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Theresa May's Shock Defeat Threatens Further Volatility

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In the sort of unexpected twist that observers have come to expect from elections recently, UK voters have dealt a bitter blow to Prime Minister Theresa May, robbing her of her narrow parliamentary majority. With further financial market volatility on the horizon, David Zahn, head of European Fixed Income, Franklin Templeton Fixed Income Group, offers his view of the situation.

Theresa May's gamble didn't pay off. She had hoped that a resounding election victory and an increased majority in the House of Commons would give her a mandate to pursue her own political agenda and, in particular, strengthen her hand in negotiations to secure the United Kingdom's withdrawal from the European Union (EU).

But those plans are in tatters and instead, slightly less than a year after the country voted to leave the EU, the United Kingdom has been plunged into further political uncertainty.

We expect the pound to plummet and gilt yields to decline as investors embark on a so-called flight to safety. Overall, we think so-called risky assets, such as equities, are likely to underperform.

Much-Needed Focus

The prospect of a hung parliament, resulting either in a minority government or a coalition, paints a picture of an administration not in complete control during a period in which the United Kingdom needs its most focused administration for 70 years.

More Scrutiny on Brexit Strategy

Instead of securing an easier passage for any Brexit deal, as May had hoped, this result increases the likelihood of Members of Parliament (MPs) more aggressively scrutinizing the Brexit progress. It also raises the possibility of Parliament rejecting an unpopular deal.

In our view, that result would significantly tie the hands of UK negotiators. MPs would be more likely to demand more transparency on the UK side of the negotiations, which will be a boon to the EU negotiators. This is likely to make the prospect of a deal that is beneficial to the UK tougher to achieve.

The Clock Is Ticking

The harder it is for the UK government—whatever its hue—to negotiate, the more likely we anticipate a "hard Brexit" scenario to be, leaving the United Kingdom without a deal to replace the current European trade agreements.

That outcome would likely result in the pound selling off further and UK bond prices surging. And although that prospect might seem some time off, yet, it's worth remembering that the clock has already started ticking, and there are only 20 months left. We're four months into the Brexit process and have officially accomplished nothing as yet.

Worryingly for the UK authorities, this election result is likely to play into the hands of the EU's Brexit negotiators. They will see the UK doesn't have a strong leader to negotiate with and could be emboldened to take a tougher line.

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