BREWIN DOLPHIN 1762

Strong and stable? Not quite…

09 June 2017

The Conservatives fell just short of a majority but achieved enough to form a weak government but one that will have some semblance of stability. If you received our note earlier this week you will know that we certainly didn't call this but we did think it was a real possibility.

We're seeing a weak pound as a result but not on the scale of the Brexit aftermath, largely because the pound already represented good value after the sharp devaluation following the EU referendum.

What happens next?

The poor showing for the Conservatives means that they are going to have a majority in combination with the Democratic Unionist Party (DUP). This won't be as part of a coalition (as the Liberal Democrats did in 2010) but most likely on a *confidence and supply* basis. This means supporting the government or abstaining during confidence votes and finance bills but otherwise retaining their independence. Cooperating with a Conservative government should provide the DUP with an opportunity to influence Brexit negotiations, which would seem very valuable given the desire for a soft border with the Republic of Ireland.

What impact will this have?

This clearly isn't the increased mandate which Theresa May wanted. She called this election voluntarily, apparently to bolster her mandate for Brexit negotiations. She will now have to cede influence in those negotiations to a third party (the DUP). Despite this we understand that she has no intention of resigning, although whether the decision is taken out of her hands remains to be seen.

In the immediate aftermath of the election there has been a lot of talk about how this result might cause a softer Brexit. We suspect it doesn't change the Brexit position that much.

The Government's position, up until yesterday, had been that no deal is better than a bad deal and that some issues could not be compromised on. Specifically that the UK would regain control of its borders and be able to control immigration from the continent and also that the European Court of Justice would lose its supremacy over UK law. That seems likely to remain the case.

Another theory for why a softer Brexit might be more likely is that Labour outperformed by getting support amongst 18-24 year olds and critically motivating them to vote with turnout potentially as high as 70%. Is this because they objected to the Conservative hard Brexit rhetoric? Maybe, but their views on Europe didn't provoke a strong turnout in the referendum and, like the rest of the country, most have accepted the result even if they still don't consider it the best outcome[1]. But we suspect that Labour's spending pledges were what motivated the turnout this time, particularly the promise to abolish university tuition fees. If the Conservatives want to try and court this group then we suspect they would need to do so through tax and spending commitments rather than a different stance on Brexit.

Aside from Brexit there was some economic reassurance for markets in the poor showing for the Scottish National Party (SNP). This makes the chances of a second referendum on Scottish Independence less likely which will benefit the pound. UK bonds and the pound spent the morning fluctuating as they try to offset this silver lining against a more general sense of uncertainty that prevails while we wait to hear from the political protagonists.

1 YouGov Polling 26th-27th March https://d25d2506sfb94s.cloudfront.net/cumulus_uploads/document/glo3xaqerh/InternalResults_170327_AnthonyBrexitQs_W.pdf

How will this affect savers and investors?

The moves we've seen in markets so far today aren't as big as those we saw following the referendum result and are pretty modest compared with previous elections. Nevertheless the market has assumed weaker growth and reacted to the weaker pound.

- Bond markets are discounting lower interest rates or, given that rates are expected to remain at just 0.25% for the rest of this year and most of next year, more quantitative easing.
- The weaker pound will see inflation go higher but the impact will be dwarfed by the currency and energy moves of recent years.
- Large multinational companies have performed well while smaller companies and those which earn their revenues in the UK have underperformed.

Buying opportunity for smaller companies?

We've seen reactions like these to elections in the past and they typically work themselves out over the next couple of market days so we may be able to take advantage of the attractive pricing today among small and midcap stocks.

While many will think that the result is unexpected, it should not prompt knee-jerk reactions. Investors need to remain focused on the longer term. While there may be some volatility in the coming days and weeks, it will wash out of the market over time. This is not a time for precipitous actions.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.