maligned political force: but the message matters.

Another unpredictable outcome

Momentum also matters. Emmanuel Macron stole into the lead in France as his opponents fell. Trump rolled through his own party's primary process, gaining popular support as he went, eventually turning it into outright victory. Now, as we enter the final week in the UK, Labour have the momentum. It's always significant when the subject of a campaign becomes the opposition. Hillary turned the final weeks into why it was dangerous to vote Trump; Marine Le Pen did the same against Macron; and now the Conservative Party are running anti-Corbyn attack adverts.

Although each pollster is now forecasting wildly different results, the direction of momentum has been the same: the resurgence of the Labour Party. The factor which varies for each polling agency's forecast is their turnout filter. Sure, the Labour Party are gaining support amongst 18-24 year olds; and yes, that cohort has signed up as record numbers of last minute voter registrations. But will they turn out on the day? Will it be in seats that are

⁸ <https://www.ifs.org.uk/publications/9164>

already metropolitan, and Labour-held? Will the pensioners forgive the Tories for their social care policy debacle, considering Theresa May the lesser of two evils?

The uncertainty comes about because we are experiencing a huge political realignment. This is what happens after massive socio-economic shocks, as it did after the Great Depression. Lives change, our expectations change, and our demands change.

With the two main UK political parties polling their highest vote share in 30 years, it appeared that we had returned to the stability of two-party politics. In reality, the collapse of the votes for the smaller parties, such as UKIP and the Lib Dems, has created a very unstable and unpredictable system. Are those voters now wedded back to the two main parties, or unhappily flip flopping between them?

The financial crisis threw all the puzzle pieces up into the air. They haven't fallen back to earth yet. The veteran psephologist Sir David Butler⁹ claims he's never seen such a volatile electorate in the run up to an election¹⁰. At least not since 1945: another period of great socio-economic turmoil. We still don't have the answers to the big questions. What are the Conservative and Labour parties and who do they represent? What are the big issues of the day, when 52% of the electorate ripped us out of a network with our closest trading partner? Immigration or public services? How will we pay for it – higher taxes or cutting spending?

We want change, and the current system of parties and candidates is straining to cope.

The result...

These are the key websites to watch for how the polls progress, along with their current predictions¹¹:

http://forecastuk.org.uk/latest-forecasts/	Conservative Majority of 60
http://www.electoralcalculus.co.uk/homepage.html	Conservative Majority of 92
http://electionforecast.co.uk/	Conservative Majority of 136
https://yougov.co.uk/uk-general-election-2017/	Hung Parliament Conservative largest party, 311 seats

A good wrap can be found on the Telegraph's website:

<http://www.telegraph.co.uk/news/0/general-election-latest-polls-odds-tracker/>

Let the real battle begin: Brexit

Whatever happens, Theresa May has suffered significant war wounds from this election campaign. She asked the electorate to vote for her in order to strengthen her hand in Brexit negotiations. She sought to unite the country behind her, personally. Any campaign rally was festooned with posters declaring "Vote for Theresa May's Team". It's not a vote for the Conservative Party, it's a vote to strengthen the hand of Britain when Theresa May goes to

⁹ [https://en.wikipedia.org/wiki/David_Butler_\(psephologist\)](https://en.wikipedia.org/wiki/David_Butler_(psephologist))

¹⁰ <http://www.bbc.co.uk/news/election-2017-39856354>

¹¹ As of 30th May 2017

the negotiating table. The anticipated landslide would be a noble unification across the party divide to face the specific challenge of Brexit. Arise, Queen Theresa...

Now, anything less than a significant Conservative Party majority would be a personal rejection. It would be interpreted that the electorate looked at 'Theresa May and her team', and didn't much like either. That would severely weaken her negotiating hand. Not just in terms of the numbers of MPs and voters who support her, but in terms of perception. The other side of the negotiating table will know:

- 1) She gambled and failed – suggesting she raises the stakes at the wrong moment
- 2) She couldn't unify the country– suggesting the court of public opinion is flexible
- 3) She couldn't unify her party – suggesting she misjudges her political capital

On calling the election, sterling rallied, with an expectation the PM would significantly increase her majority from a precarious 12 MPs, minimising rebellions and thus reducing the risk of a disorderly Brexit. The election would not only give her more MP firepower, but also bind the hands of peers. In her speech to call the election, she referred to “*unelected members of the House of Lords*” who “*have vowed to fight us every step of the way*”¹². The Salisbury Convention¹³ dictates that members of the Upper Chamber should not oppose the final reading of any legislation that's contained within the government's manifesto. Given that David Cameron expected to win the Brexit referendum, there was nothing in the 2015 manifesto about triggering Article 50. The Lords could oppose it without the Prime Minister being able to apply the usual pressure. Hence Theresa May's obsession with crafting the perfect manifesto in order to avoid this opposition. It's possible that her focus on cramming in policies may have backfired, given the reversal in the polls once the manifesto was released.

A larger majority for May does not even necessarily minimise the risk of rebellion. Her ivory tower style has left her unusually vulnerable for a leader. She may appeal to new voters by not being a clubbable Old Etonian, but it means she has few outriders, as Robert Colville of CapX puts it¹⁴:

'Yet while the Camerons were always a minority within the parliamentary party, they did have their outriders, those MPs and journalists who had been making the case for Tory modernisation since the apocalypse of 1997... the tight ship that May runs means there are, for example, few columnists making the case for her, explaining (as they did with Cameron) precisely why Downing Street is thinking what it is thinking, or expounding the meaning and merits of Mayism. And the hurried selection of candidates means the views of the new cohort are largely unknown.'

A larger majority doesn't always translate into a loyal one. The Tories have always been quick to indulge in regicide, particularly when it comes to the existential question of Europe. The irons are already out for Theresa's closest confidante, one of her two chiefs of staff, Nick Timothy¹⁵. He is the man responsible for the social care reforms in the manifesto that became portrayed as the unpopular 'dementia tax'. Even upon winning, Theresa might have to sacrifice those close to her in order to remain in charge.

¹² <http://www.bbc.co.uk/news/uk-politics-39630009>

¹³ https://en.wikipedia.org/wiki/Salisbury_Convention

¹⁴ <https://capx.co/theresa-may-and-the-battle-for-the-conservative-partys-soul/>

¹⁵ <http://www.politico.eu/article/nick-timothy-theresa-may-uk-conservative-conference/>

How much in charge can she even be? Her Minister for Brexit, David Davis, is already publicly chomping at the bit to fight the EU27, squawking that “We don't need to just look like we can walk away, we need to *be able to walk away*”¹⁶. Loose cannons cost lives.

The election is the phoney war ahead of the real battle. Theresa May is kicking off negotiations already bruised by the brush with her own electorate, before her MPs or the EU27 start to throw in their own punches.

UK risk premium

Brexit negotiations kick off on June 19th. The EU27 have been remarkably unified in their initial demands, with the emphasis on the divorce bill. No-one wants the person with the money to walk away from a relationship without a fight. Who cares about who keeps the dogs when you realise you're not getting the same income? All of the EU27 are upset about losing British contributions: the richer nations because they have to make up the shortfall, and the poorer nations in case they don't get their usual transfers. When everyone agrees, it's tough to budge them.

Eventually, the EU27 will fragment, as individual nations fight for the trade deal or competition issue that bothers them the most. That will be the meat of the debate. That's some time away. All negotiations start with digging the trenches. The market will decide which side's intransigence is more rational, and punish the other. If the UK walks away, it's likely the risk premium on its assets increases further.

Market impact

- The expression of Brexit risk in currency markets should shift from GBP/USD to EUR/GBP as the focus turns explicitly to the UK/EU relationship
 - Implied volatility in any GBP-based cross should relatively increase
 - FTSE 250 and other wider UK equity indices under pressure if higher inflation is accompanied by lower growth, and company margins are squeezed
 - Gilt markets to remain mostly insulated until all bond markets escape the wall of money flattening curves and hunting for yield. When the longer end of all bond markets becomes unanchored, UK bond markets to underperform the rest, given risk of capital flight and currency crisis in any disorderly Brexit
- ➔ **The risk, however small, for a disorderly Brexit ahead of the 2 year deadline needs to be factored into GBP asset prices whoever wins the election**

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¹⁶ <http://www.reuters.com/article/us-britain-eu-davis-idUSKBN18HOPZ?il=0>