CIO Special

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Brexit: Waiting for the election outcome

Key take aways

- We currently put the indicative probability of a clear Conservative majority at 75%, a hung parliament at 20% and a clear Labour majority at 5%.
- In the case of a clear Conservative victory, we would expect UK economic momentum to improve over the short term. The scene would be set for an orderly Brexit – although the final shape of Brexit would still be unclear.
- Markets have already been pricing in a Conservative victory, but a further rally in UK-based stocks and GBP looks likely if Johnson wins.

01 Another Brexit hurdle looms

With just one week to go for the December 12 UK general election it seems that only one question matters for investors and financial markets: will Boris Johnson and his Conservative Party win a convincing majority of seats to “Get Brexit Done”? Doing so would set the stage for an orderly Brexit on the basis of the previously-seen Johnson Withdrawal Agreement Bill, accompanied by some pro-growth supply and demand reforms and a sizeable fiscal stimulus that could lift real GDP growth above trend for a while. This scenario more and more becomes the base case and the consensus which the market is increasingly pricing in.

However, if the Conservatives fall short of winning an absolute majority in the House of Commons, uncertainty would rise sharply again. Even if the Conservatives won the most seats, they would have no obvious coalition partner to ally with. A hung parliament again or – less likely – a Labour-led government would be the consequences. A hung parliament would imply continued political uncertainty as the two major parties scramble to find formal coalition partners, attempt to govern as a minority government with some form of support on certain issues from other parties, or else face repeat elections. This would further damage economic confidence and reverse some of the recent gains for UK assets.

While a Labour-led government would probably call a second EU referendum that might reverse Brexit, the UK would face fresh economic risks with the party’s leader Jeremy Corbyn installed as prime minister and keen to pursue his redistributive policy agenda – the so called “Corbyn risk” we have referred to in past CIO Brexit Memos.

Against this background, we analyse in this CIO Special three particular themes:

- Current polls and likely election outcome scenarios
- The economic consequences of these scenarios for the UK economy and for Brexit
- The financial implications of these scenarios for major UK assets

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02 What current polls tell us

Prime Minister Boris Johnson and his Conservative Party have a stable lead in the polls. Although Johnson's lead over Jeremy Corbyn's Labour Party has narrowed from c. 13ppt to c. 10ppt in the past week, his party continues to sustain robust support at c. 42%. As long as support for Conservatives remains close to or above 40%, a poll lead of at least 8pts over Labour keeps Johnson well on track to win a majority of seats – although some tail risks remain given the "winner takes it all" election system in the UK and recent historical experience (see former CIO Brexit Memos for details).

Support for Labour has however increased by c. 4ppt to c. 33% during the past week. It is up by c. 7ppt since parliament voted for an early election on October 30. The loss of momentum by the Liberal Democrats – who are pledged to stop Brexit – helps explain some of this Labour gain. Much of the recent rise in support for Labour seems to come from pro-remain voters who fear that a vote for the Liberal Democrats would be wasted. Labour's promise of a second referendum may be keeping pro-remain voters' hopes alive that the UK could eventually reverse its 2016 decision to leave the EU.

Having polled as high as 20% during the summer, support for Nigel Farage's Brexit Party has steadily declined since then. Recent polls put support at c. 3%. After winning the UK's European Parliament elections in May 2019, the Brexit Party looks unlikely to win even a single seat at the UK general election. This cuts off the risk that the Conservatives, if they fell short of a majority, could end up in coalition with the (pro-hard Brexit) Brexit Party. The risk that the election could result in a hard Brexit on January 31, 2020 has therefore fallen significantly further.

While a Labour government remains rather unlikely given current polls, it is the key tail-risk to watch given the party's focus on redistributive policies. Based on current polling, it seems inconceivable that Labour could win a majority outright. Chances are that, even if Johnson fails to win a majority, Labour would be short of a majority too and thus would need to find a coalition partner in order to form a government. The pro-market, mostly fiscally-prudent, Liberal Democrats have hinted that they would rather go for repeat elections than join forces with Labour under Corbyn. A more realistic coalition partner for Labour would be the SNP (Scottish National Party) – but that could only happen if Labour promised to give the SNP a second Scottish independence referendum. Corbyn has recently ruled this out for the first one to two years of a potential Labour government. Whether the SNP, whose main ambition would be to get a second Scottish vote, would temper Labour's policy agenda is unknown.

Overall given current polls and historical evidence we put a c. 75% chance of a clear Tory majority, 20% of a hung parliament and only 5% of a Labour majority government.

03 Economic and Brexit impacts

If our base case prevails and Johnson wins a majority of seats, we expect UK economic momentum to improve over the short term, lifted by increased confidence, less political uncertainty (reduced chance of a hard Brexit/no Corbyn government) and a sizeable fiscal stimulus.

In a hung parliament scenario, a lot would depend on the time frame of such a constellation and quite how it played out: at one end of the spectrum, it could result in new elections, at the other end of the spectrum an eventual formal coalition government – but a middle option might (in theory) be a single party trying to form a durable minority government on the basis of a loose agreement of support from other parties on specific issues, although the UK has little experience of this. In all these sub-scenarios another possible renegotiation with the EU27, certainly another extension of Article 50 and no clear Brexit outcome again, would create political and economic uncertainty once more in the 3½ year-long Brexit saga, in particular about regulatory, immigration and trade policy, which could dampen sentiment, growth and output during H1 2020, in particular. However, we would assume some kind of compromise, delivering some form of soft Brexit during that period, as the Brexit stance of the Tory party appears to have changed since the "Johnson" deal and also Labour has probably a more flexible approach as pressure on the established party to finally deliver some sort of Brexit will increase – including from the EU27.

Probably the most problematic scenario would come from a Labour-led government. The Labour Party's election manifesto sets out plans for widespread nationalisation, increased regulation and a much larger state, financed by a significant rise in taxes, plus extra borrowing to finance a rise in public sector investment from £47bn in 2019/20 to £114bn by 2023/24. Labour wants to nationalise broadband, rail, postal services, water, energy and all private sector contracts with government. The party pledges to increase current annual government spending by c. £80bn by 2023/24. Labour wants to finance this by increased taxes on incomes at the top end, on corporations (especially oil-producers) and on capital gains while introducing new taxes on financial transactions.

As it stands, Labour policy would transform the UK from a mixed economy with a clear tilt towards free markets, supported by a light-touch approach to regulation and a relatively small government sector, to a mixed economy with a clear tilt towards public ownership and production and more centralised control of economic activity. The plans represent a downside risk to UK growth potential that would likely exceed any potential tailwind from a soft Brexit/no Brexit at all under Labour (after another six month period of Brexit uncertainty, ahead in this scenario of a very likely 2nd referendum – the design, timing and result of which is of course highly uncertain as well).

So despite some chance that the UK could remain in the EU under a Labour government, on balance, the economic risks from Labour's economic plans and the increased political uncertainty stemming from second referendums on the EU and (as the SNP's price for coalition support) on Scottish independence would tilt the economic risks from such an election outcome strongly to the downside and would overcompensate some Brexit relief trades, in our view.

Table 1 summarizes the economic and Brexit impact of the major parties' policies.

Table 1: Economic Policies and Brexit plans of the major parties

	Conservatives	Labour	Liberal Democrats
Fiscal Policy	Very stimulative: higher public expenditure and lower taxes	Huge public investment financed by borrowing, high taxation	Rise in public sector offsets increase in capital investment
Monetary Policy	Unchanged	Plan to bring BoE into fiscal discussions risks independence	Unchanged
Reform Policy	Some growth reforms and deregulation	Increased regulation and nationalisation of important sectors as well as centralisation of production	Neutral
Brexit	"Johnson" Withdrawal Agreement Bill, accompanied with intended Free Trade Agreement (Canada style), later in the transition period	Promise of second referendum, probably between Johnson deal/new deal with EU (custom union, to be renegotiated) on one side and no Brexit on the other side	No Brexit

Source: Political manifestos of corresponding parties; Deutsche Bank Wealth Management. Data as of December 4, 2019.

Hence, in a nutshell we see the following:

- The Conservatives would lift growth through fiscal stimulus and pro-growth reform, while they pursue a free trade agreement (FTA) Canada-style Brexit that threatens to damage long-term growth potential via tighter restrictions on EU worker inflows. Deals with non-EU countries are unlikely to offset Brexit damage ("There is no market like the Single Market") after the transition period, currently scheduled for end 2020, but likely to be prolonged for another two years or so (although Johnson ruled that out in his manifesto).
- Labour's domestic economic policies would lower potential growth by business-unfriendly supply side policies and reforms. Also, Brexit would remain a wild card under this scenario – the UK could end up staying in the EU after a 2nd referendum, with nothing guaranteed.
- The Liberal Democrats' policy proposals are restrained by comparison; remaining in the EU combined with mostly sensible economic policies would lift medium-term growth and would be neutral for potential growth. However, they are unlikely to play a big role in any future government given their current polling (see above).

04 Investment implications

On the whole we think that

- Hard Brexit risk has receded since Johnson managed to strike a new Brexit deal with the EU 7 weeks ago.
- A Conservative majority on December 12 would be positive for UK risk assets while a Labour victory would clearly be a very negative surprise for markets – despite the latter creating a chance of reversing Brexit.
- A hung parliament would result in a déjà vu experience with ongoing uncertainties and higher risk premia for UK assets as well.

Given that some of the good news has been priced in already, highlighted by the appreciation of trade-weighted GBP, only a few investors have seemed ready to further increase their exposure to the UK ahead of the election. This, in our view, sets the stage for a further rally in UK-focused stocks – and GBP – if Johnson wins. While some investors remained concerned about the prospect of a potential hard Brexit at the end of 2020 when the Brexit transitional period is scheduled to end (absolutely possible in our view), the election and its implications remains the most pertinent issue at hand for now and also for the start of the new year and well into H1 2020.

However, one should also continue to keep in mind the Brexit upset of 2016 and the poor performance of the opinion polls at predicting the outcome of the 2017 general election. With the good news already partly priced into GBP and UK equities, investors seem inclined to hold off increasing their UK exposure until the election result confirms expectations of a Johnson majority – a very sensible strategy in our view. While the risk of a hard Brexit at the end of January 2020 has declined significantly it can show up again at the end of 2020, although this may become a more real issue next year. Of course, after the relief trade for UK assets in case of a Johnson majority government, the Brexit-eternity issue might pop up again during the course of 2020, but markets are by nature more short-term orientated and the issue of the transition period and renewed negotiations of a EU-UK trade agreement etc. will be more a subject for H2 2020 then H1 2020. Hence, investors might consider jumping on the GBP train in case Johnson wins an absolute majority on December 12. But if they want to be "better safe than sorry" they should wait for the final outcome on Thursday night/Friday morning next week.

Table 2 summarizes our assessment of the likely impact of the UK election on financial assets.

Table 2: General election potential outcomes and macro/market impact

New Parliament	Likelihood / "Best guess"	Brexit uncertainties	Reform agenda	Policy uncertainties	Potential market implications
Clear Conservative Majority	75 %	Very low; "Johnson Deal" to get ratified; Brexit on Jan 31, 2020	Modest: Business friendly tax cuts, some deregulation	Rather low, some uncertainties during transition period with EU-UK-trade talks	GBP ⬀ Gilt yields ⬀ FTSE ⬀ FTSE250>FTSE100
Clear Labour Majority	5%	Still high: 2nd referendum proposed but vote options unclear, potential new negotiations with EU, outcome of 2nd referendum unclear	High: Extreme policy shifts across the board (regulation, taxation, nationalisation, centralisation etc.)	Very high: No quick Brexit fix, unfriendly business policy proposals likely to weigh on investment and consumption	GBP ⬂⬂ Gilt yields ⬀⬀ FTSE ⬂⬂ FTSE250<FTSE100
Hung Parliament (i.e. no majority for any party)	20%	Still high; Déjà vu of last 3 years or cross party compromise, but no deal Brexit still unlikely	Low or nothing as no decision to be expected by definition	Rather modest as big or radical shifts unlikely given parliamentary situation	GBP ⬂ Gilt yields ⇨ FTSE ⬂ FTSE250≥FTSE100

Source: Deutsche Bank Wealth Management. Data as of December 4, 2019. ⬀ high, ⬀⬀ very high, ⬂ low, ⬂⬂ very low, ⇨ sideways

05 Not the end of the story

A final warning: apart from the election result some uncertainties will persist even in the case of a convincing Tory victory. An orderly Brexit on January 31, 2020 reduces uncertainty by dramatically narrowing the range of scenarios for the UK's near-term economic and financial outlook. This is a big plus. However, it does not end the uncertainty about the final shape of Brexit – i.e. the future UK-EU economic relationship – which could remain a modest drag on business and consumer activity going forward in 2020 and beyond. The risk of a hard Brexit is therefore not fully off the table in case the EU and the UK fail to strike a deal on their future economic relations – that leaves open the risk of a hard Brexit at the end of 2020. Hence, investors enjoying a possible convincing Tory victory with a corresponding positive performance of UK risky assets should consider our well established moto – take profit and recalibrate during H2 2020 depending on news flows and political progress in the EU-UK trade talks commencing sometime during next year. Like it or loathe it, Brexit will stay with us in 2020.

Glossary

Article 50 refers to the process by which the UK is attempting to leave the European Union.

The Bank of England (BoE) is the UK central bank.

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

The UK Conservative Party is a centre-right political party, in power since 2010, often referred to as the Tories.

The EU27 refers to the EU membership excluding the UK.

Free trade agreements (FTAs) are designed to allow free trade in goods and services between countries but not free movement in capital or labour.

The FTSE 100 Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

The FTSE 250 Index includes the 10st to 350th largest companies on the London Stock Exchange.

GBP is the currency code for the British pound/sterling.

Gilts are bonds that are issued by the British Government.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The House of Commons is the lower elected house of the UK parliament.

The UK Labour Party is a centre-left political party, and is the main opposition to the Conservative Party.

The UK Liberal Democrats, or Lib Dems, are a centrist political party formed in 1988.

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