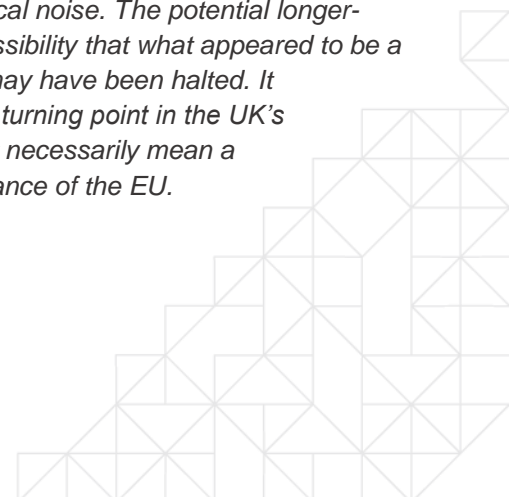
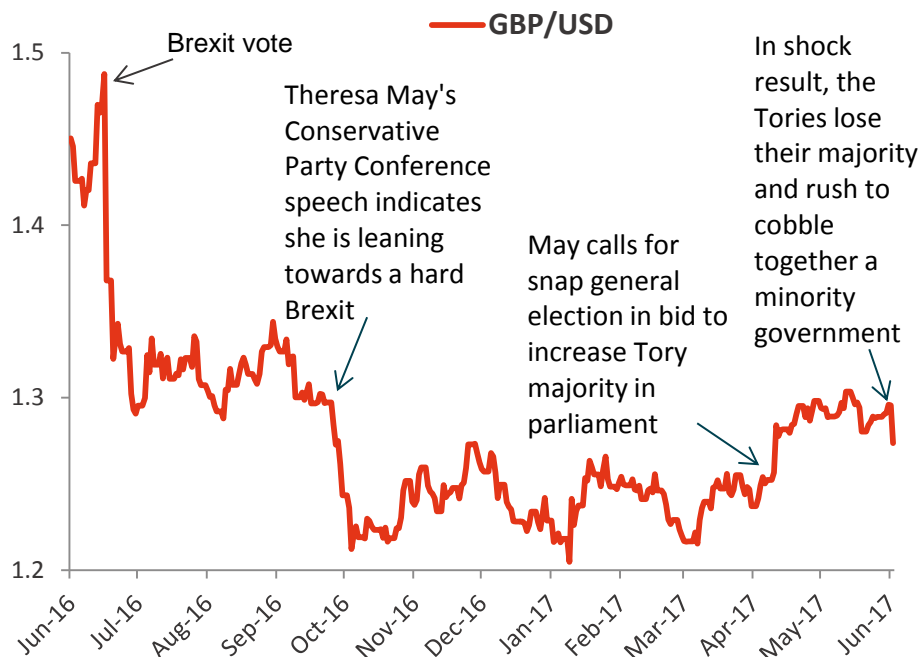


UK Election: A Blow to Theresa May and Her Hard Brexit Plans

- The UK Conservative Party, led by Prime Minister Theresa May, lost its majority in parliament in a shock result that ratchets up political uncertainty, but likely does not lead to substantial changes to domestic fiscal and economic policies.
- The Tories lost their majority but remain the biggest party with 318 seats (326 are needed for a majority) versus Labour with 262. Theresa May is in the process of trying to cobble together a coalition with the Democratic Unionist Party (DUP), a Northern Irish party, which now has 10 seats.
- The result is a major blow to Theresa May and a rejection of her main election push to gain a stronger mandate to negotiate what many view as a particularly hard form of Brexit. The question now is whether a reformed government will have the stability and unity to negotiate with the EU. There is a relatively high risk that a Tory relationship with the DUP doesn't prove durable, and with Labour unlikely to be able to forge a coalition government, another general election cannot be ruled out.
- Initial comments from the DUP are that they will consider a "confidence and supply" deal to lend support on key votes but do not want a full-fledged coalition. The DUP supported leaving the European Union in the Brexit referendum, but are against a "hard Brexit" (i.e. May's "no deal is better than a bad deal" stance and her stated intention to leave the customs union and the single market).
- The balance between hard and soft/no Brexiters in parliament and within the cabinet are important variables to monitor to gauge how the UK's stance towards Brexit may change. Although most of her cabinet members have held onto their jobs, a notable change has been the purging of pro-Brexit advisors Nick Timothy and Fiona Hill and the addition of pro-Remain Damian Green as "deputy prime minister" and pro-Remain former MP Gavin Barwell as her new chief of staff.
- The market reaction to the news has been relatively muted, with the pound down around 1.7% on the day and the FTSE 100, dominated by companies with overseas earnings, up around 1% as the pound fell. Gilt yields fell and the yield curve steepened slightly. While political uncertainty will likely remain high in the near term, the medium term impact on the UK is still unclear. The Conservatives' fiscal and economic policies are likely to remain intact in a DUP coalition, but the strong voter rebuke to Theresa May and her close advisors may force them to soften their current hard-line stance on Brexit, which could be a potential longer term positive (or reduced negative) for the UK economy.
- **The bottom line:** *The election ushers in a period messy political uncertainty. However, near term fiscal and economic policies are unlikely to change. As we have seen recently in the US, markets tend to react to real changes in economic fundamentals and ignore political noise. The potential longer-term silver lining of the election result for markets is it opens the possibility that what appeared to be a rapid march by Theresa May and her team towards a hard Brexit, may have been halted. It remains to be seen whether this is a temporary reprieve or marks a turning point in the UK's negotiating stance. Of course a softer approach by the UK does not necessarily mean a soft Brexit will be achieved given the current hard public negotiating stance of the EU. However, it may give it a better chance.*



Brexit and the pound: A volatile relationship



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