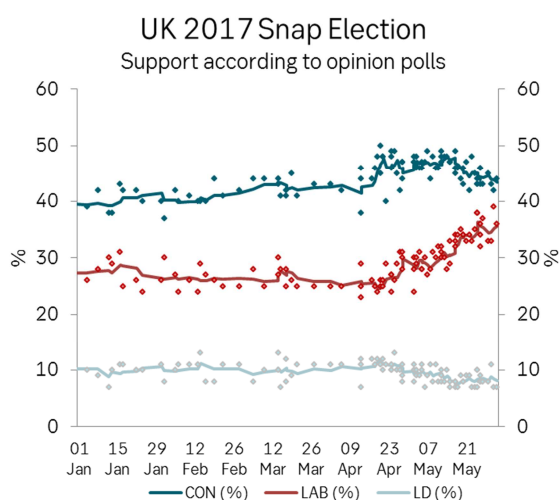


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GBP and the General Election

The UK parliamentary election on Thursday may turn out to be a closer race than expected just a few weeks ago. While we believe that any outcome but a Tory majority would weaken the GBP initially, it might in fact be the other way around over the longer term. An outcome that would soften the tough stance of the Conservative party in the upcoming negotiations with EU will improve chances of reaching a deal and should reduce the 'hard Brexit' premium on the GBP.

MAY WAS BAD FOR MAY. The UK parliamentary election will be held on June 8. What initially was seen as a bright move by PM Theresa May to take advantage of significant popular support to potentially strengthen her position amongst Tories and increase the power of the governing Conservative Party in the lower House of Commons has in recent days turned into something that might well become a nightmare for the present administration. In mid-April, when PM May decided to call a snap election, the Tories had an overwhelming 20-22% lead over the largest opposition Labour party according to opinion polls, which was seen to be at its weakest in years under supposedly unpopular leader Corbyn.



However, the Conservative party and PM May have been unable to sustain their early large lead while Labour have successfully increased their support according to opinion polls. Still, although the election

seems to have turned into a closer race than anyone could have imagined just a few weeks ago, the incumbent government still holds a comfortable lead with most polling institutes indicating that the Tories should increase their current parliamentary majority in the lower house. Further, in the 2015 general election opinion polls exaggerated support for Labour indicating a tie only days before the election. This suggests that any outcome other than a comfortable Conservative majority would be a major surprise.

ANY OUTCOME BUT A TORY MAJORITY WOULD WEAKEN THE GBP.

During the last year it has certainly been shown that election and referendum outcomes may prove very different from those indicated by opinion polls. Therefore, although the result this time around might seem fairly certain it may still be worthwhile to consider potential reactions to different outcomes:

- 1) **Tory majority:** This is by far the most expected outcome and is likely mostly discounted in current market prices. Nevertheless, we believe such a result would cause the pound to strengthen mainly because the risk of a different outcome has been eliminated. In 2015 the GBP appreciated by just over 1% after exit polls showed a lead for the Conservative party, which later was confirmed. We forecast Sterling to gain around 1% if the Tories win a majority.
- 2) **Labour majority:** Given current polls this would be by far the biggest surprise to markets. In view of the Labour leader's supposedly low popularity and socialist oriented programme with higher income and corporate taxes, we expect the GBP initially to weaken significantly if this is the result of the election. In this case we estimate Sterling will depreciate by 5%.
- 3) A more likely outcome than a Labour majority would be a **hung parliament** where the Conservative party receives most seats in Parliament but loses its overall majority. Although this probably would be less of a surprise than a Labour majority it would nonetheless cause a fairly large initial, negative reaction in the GBP. Given such an outcome we expect the currency to fall by 3.5%, to reflect the vast political uncertainty likely before parties devise a workable solution to govern the country. The market's subsequent reaction

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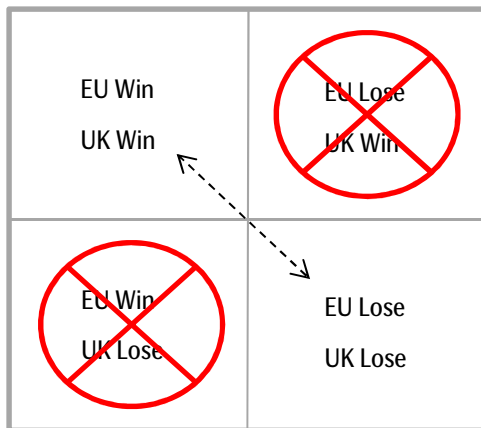
would then depend on whether the Conservatives were to receive sufficient support to remain in power or whether Labour would take over.

Initial GBP reaction on different Election outcomes

	GBP reaction	EUR/GBP	GBP/USD	GBP/SEK
<i>Current spot</i>		0.87	1.29	11.17
Conservative majority	1.1%	0.86	1.31	11.30
Labour majority	-5.0%	0.92	1.23	10.61
Hung Parliament	-3.5%	0.90	1.25	10.78

LONG-TERM GBP REACTION DEPENDS ON BREXIT STANCE. The British currency has been substantially undervalued since it sold off last year following the unexpected outcome of the EU membership referendum. GBP weakness reflects uncertainties regarding the substance, course and potential outcome of upcoming Brexit negotiations with the EU and the potential negative economic consequences in the event of a clean Brexit. In fact, this might suggest that any election outcome that would increase the probability of a softer Brexit, which would only be possible if UK leaders weaken their present stance, is likely to reduce the Brexit premium and consequently strengthen the GBP more long-term.

Frankly, there are only two possible outcomes to the upcoming negotiations between EU and the UK. Either both sides see the benefits of a lasting relationship including partnerships in different areas like security and trade or there will be no deal before the day the UK finally leaves the EU.



Among parties capable of wielding meaningful influence in the British Parliament the Conservative party probably has the toughest Brexit strategy. Consequently, of all possible election outcomes a Tory majority just like today would be most likely to result in negotiations ending in a clean Brexit without any deal, which would further undermine the GBP going forward. Other parties like the Labour party, the Liberal Democrats and SNP are all much more EU-friendly, which should increase the chances of reaching a deal between the EU and UK. Indeed, the UK might even end up remaining an EU member if the

Liberal Democrats were to prevail and demand a second referendum before approving a new deal with the EU.

Consequently, if the outcome of this week's general election forces the Conservative party to seek parliamentary support from one or more of these EU-friendly parties it might well soften the UK's position in upcoming negotiations with the Commission and increase the chances of a more favourable outcome. Consequently, although the GBP is likely to weaken initially on the back of any election outcome apart from a Conservative majority, we believe this effect could be short-lived. While the risk premium attached to Sterling concerning a possible hard Brexit should persist following an outcome with a Conservative majority it is likely to decline over time strengthening the British currency should the outcome of the election force the conservative party to seek support. By how much it might appreciate is impossible to say. However, overall the GBP is around 20% undervalued in trade weighted terms because of the Brexit vote last year, which provides plenty of scope for recovery against most currencies. Therefore, an outcome on Thursday that could trigger a negative initial reaction may in fact have the complete opposite effect on the GBP over the medium to long term.