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Weekly Note – May steps into the unknown

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Good Morning,

When it comes to negotiating the UK's departure from the EU, the current size of the government's majority (17 MPs) was always going to be an issue — especially with 50 or so Tory MPs in favour of a hard Brexit and unwilling to hear any utterance of the word 'compromise'.

Opposition parties, particularly the Lib Dems, will now make the case again for the UK remaining within the single market and having another referendum once the terms of the exit have been laid out. But, with the Labour party currently in disarray and polling (in a poll of the polls) around 15 points behind the Conservatives, and the Lib Dems still facing an uphill struggle to win considerably more seats, the 8th of June will likely see Theresa May elected with a larger majority. This will not only strengthen her hand at the negotiating table in Brussels, but should also see the influence of some of her own backbenchers vouching for a hard-Brexit being significantly diluted. It is critical to remember that a majority of Tory MPs actually voted to Remain, and will be keen that the whole process of the UK's exit is managed.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	3.64%	-0.88%	-0.53%
S&P 500	4.77%	-0.72%	0.03%
RUSSELL 2000	1.13%	-0.97%	0.98%
NASDAQ COMPOSITE	9.36%	-0.42%	0.87%
Euro Stoxx 50	4.65%	-1.64%	-0.77%
FTSE 100	-0.35%	-2.80%	-3.36%
DAX 30	4.83%	-2.26%	-0.86%
NIKKEI 225	-3.58%	-2.53%	0.02%
HANG SENG	9.35%	-0.23%	-0.13%
S&P/ASX 200	2.75%	-0.74%	-1.82%
EUR-USD X-RATE	2.33%	1.03%	1.40%
EUR-GBP X-RATE	1.69%	1.09%	1.14%
Gold Spot \$/Oz	11.70%	2.61%	-0.48%
Crude Oil	-5.88%	-0.08%	-4.80%

Tactically, opposition parties like the SNP are already suggesting that Theresa May's objective is to get a clear mandate for a hard Brexit, with more austerity. Logically, that makes entirely sound political sense (the 'scare' tactic). However, like the two ice-cream vans on the beach, the optimal strategy for May should be to take the centre ground and make the case for a Brexit that, in theory, works for everyone — even if the practice is likely to prove very

different. This implies a Brexit that is hard on the outside, but soft in the middle. Control of migration is important, but so is securing as much continuation of free trade as possible.

As things stood, matters could have rapidly come to a head after the German elections, at the EU Heads of State Meeting on the 19-20th October. These discussions will likely centre more on the need to settle, in principle, the divorce bill, before the conversation can move on to the new arrangements, once the UK has left the EU in effectively two years' time. With a working majority of only 17 reliable MPs and 50 or so of her own MPs unwilling to hear of any compromise, Theresa May's room for manoeuvre could have been severely limited. A period of heightened political uncertainty was likely to have ensued, with the risk of negotiations breaking down a near inevitability.

However, with a larger majority at her disposal after the snap election, May's hand would be significantly strengthened. Rather than leading to a hard-Brexit, this arguably increases the odds of the whole process being better managed — especially if a diminished opposition actually becomes more effective. Moreover, the fact that Theresa May is seen to take big political risks will not go unnoticed in Brussels, which again will probably help behind the doors of the negotiation room. In any negotiations, threats become much more credible if the other side is seen to be content to walk away.

Of course, the situation remains volatile and a lot could change in the coming weeks. Much more will be known of the government's true intentions once the manifestos are published over the next few weeks. In the interim, we have the UK's local elections on 4th May, which may well see swelling support for the Lib Dems.

Moreover, it is also important to remember that whatever the result on 8th June, with Article 50 triggered, the Brexit clock is now ticking and the balance of power lies with the rest of the EU. The whole process will be long and torturous, with transitional arrangements certainly a necessity. The UK economy may have continued to hold up relatively well (likely another important reason why Theresa May felt emboldened to call a snap election), but real incomes are still in the process of being squeezed, the household savings ratio is at a multi-decade low and uncertainty will likely hold back investment decisions. Similarly, the results of the French and German elections could, of course, change everything.

Sterling's pop on the foreign exchanges markets is certainly consistent with that asset class buying into the scenario of a soft Brexit. For the BoE, this remains a double-edged sword. A stronger sterling underlines confidence in the British economy, but at the same time, a weaker exchange rate is still needed to help rebalance the economy and further reduce the size of the current account deficit.

Brexit will certainly feature heavily in the forthcoming campaigning, but as much as the Liberal Democrats and UKIP would like for it to be the defining issue with 8th June on the doorstep, the election will be decided on a broader set of priorities. Looking at the latest polling by YouGov, for example, Brexit features as the single most important issue facing the voters, but this is also tied into concerns about the state of the economy and immigration. However, the general public is also heavily focused on the NHS — one of the few areas of domestic policy where Labour is seen to be more competent than the Conservatives; and education — where the cuts to school budgets are putting the government's policies under the spotlight.

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