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Amundi ASSET MANAGEMENT

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UK election could pave the way for an orderly Brexit and a rebound in equities

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- ***Possible scenarios:*** *The possibility of seeing a smoother, faster Brexit will depend on the outcome of the UK election on Thursday, 12 December.*

SCENARIO 1	SCENARIO 2	SCENARIO 3
Tories secure an absolute majority	**Labours lead a coalition of opposition parties**	**Hung Parliament**
The UK can exit the EU smoothly in January 2020. Minor risk of another "Brexit cliff" at the end of 2020, if Tories wil not seek an extension.	Another Brexit extension followed by a second referendum. Hard Brexit will likely be ruled out.	A referendum may also be the most likely consequence, although it will take more time and stress before it is decided. Fears of hard Brexit may resurface and as the 31 January Art. 50 deadline gets nearer.

Investment implications: *Based on the potential for a Conservative government, we* ***believe that the probability that a Brexit deal is ratified is now about 80%.*** *As alternative scenarios, there is also the lower potential that the UK remains in the EU (15%) or of a Hard Brexit (5%). Under the main scenario, the* ***10Y Gilt yield could move up from the current levels, remaining below 1% at the end of 2020****. We still see room for the GBP to rebound in the short term, although the outlook for the medium term is less compelling.* ***On the equity side, a stable government could drive a re-rating of the UK market,*** *which is currently trading at discount to the EU and global markets. We remain positive on the more UK-focused domestic names: house builders, consumer discretionary stocks and financial companies.*

What are, in your view, the possible outcomes and associated probabilities for UK election?

Polls imply a comfortable lead for the Tories and **the most likely outcome is that the party will secure an absolute majority in Parliament**. However, due to the first-past-the-post system, British elections are notoriously difficult to predict: in the past, polls have failed spectacularly to predict the correct outcome several times. If the Tories do not obtain a majority, given it would be difficult for the party to find coalition partners (reaching agreements with the Democratic Unionist Party [DUP] or Brexit Party would not be easy; moreover, is not certain that the latter will see any candidates elected as Members of Parliament), **we see two main alternative outcomes.** First is a coalition of opposition parties led by the Labour Party, as it seems very unlikely that Labour will win a clear majority. Despite their dislike for J. Corbyn, the LibDems and SNP could choose to share power with Labour so that a second referendum on Brexit could occur. The second alternative outcome is another hung Parliament, a problematic outcome but one that cannot be ruled out.

"UK election will not end Brexit process, but depending on the outcome, the path could be smoother or harder".

How would these potential outcomes impact Brexit?

In Scenario 1 of an outright Tory victory, the ratification of the October Brexit agreement will very probably be fast-tracked so that the **UK can exit the EU smoothly at end-January 2020**. Remember, however, that this will not be the end of the Brexit process. A trade deal will then have to be negotiated with the EU. Before July 2020, the EU and the UK will also have to decide whether to extend the transition period (during which the UK will retain most of its access to the EU Single Market) beyond the end of 2020. In its manifesto, the Conservative Party stated that it would not seek such an extension. In theory, this could create another "Brexit cliff" risk at the end of 2020 (ie, the UK is abruptly cut off from the Single Market), although we believe that solutions will be found to smooth the transition to a new trade regime, which may take years to be fully negotiated and implemented.

In Scenario 2 of a majority coalition of opposition parties, **we will very likely see another extension regarding Brexit, followed by a second referendum**. Labour says it wants to negotiate a "softer" Brexit deal with the EU, and then give voters the choice between that other deal and *Bremain*. If this is indeed the alternative brought to voters (assuming other opposition parties agree to this strategy, and considering that the EU would probably accept it as well) it will de facto rule out any "Hard" Brexit.

In Scenario 3 of a hung Parliament, a referendum may also be the most likely result, although it will take more time and stress to be decided than in Scenario 2. In that event, the current minority government will probably soldier on and there will be tense negotiations with the EU and new fears of a Hard Brexit as the 31 January Art. 50 deadline gets nearer. While a worse scenario cannot be ruled out, we believe that all parties may well decide that a second referendum is the only way to resolve the gridlock.

"UK is moving to a more supportive fiscal stance after years of austerity".

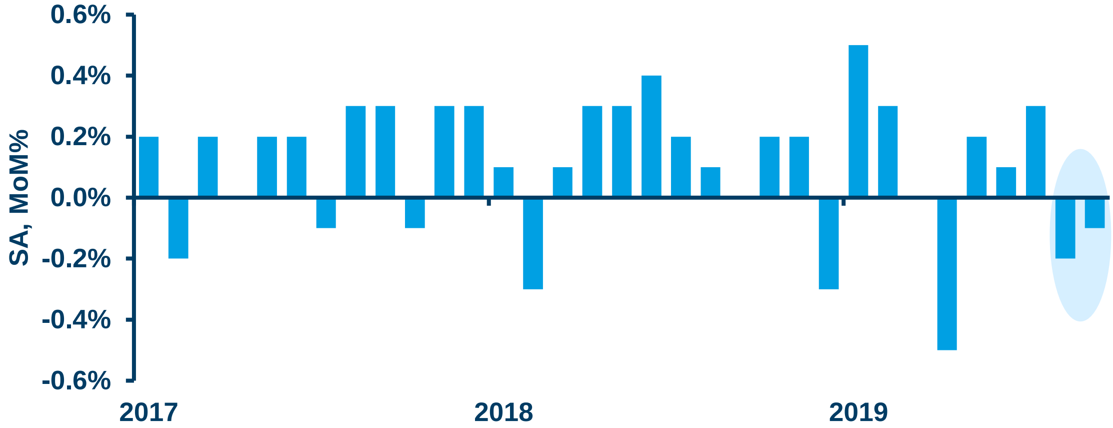
Do you expect any change in the attitude of the new EU commission on Brexit?

In Scenario 1 of a Tory victory, followed by an orderly Brexit, the new EU Commission, unlike its predecessor, will have to negotiate not the "official" Brexit but the future trade deal with the EU. It will have to reconcile two goals, which are first to ensure ongoing smooth trade with the UK and second to ensure that the UK does not negotiate better conditions outside the EU than when it was inside. These two goals will more or less be the same if a Labour-led UK government wants to negotiate a "softer" deal with the EU. In all cases, however, note that a trade deal with the UK is a too large and strategic topic for the EU Commission to completely handle the process, which will be heavily, monitored by the governments of large EU countries.

What is your view regarding the UK economy based on recent data and what do you see as the outlook for next year?

Brexit has weighed on 2019 economic activity, with a lot of volatility due to precautionary spending. Conditional on a smooth exit at end-January 2020, **we forecast UK GDP growth of 1.1% in 2020, with significant upside risk to that number**.

UK GDP Growth



Source: UK Office for National Statistics, Amundi. Data as at 11 November 2019

While new stress may arise (which will, in our view, be only temporary) regarding what happens at the end of the transition period, the relief that a Hard Brexit was avoided in 2019 will be positive for investment. Furthermore, it appears that the UK may also be moving towards more supportive fiscal policies after years of austerity.

INVESTMENT IMPLICATIONS

Based on the possible electoral outcomes, we believe that the likelihood of seeing a Brexit deal ratified is now about 80%. That likelihood falls based on other potential outcomes: the UK remaining in the EU (15%) and Hard Brexit (5%).

Brexit scenarios and possible investment implications

Scenarios	**Ratified Brexit deal**	**UK remains in the EU**	**Brexit without a deal**
Probability	**80%**	**15%**	**5%**
GBP/USD (range)	1.35 – 1.40	1.40 – 1.45	1.10 – 1.20
Stocks	Positive absolute and relative return	Very positive absolute and relative return	Negative absolute and relative return
10Y Gilts	Fiscal spending leads to higher yields, BoE not able to cut rates	EU Budget constraints keep yields low, dovish BoE	Higher yields as weak FX does not allow rate cuts & possible downgrade
Corporate spread	Modest tightening	No change	Widening in € and £; UK consumer & auto worst off from FX

Source: Amundi Research, 10 December 2019.

FIXED INCOME AND FX VIEWS

What will be the driving forces for UK rates, in your view?

Since the referendum in June 2016, 10Y Gilts have traded in a range between 0.50% and c. 1.5%. With a backdrop of strong global growth, economic data have held up relatively well, with PMIs expanding and buoyant consumer spending fuelled by solid wage and credit growth. The ebb and flow of rates (and of sterling more broadly) were predominately driven by the perceived "hardness" of the Brexit outcome.

"10Y Gilt yields should move up slightly, but remain capped below 1% in 2020".

The tide has now turned and business surveys continued to weaken into the fourth quarter, even if they are not yet pointing to a contraction in GDP. Both the Brexit Party and the Liberal Democrat have lost support, with the Conservatives maintaining an estimated 10% lead over the opposition Labour party. While a polling error on the scale of 2017 does not preclude a hung Parliament, a Conservative majority capable of passing the proposed withdrawal agreement should remove some uncertainty. In this context, **Gilts would be at the lower end of their post referendum trading range and should move up towards the middle of their range in the "post-election" period**. Farther out, there is increasing evidence that job vacancies are becoming less plentiful, wage growth is waning and residential and commercial property prices are stagnating. The damage is already done: if the withdrawal agreement forced firms to delay hiring (transfer staff) and investment, the Free Trade Agreement "negotiation" will be at least as gruelling.

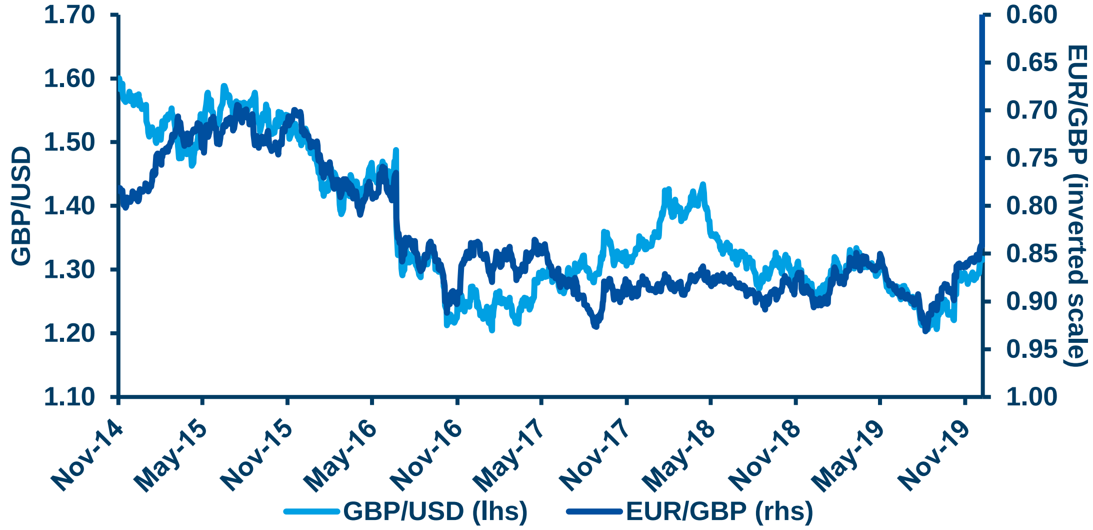
"We think there is still room for the GBP to increase from the current level (1.35-1.40 vs the USD) if the election results in a stable government and Brexit plays out smoothly".

We believe Gilt yields will continue to be capped well into 2020. Our forecast are for 10Y yields below 1% in December 2020.

What is the GBP pricing in and what is your current view/positioning?

The GBP long trade is the favourite and probably most conviction trade of hedge funds. There are many GBP long positions of so-called fast money in the market. But, there is also significant scepticism in the medium term on what might happen given all the negotiations that will have to start after the election, and the economic data has been deteriorating significantly. Therefore, many observers are expecting a positive kneejerk reaction for the GBP if the Conservative Party wins a majority, but then there is also the risk of profit-taking afterwards: a typical buy the rumour/sell the fact situation. Therefore, many investors are already considering taking profits on long GBP positions. **We think that there is some more room for the GBP to move higher** as long as the polls continue to show a Conservative majority as the outcome and then, after the election, if it is certain that the new government will be stable. We expect to see a wave of profit-taking and a lower GBP after that as the medium-term outlook for the GBP is not supportive. In our view, investors should remain only moderately constructive on the GBP, ready to review the situation if alternative scenarios, not priced into the market, of a hung Parliament or an unstable government, play out.

GBP vs USD and EUR



Source: UK Office for National Statistics, Amundi. Data as at 10 December 2019

EQUITY MARKET VIEWS

What impacts do you see from UK election results on the UK equity market and why?

"Markets expect a Conservative government: if this does not play out, it could represent a negative surprise".

The markets are clearly highly sensitive to political events, and the outcome of the UK election will be important. Political uncertainty has been high in the UK and in Europe since the 2016 Brexit vote.

In the event of a Conservative victory, we expect an agreement on Brexit based on what Boris Johnson has outlined, which would be positive for markets. **It could be the trigger for a re-rating of the UK equity market,** which is currently trading at discount to the broader European market due to Brexit-related risks.

A Labour victory, on the other hand, could increase uncertainty around Brexit and raise new uncertainties given the Labour rhetoric about business in the UK.

Market expectations, now, are clearly for a Conservative victory. If this does not play out, it could represent a negative surprise for markets. Importantly, we expect political risks to remain

"We remain positive on the more domestically focused UK names: house builders, consumer discretionary stocks and financial companies".

elevated even after the UK election. Even an agreement on Brexit could lead to extended uncertainty about how Brexit will actually play out.
As the UK could benefit from fiscal expansion and reduced 'no-deal' Brexit risks, we do expect some improvement in UK domestic activity in the near future, looking for a recovery in business and consumer confidence from what are relatively depressed levels.

Investors' positioning on UK equities seems particularly light at present, as outflows have been almost uninterrupted since the EU referendum of June 2016. Within this, UK domestic exposure (proxied by FTSE250) has seen the bulk of the outflows while the more internationally geared FTSE100 has seen inflows.

We remain positive on the more domestically focused UK names for which earnings will not solely depend on the strength of sterling. To be more specific, we are very constructive on UK domestic house builders, consumer discretionary stocks and financial companies.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

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Definitions

- **Correlation**: The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **First-past-the-post**: An electoral system in which voters indicate on a ballot the candidate of their choice, and the candidate who receives the most votes wins.
- **Curve steepening/flattening:** A steepening yield curve may be a result of long-term interest rates rising/falling more than short-term interest rates or short-term rates dropping/raising more than long-term rates.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

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