

# Research UK

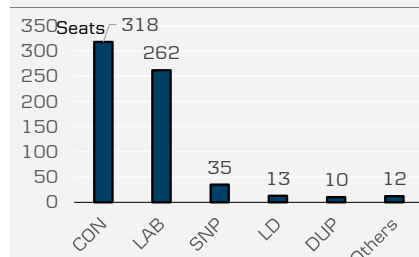
## Hung parliament adds government risk premium to GBP

- Hung parliament but the Conservative Party seems likely to form a minority government backed by the Democratic Unionist Party (DUP).
- The very slim majority makes it difficult for the new government to govern and it is likely to be put under pressure both by pro-Brexit and pro-EU forces.
- It is difficult to say what this means in terms of Brexit. The new government at least has some thinking to do about how it will proceed with the Brexit negotiations and whether or not to adopt a softer approach.
- Theresa May is currently considering her own position. Therefore, the Conservative Party may be thrown into a new leadership contest.
- A second Scottish independence referendum seems unlikely at this point given the SNP's loss of seats.
- With respect to GBP, we now have a 'government risk premium' on top of the 'Brexit uncertainty premium'. We target EUR/GBP in the range of 0.84-0.90.

Very much against expectations, Theresa May and the Conservative Party fell short of winning enough seats to win a clear majority in the House of Commons. Hence, we have a hung parliament with the Conservative Party as the biggest party. Still, the Conservatives may have won enough seats to remain in power, as Sinn Féin in Northern Ireland has said it will not take its seats (seven seats) and the DUP has said it is willing to cooperate with Theresa May (DUP won 10 seats). Jeffrey Donaldson, an MP from the DUP, has said, 'we have a lot in common, we want to see Brexit work, we want to see the Union strengthened. I think there is a lot of common ground'. See also [Reuters](#). Based on the current projections, we think it is likely that the Conservatives will form a minority government supported by the DUP but it will have a hard time manoeuvring in the House of Commons. It may take at least a few days to form a new government, as the Conservatives probably need to talk with the DUP. Given the very slim majority, it is possible that the new election term will not last the supposed five years, as the government will be weak, not least in connection with upcoming Brexit negotiations.

Theresa May's position has clearly weakened and there is some pressure for her to resign as leader, as the entire Conservative campaign centred on her as a person and her ability to be a stable leader in uncertain times. In her victory speech in her own constituency, Theresa May said that the UK now needs 'a period of stability' without saying whether she wants to stay or not. At least, it was quite interesting that May said that it is the Conservative Party's aim to ensure stability and form a government and not hers. Sources say it will be 50/50 as to whether she resigns or not. Brexit negotiations should have begun in 11 days' time but this seems unlikely given the Conservative Party has now been thrown into a new leadership contest.

Projected final result as of 07:00 CET



Source: BBC

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Although the polls showed the Conservatives' lead over Labour diminished throughout the election campaign, only a few predicted it would be this close. One reason is that the turnout among young voters – mainly Labour leaning – was higher than in previous elections. Despite the Conservatives winning some of the previous UKIP voters (UKIP totally collapsed from nearly 13% of the votes in 2015 to around 2% now), it was not enough for the Conservatives to increase the number of seats. Overall, the election was a major blow for Theresa May, as prior to it, she was close to 20 percentage points ahead of Labour and Jeremy Corbyn was viewed as a weak leader – now it is quite the opposite.

In Scotland, it is also interesting that the Scottish National Party lost many of the seats they won in the last election in 2015. This – combined with polls suggesting that the Scotsmen want to remain in the United Kingdom – makes it less likely we will get a second Scottish independence referendum.

### Brexit clock is ticking but we do not know whether a new government will change the 'hard Brexit' approach

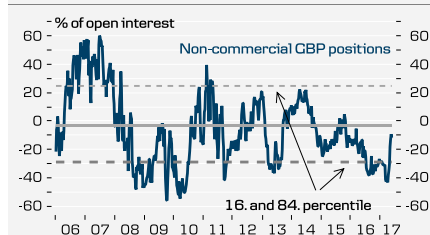
It is difficult to say what this means in terms of Brexit. On the one hand, this could be viewed as a rejection of Theresa May's hard Brexit stance with the UK leaving the single market and the customs union. However, given the election campaign was more about domestic issues like austerity, social care and education than Brexit, it may also be the case that Brexit voters have simply moved on to other issues, as they expect the government to move forward on Brexit. The new government at least has some thinking to do about how it will proceed with the Brexit negotiations and whether or not to adopt a softer approach. Unfortunately, time is short, as there is a sharp deadline by the end of March 2019, where the UK is due to formally exit the EU. No matter which Brexit approach the new government takes, the slim majority means it will be put under pressure both by pro-Brexit and pro-EU forces in parliament. One of the reasons for Theresa May to call for a snap election was to consolidate power within the Conservative Party and the House of Commons, making it easier for her to negotiate Brexit, but the election result has actually made it more difficult. One game changer could be more cooperation across the political centre between moderate Conservatives and moderate Labour MPs.

### GBP: worst-case outcome adds to Brexit risk premium

So far, the election outcome looks close to the worst possible for sterling – if any winner, it may be regarded the EU. The prospect of a hung UK parliament based on the first exit poll initially led EUR/GBP to jump above the 0.88 level last night but the knee-jerk reaction has been moderated a bit with the possibility of a Tory-led government that may just about get a slim majority and the cross is trading around 0.8780 at the time of writing.

What matters for sterling near term is the strength of the government that goes to Brussels to negotiate Brexit terms on behalf of the UK – and with any possible governing coalition set to be weak, so will GBP be. There is clearly a risk of EUR/GBP breaking above 0.88 again if the Tories fall short of even a slim majority. Notably, speculators covered GBP shorts ahead of the election, suggesting room for speculative GBP selling near term. What matters for the sterling longer term are the Brexit terms – and the prospect for these have not become more favourable following the present election result as negotiation power has essentially shifted from the UK to the EU. However, if the new government adopts a softer Brexit approach it may be GBP positive later on, but it is obviously very speculative at this point.

#### Speculative GBP shorts reduced significantly ahead of election



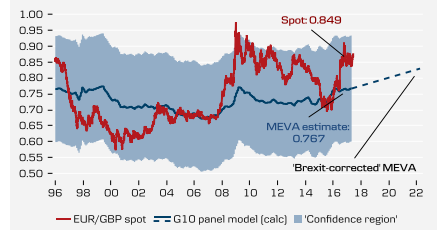
Source: Bloomberg, Danske Bank

Our Brexit-corrected medium-term valuation (MEVA) model estimate for EUR/GBP is around 0.83, which notably suggests that even when Brexit uncertainty is out of the way, GBP is not necessarily set for large-scale appreciation. But it remains too early to judge e.g. the implications for trade terms from this election outcome.

On top of the ‘Brexit uncertainty premium’, which has been haunting GBP markets since June last year, a form of ‘government risk premium’ has now been introduced for the very short term as well: almost irrespective of what government is formed, the UK will not be heading for Brexit negotiations with any great sense of confidence based on the election result as it stands at present, and this will weigh on the pound. We see EUR/GBP in the 0.84-0.90 range near term.

A wildcard for GBP would be a new election: while this would introduce continued uncertainty for the short term, it would also open up the option of a majority government after voters had their say again, and possibly be GBP positive eventually that way around.

**Danske MEVA model suggests Brexit-corrected EUR/GBP is 0.83**



Source: Eviews, Macrobond Financial, Danske Bank

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