

FIXED INCOME

New UK Prime Minister Boris Johnson Faces Challenges at Home and Abroad

July 24, 2019



David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group®

Boris Johnson, one of the most enthusiastic supporters of Brexit, is the United Kingdom's new prime minister. David Zahn, Franklin Templeton's Head of European Fixed Income, doubts Johnson will have much of a honeymoon period in the new role as he faces stiff challenges domestically and internationally, with global markets scouring his every move.

As expected, Boris Johnson won the UK Conservative Party leadership race and with it the keys to 10 Downing Street.

But as he looks to establish his administration and set out a policy agenda over the coming weeks, Johnson faces profound challenges and scrutiny both at home and abroad.

He enters Downing Street at a time of heightened international tensions between the United Kingdom and Europe over Brexit, but also in the Middle East, where the UK relationship with Iran has deteriorated dramatically in recent days. All of these considerations are likely to have significant implications for markets.

Markets Respond to Johnson's Victory

We've already seen some market movement in response to news of Johnson's leadership victory, and we expect volatility to continue for several weeks as he builds his government.

Yields on 10-year Gilts are around 70 basis points (bps), or 0.70%,¹ reflecting an overall decline in yields globally but also weaker UK growth numbers.

While 0.70% 10-year Gilts may not sound attractive to investors, we'd expect to see that number go much lower in the event of a no-deal Brexit.

The pound has also come under pressure against the US dollar and euro, again reflecting concern about the possibility of a no-deal Brexit.

Sterling weakness has prompted some interest from investors outside the United Kingdom who consider it cheap. So, we think any sterling selloff in the event of a no-deal Brexit might not be as much as people think, and/or it could be a quick selloff followed by a swift rebound.

Uncertainty over Brexit is continuing to weigh on UK corporate credit valuations. That is probably going to persist for the foreseeable future until we have some resolution of Brexit.

Still, we see those valuations as an opportunity to own names that are internationally focused (those whose exposure to the UK is minimal), or companies that are focused on the UK domestically. We recognize the UK economy will not disappear completely post-Brexit.

Brexit Countdown Continues

Meanwhile, time is ticking away. Johnson has less than 100 days to find a solution to Brexit, a problem which persists despite three years of negotiation between the United Kingdom and the European Union (EU).

We think no-deal is now a much more likely scenario because it will be one of Johnson's negotiating points. But just as the United Kingdom is entrenching its position, so the EU could take a tougher line under European Commission President-elect Ursula von der Leyen.

Europe has a reputation for taking an "extend-and-pretend" approach of kicking the can down the road, but could force a no-deal exit, simply by refusing to extend Brexit further.

Holding the Party Together

Johnson inherits a government with a razor-thin majority and will need to ensure he can maintain the unity of the Conservative Party if his administration is to survive. If only a handful of Conservative members of parliament (MPs) were to withdraw their support or even switch party, he'd lose that majority, potentially sparking a general election.

We expect to see a radical overhaul of his cabinet. Quite a few prominent Conservative politicians who seem implacably opposed to Johnson's agenda are moving from front bench positions to the backbenches where they can more freely articulate their views.

As a result, the new cabinet will likely be dominated by Brexiteers. Johnson cannot have as politically diversified cabinet as Theresa May did because he cannot afford to have waves of resignations every time a disagreement over Europe occurs.

The tenets Johnson set out in his leadership campaign are very much the sort of business-friendly, tax-reduction ideas that we'd expect from a center-right party.

However, with other considerations to address in short order, we expect a period of extreme uncertainty over policy from the UK government.

Johnson's cabinet will be working hard over August to bring a plan to parliament when it returns from summer recess in September.

But in the meantime, we expect volatility to remain the central theme for European markets.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the [Beyond Bulls & Bears](#) blog.

For timely investing tidbits, follow us on Twitter [@FTI_US](#) and on [LinkedIn](#).

Important Legal Information

The comments, opinions and analyses expressed herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

Data from third-party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FTI affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

This information is intended for US residents only.

What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments.

[1.](#) A basis point is a unit of measurement. One basis point is equal to 0.01%.