Hung parliament – Minority Report

UK general election result

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In a surprising result, the general election has ended in a hung parliament. At the time of writing, the Conservative party has won approximately 318 seats. Labour is at 261, the SNP 35, the Liberal Democrats 12 and the DUP 10. UKIP did not win any seats.

When Theresa May called the snap election in mid-April it was hers to lose, with the Conservatives leading Labour in the polls by around 20 percentage points – the highest since the early 1980s – which could have yielded a majority of circa 100 seats.

In the event, the gamble has failed to pay off, and the governance of the country hangs in the balance.

From here there are several possible outcomes that could evolve over the coming days.

Theresa May could face a rebellion as some in her party might blame her for losing both a sizeable lead in the opinion polls and valuable Brexit negotiation time. This could mean that her position might become much weaker, possibly to the extent that she will have to stand down, thereby triggering a leadership contest. As we saw after the EU referendum last year, the Conservatives can pull together relatively quickly to elect a leader, but the risk is that the process is long and drawn out over the summer.

If the Conservatives become preoccupied with internal party politics, the chances of forming a minority government quickly may be lower, although an arrangement with the DUP is emerging as a likely outcome.

However, the situation is extremely fluid, and it is worth remembering that back in 2010 the coalition between the Conservatives and Liberal Democrats took six days to form, and that was when that partnership was among the likely outcomes. As such, the uncertainty and political wrangling is unlikely to lift quickly.

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HOW DOES THIS AFFECT THE BREXIT PROCESS?

A weak government would be vulnerable to fracturing under the pressures of the legislative agenda associated with leaving the European Union. Hence a Conservative-led government will most likely have to make compromises with the other parties in relation to strategic objectives in negotiating the terms of withdrawal with the EU, possibly resulting in a softer Brexit (e.g. the DUP have said they are not in favour of a 'hard Brexit'). Having to negotiate at home and abroad could lead to an accidental Brexit if deals cannot be made within what is a tight timeframe.

However, with the election out of the way three years ahead of the original schedule, it does remove the political imperative to have a clean break with the EU in place by 2020 (the previously scheduled election date) and a transition arrangement is more likely.

WHAT COULD BE THE ECONOMIC IMPACT?

In the short term, the outcome of the election is unlikely to shift the momentum of the economy, but the risk is that the increased uncertainty creates a confidence shock that hurts investment and consumption. The Bank of England will monitor currency movements and financial markets more broadly in case they need to intervene with liquidity.

The Conservative manifesto was very light on fiscal arithmetic so it is hard to make a strong inference, other than that a government led by them is likely to pursue a path of slower fiscal consolidation as it tries to broaden its appeal.

All else equal, under looser fiscal policy we would typically see tighter monetary policy (i.e. higher interest rates and a stronger exchange rate). However, that cannot be taken for granted in this case. The high degree of uncertainty remaining over the UK economic outlook is likely to keep interest rate increases off the table for 2017 and perhaps beyond.

To a large extent, how the economy fares is still greatly dependent on how the Brexit negotiations shape up and the type of deal that can be struck. A softer Brexit could be a plus for the economy in the long run.

HOW HAVE MARKETS REACTED?

The initial market response has seen sterling fall around 2% (on a trade-weighted basis) and the sterling/US dollar exchange rate is currently hovering close to 1.28 as markets appear to have been anticipating a larger majority. A move towards a softer Brexit is likely to put a floor under the currency in our view. Yields have edged around 0.03% lower in a mild risk-off move which counteracts the currency-induced increase in inflation expectations. The FTSE 100 is 0.5% higher, although the currency depreciation is probably the supporting factor here as the more domestically focused FTSE 250 is 0.6% lower. Credit spreads are relatively unchanged, reflecting the uncertainty ahead.