Investment Strategy Note

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UK snap elections - what it means for our UK large cap hedged equity call

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- **Yesterday British Prime Minister Theresa May surprised markets by calling a snap general election scheduled for June 8**
- **Pound sterling strengthened sharply on the back of expectations that Mrs May will be able to strengthen her position, thereby side lining hard-line Brexiters inside her own party**
- **A stronger pound is negative for UK large cap corporate earnings, and therefore also for our overweight call on UK large caps (currency hedged)**
- **However, we believe it is too early to call a permanent inflection point in the currency**

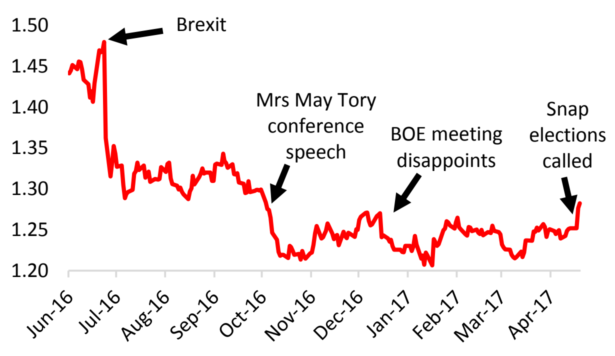
Investors' first reaction suggests "Soft Brexit" now likely

Yesterday British Prime Minister Theresa May announced snap general elections to be held on June 8. The decision comes just 3 weeks after the Prime Minister began the formal Brexit process. Mrs May painted the decision to hold elections as a necessary one to give her the required backing to steer the UK through the Brexit process.

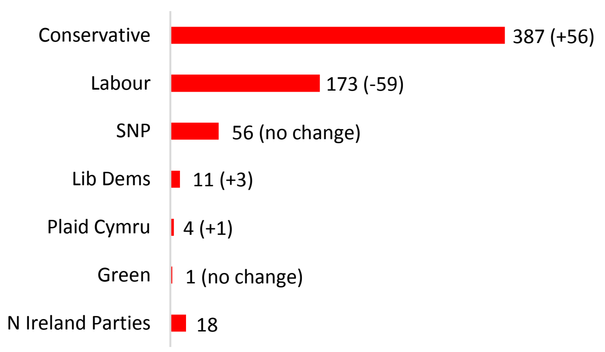
The initial market reaction saw a drop in the value of the pound followed by a sharp strengthening to 1.2850 vs. the US dollar. The reaction in the currency suggests that the initial expectation is that this news makes a "soft Brexit" more likely, meaning a more amicable outcome between the UK and the EU (which is GBP positive). The reason for this belief is that Mrs May is expected to win the election and increase the majority her conservative party holds (see chart below from the FT). By strengthening the party Mrs May will be able to dilute the influence of so-called "Brexit hardliners" within her own party who have been pushing her towards a "hard Brexit". The reaction in UK government bonds (gilts) was more muted, which is to be expected given bond yields are to a large extent influenced by Bank of England's quantitative easing program. Yields are therefore suppressed and much of the volatility spills over to the currency.

For our GBP-hedged overweight call on UK large caps GBP strength is damaging. The call is based on the assumption that the endgame of the Brexit saga is going to be a "hard Brexit". A hard Brexit would lead to sustained GBP weakness which in turn would boost earnings for the UK-listed companies, given that these derive (in aggregate) around 70% of their revenues from outside of the UK. **Thus the key question we need to address following yesterday's announcement is whether a "softer" Brexit is now more likely (which would mean a stronger pound and more lackluster UK corporate earnings). Whilst we believe that the probability of a softer Brexit has indeed risen, we still think that a "hard Brexit" is still the most likely final outcome. Thus we will need to monitor the developments closely. Before yesterday's announcement the call was +9.7% in total return terms since inception, today it has fallen to +7%.**

Pound sterling and politics (GBP vs. USD)



June 8 2017 general election expectation based on average of most recent polls



Source: ADCB, Thomson Reuters, FT, PA

From a purely political standpoint, Mrs May and her Conservative party are very likely to win the election. The opposition Labour party are in a state of disarray which has few historical precedents while the smaller Liberal Democratic Party is hardly in a position to pose a meaningful threat to the ruling party. It follows that Mrs. May's position will be much stronger as of June 8: she will have been elected directly by the people, thus she is less likely to face internal rebellion and therefore has a very good chance to remain prime minister at least until June 2022 (when the subsequent elections would be normally scheduled). Will a stronger domestic hold on power also translate in a stronger bargaining position with the EU? We doubt it, since the EU's incentives to eventually accommodate to British requests are going to be entirely dictated by EU-internal pressure groups, not by the British PM (independently of whether she is more powerful at home).

The next question then to ask is whether a more powerful Mrs. May is going to be more or less inclined to strike a deal with the EU, and thus steer the country towards a "softer Brexit"? We would argue that the probability of a "softer Brexit" would definitely rise if Mrs. May gets re-elected as we expect. She was after all a (not so enthusiastic) remainer during the Brexit campaign who found herself forced to embrace a hardline Brexit cause by powerful members inside her own party. However, whilst the probability of a "softer Brexit" might have risen (thus also explaining the strengthening of the pound sterling), it seems to us premature to conclude that it has become the most likely outcome (i.e. a probability in excess of 50%). Indeed, we believe that a "hard Brexit" is still more likely than a "soft Brexit". This is so because the EU still holds stronger cards at the negotiation table and nothing that happened yesterday has changed the EU's bargaining position or inclination to accommodate Mrs. May (in that regard it will be far more important to see how the French and German elections play out). Thus, based on the strength of the EU's bargaining position, the only way for Mrs. May to avoid a hard Brexit would be to give in on the issue of freedom of movement of people. We don't think that even the more powerful Mrs. May would be ready to do that.

Certainly for our hedged UK large cap overweight call the sharp move in GBP has hurt. But we maintain that it is too early to draw a firm conclusion on the direction of the currency beyond the initial snap reaction. It is also worth noting that initial reactions to recent political events have been the wrong ones. Think of the large sell-off in equities on the day Mr Trump was elected only for equities to embark on a 5-month winning streak.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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