
# Election surprise sends UK into a tailspin

*Brexit negotiations up in the air while Middle East tensions escalate.*

News Analysis

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For the second time in 12 months, we have witnessed a political outcome in the UK, which will come as a surprise to many, with a hung Parliament exposing the regional and generational splits across the country. Our initial assessment is that Theresa May is very likely to leave and new elections will probably be called at an early opportunity, as we see little scope for a workable majority. In more ordinary times one would not want to become overly exercised by such a prospect, but with the Brexit clock ticking, the UK seems to be in a difficult constitutional position. We continue to take a negative view on Gilts and the Pound and continue to contrast an economically and politically strong and stable eurozone versus a weak and wobbly UK. Ultimately the election result may make a hard Brexit less likely, but in the very short term we expect international investors to shun a country, which remains dependent on attracting overseas capital against the backdrop of twin fiscal and current account deficits.

Meanwhile in the eurozone, Mario Draghi continued to deliver a dovish message at this week's European Central Bank (ECB) meeting, reiterating the Board's commitment to ongoing asset purchases. Growth estimates were revised up slightly, whilst inflation was revised lower and although the ECB changed its assessment of risks to neutral, those looking for signs that policy is about to follow a more restrictive course, were left broadly disappointed. We continue to believe that the ECB will continue its asset purchases through 2018 at a reduced pace and that communication around this will be forthcoming at the September ECB meeting when quarterly forecasts are next updated. More generally it feels that the eurozone is currently benefitting from improving growth prospects, benign inflation, accommodative policy and decreasing political risks and all of this should make for a constructive backdrop for assets in the region.

Politically speaking, our policymaker meetings continue to suggest a growing rapprochement between France and Germany at this time, with Macron building a team of German speaking deputies, who appear to be laying the groundwork for a renewed strengthening of the Franco-German axis at the heart of the eurozone. We believe that budgetary co-ordination and a possible pathway to common Bill issuance could be an important step forward for Europe in the months ahead and in the shorter term, Macro's hand should be strengthened by a dominant showing for his En-Marche party at the upcoming parliamentary elections. Further south, political developments in Italy have been a particular focus in the past week. We continue to rebut the idea that elections will take Italy towards an 'Italexit' referendum and continue to believe that the 5 Star Party continue to moderate their thinking around the EU; as has been seen by populist parties such as Syriza in Greece and more recently Front National in France, which has dropped the notion of Frexit from its manifesto, as one of the principal contributors to a poor election showing by Le Pen in this years' vote.

Elsewhere globally, geopolitical risk returned to the fore during the past week, in a dramatic spat between Saudi Arabia and Qatar. It can be interpreted that following the recent Trump visit to Riyadh, the Saudi regime has felt emboldened to call out Qatar for its rapprochement towards Iran and support for political and 'militia' groups across the Middle East and that this will play out as a short lived slap across the knuckles for a country, which has tried to punch above its weight in the region. However, with Turkey being drawn into the equation, there is a risk that this leads to a more problematic regional stand-off with Iran, Russia and the US drawn into a regional power struggle. We see this risk as relatively remote for the time being, partly as too many countries have too much to lose from an escalation of hostilities, but what we are witnessing in the region underscores our view that the Middle East and the Gulf look intrinsically unattractive from an investment risk/reward perspective and that a short position in Saudi riyal looks to be an attractive hedge, as its budgetary position continues to deteriorate.

Notwithstanding events in the Middle East, an absence of firework's in Comey's testimony on Trump saw a flight to quality trades unwind, with US stocks continuing to flirt with yet new record highs and credit spreads edging tighter. In Europe, the write down of equity and subordinated debt in a Spanish lender following a takeover by a larger Spanish lender, was the focus for credit markets in the past several days. In different times, the news that tier 1 and tier 2 debt holders would receive nothing for their bonds could have led to contagion risks across markets, yet investors instead read these moves as evidence that the system was working as it had been designed to and after a short dip, both financial bonds and equities traded high on the day of the takeover announcement. We continue to maintain a constructive view on subordinated bank debt in the eurozone and believe that the treatment of this situation should demonstrate that the spread relative to tier 2 debt should trade at a much tighter premium than is currently the case.

As we head towards next week's crucial Federal Reserve (Fed) meeting, it is striking to reflect that strength in stocks and weakness in the US dollar have all conspired to mean that broad financial conditions today are now easier in aggregate, than they were when the FOMC hike back last December. We continue to view a rate hike in June as a formality and believe that the median dots should be little changed compared to the March meeting. We believe this would infer a further four hikes from July through December next year and with markets currently only discounting one of these moves, we feel that such an outcome could offer a hawkish surprise. Of course it is possible that Yellen takes a dovish course and focuses on low levels of inflation, but in contrast to the ECB, the Fed sits with unemployment at 4.3%, inferring an economy at full employment and with real interest rates still in negative territory. All said and done, we continue to believe that we are in a benign, low volatility and pro-carry environment. Higher US rates continue to look like the biggest risk to this world view, so as we assess the week ahead, the question we will really want to see an answer to, is whether Janet does anything to hurt Goldilocks or whether we continue to look for a summer of sun.

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