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INDEPTH

RESEARCH NOTE

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UK election: déjà vu

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- REGIONAL PORTFOLIO CONSTRUCTION

In this edition of *Indepth*, Daniel Murray, Chief Economist, EFG, examines the UK's snap general election on 8 June – the background, the polls and what the outcome could mean for the markets.

Introduction

Thursday's general election will be the third time in as many years the UK electorate will have been asked to cast their votes. Some people were additionally invited to vote in local government elections in May. So voters could be forgiven for having election fatigue. And yet this election is one that elicits strong feelings across the entire country. The reason, of course, is that the outcome will determine which party leads the UK in its negotiations regarding withdrawal from the EU, something that will impact the nation for decades to come.

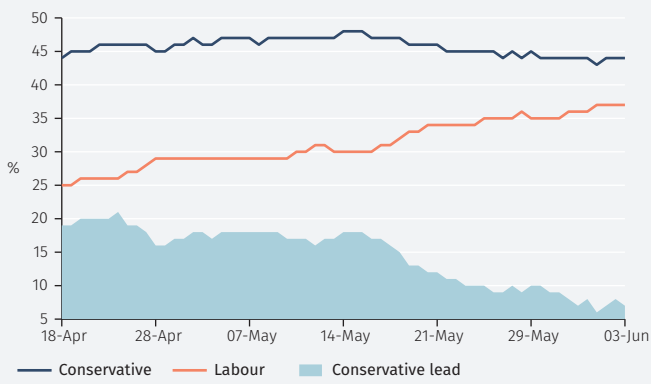
Polls

A cynic would say that Theresa May, current Prime Minister (PM) and Conservative Party (Tory) leader, called the general election not because she wanted a stronger mandate for negotiating Brexit, as claimed, but because the Conservative Party were so far ahead in the polls that the opportunity to inflict a crushing defeat on the opposition was too great to resist. Indeed, when previously asked about the possibility of a snap election, the PM had always indicated that it was not going to happen. As shown in Figure 1, when the election was announced on 18 April, the polls gave the Tories a lead of around 20% over Labour with the pollsters also predicting a large increase in the Tory majority in the House of Commons.

This is important because at the moment the Conservatives hold only a slim majority. The implication is that the Prime Minister is dependent on support across the entire party to pass legislation, something that may be hard to achieve for controversial bills. In particular, it raised the prospect of a handful of Conservative MPs holding the government to ransom over issues associated with Brexit. So, cynical or not, May could be excused for wanting to strengthen her and her Party's position.

The polls also show that the Conservative lead in the polls has fallen dramatically over the past few weeks. Some recent polls are even predicting a hung parliament where no party has an overall majority.[1] Whilst there has been variation in support for all parties over the sample period, it is notable that support for the Tories has been more stable than that for the Labour Party. It is true that a part of the reason

1. UK general election polls: seven-day averages



Source: BBC, EFG calculations

for the fall in the Tory lead is because of an associated decline in their polling support but the steady increase in Labour Party popularity has been the dominant factor. For example, taking the average of the last seven polls shows Conservative Party support has declined from a peak of 48% in mid-May to the latest value of 44%, whereas Labour Party support has risen much more dramatically from a low of 25% at the start of the campaign period to 37% at present. The big losers over this time period have been the Liberal Democrats (down to 8% from 11%) and the UK Independence Party (down to 4% from 8%). With the two largest parties committed to delivering Brexit, support for the latter has dwindled.

As was evident with regard to the UK general election of 2015, the US presidential election of 2016 and, to a lesser extent, the UK Brexit referendum of 2016, we should not place blind faith in the reliability and accuracy of the polls. Potential problems have been identified due to the age distribution of respondents, the way questions are phrased, whether the polls are conducted through telephone or the internet, turnout rates and interactions between these and other inherent biases. Furthermore, as ever when using a relatively small sample (most polls are based on between 1,000 and 2,000 responses) to predict the actions of a very large number of people. There is always a degree of error even if the previously mentioned problems are mitigated against.[2]

[1] See YouGov poll and associated seat projections 31 May 2017.

2 In the present case, the margin of error is about 3%

Our expectation for the 2015 UK general election for a second consecutive hung parliament was both consensus and incorrect and, like the majority of commentators, we were also wrong-footed over the outcome of the US presidential election. However, there are good reasons to believe that Theresa May's Conservatives will prove victorious in the UK general election this week:

— All the polls show the Conservative Party ahead, albeit with a narrowing and variable lead;

— There is a known bias for the polls to underestimate the share of the Tory vote, sometimes called the shy Tory effect;[3]

— The Tories performed exceptionally well in the recent local government elections, gaining 563 councillors on a +8% vote swing;

— May's approval rating is much higher than that for Jeremy Corbyn, the Labour Leader;[4]

— The economy is performing well. People are employed, house prices are holding up and growth is relatively robust, reinforcing support for the status quo.

Putting all this together strongly endorses the view that the Conservatives will gain the largest share of the vote and the most seats in the House of Commons following this Thursday's election. The bigger question and the one that is most important for the upcoming Brexit negotiations (due to start just 11 days after the election) regards the size of the Tory majority. This is also what markets are most interested in.

Election outcome and market impact

Prior to the dissolution of Parliament, the Conservatives held 330 seats in the House of Commons out of a total of 650. Excluding the Speaker (1), Deputy Speakers (2) and Sinn Fein (4), this gave the Conservatives a working majority of just 17. For the reasons stated above, it is widely expected the Tories will see this majority significantly increased. Sterling, gilts and UK equities have all rallied, partly in response to these expectations and the more stable government that would result.

At the time of writing, spread betting sites are pricing in a Conservative majority of around 90 in spite of the recent narrowing of the Tory poll lead, although if the momentum in recent polls is maintained into the election this could fall quickly and sharply. Nonetheless, we may take this as a guide to market expectations. The size of the Tory majority is important. As noted in the *Financial Times*, "Anything below a 30-seat lead for Theresa May could give hardline Tory Eurosceptics an outsized influence on the course of the Brexit talks; 50 is widely considered to be the start of the safety zone above which her grip on her party is secure."[5] Figure 2 shows our expected short-term market reactions under a number of different scenarios:

Of course, many factors influence markets so it is hard to isolate what impact will be due solely to the election

2. UK election outcome and expected market reaction

	Hung Parliament	Tory Majority			
		1-30	31-50	51-90	Over 90
Comment	Outside chance. Negative for UK risk assets. Gilts rally.	Maintains status quo. Again, disappointment for markets.	Smaller than expected increase in majority but limited market impact.	Broadly what the market expects. Relief rally in UK equities. Limited impact on sterling and gilts.	Ahead of market expectations. Sterling and equities rally. Gilts sell off as part of risk-on trade.
Sterling	Much weaker	Weaker	Limited impact across the board	Limited impact	Stronger
UK Equities	Much weaker	Weaker (selectively*)		Stronger	Stronger
Gilts	Mildly stronger	Limited impact		Limited impact	Weaker

*Substantially weaker sterling would benefit large cap exporters

Source: EFG.

[3] See *EFG Indepth: Research Note,* 'UK Election: Once, Twice or Thrice?' from April 2015 for a discussion of this.

[4] A recent Ipsos Mori poll from 2 June found that 50% of people questioned think Theresa May will make the best Prime Minister compared to only 35% for Jeremy Corbyn.

[5] See *Financial Times* article 'A UK election surprise for investors and the pound this week?' 4 June 2017.

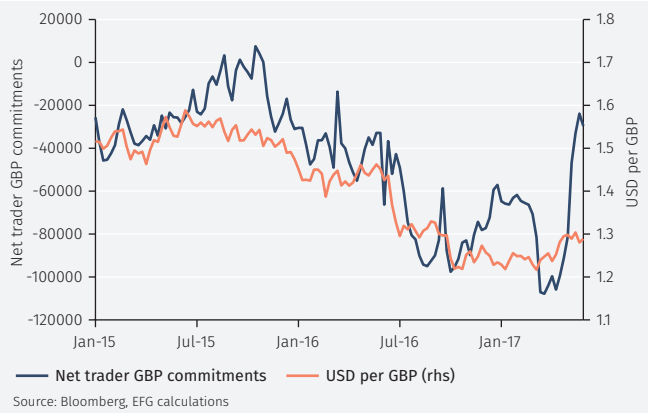
result. Moreover, there will be nuances within markets in terms of how the result is interpreted. For example, many UK listed companies generate a significant proportion of their revenues from overseas so weaker sterling would be beneficial for these firms, as it would for exporting firms which have a sterling cost base. Whilst the election has the potential to impact all UK-related asset markets, it is sterling that we expect to be the main conduit via which the market expresses its interpretation of the election result.

Sterling: medium-term prognosis

From the middle of March, sterling has rallied by around 6% against the US dollar. However, this reflects in part general dollar weakness against all major currencies; the euro has rallied by a similar amount against the US dollar over the same time period. Nonetheless, against other currencies sterling has also performed relatively well – on a broad trade weighted basis sterling is up by around 2% since mid-March, according to data from the Bank of England.

One feature supporting the pound over the past few months is the fact the market had positioned itself very short in sterling futures contracts. This short positioning began following the 2015 election after which David Cameron announced his intention to proceed with the manifesto promise and hold a referendum on UK membership of the EU. The short positions grew steadily in size until they reached an unusually extended position in mid-March. The combination of more robust economic data alongside the initial large Tory lead in the polls encouraged these short positions to be closed off, with associated sterling strength. The market is today positioned much more neutrally with regard to sterling futures, as shown in Figure 3.

3. Sterling and trader commitments



Source: Bloomberg, EFG calculations

Market expectations for sterling are now well balanced. Of the 90 analysts whose views are recorded by Bloomberg, roughly one-half think sterling will be stronger against the US dollar by year end and one-half think sterling will be weaker; the median forecast exchange rate is $1.275/£1 which is only very marginally weaker than the value at the time of writing. Yet there is positive skew in the data: the average of the lowest half of the distribution is 1.226, suggesting a depreciation of 3.8% versus the median, whilst the average of the top half of the distribution is 1.348, consistent with an expected 5.7% appreciation.

However, in spite of recent strength and the skew in market expectations, we believe sterling is vulnerable to another sell off:

- Once Brexit negotiations begin there will be periods during which relations between the two sides become stressed, damaging confidence;
- At some point we expect this to impact negatively growth and growth expectations;
- If the economy is weaker than expected, due for example to the government being compromised by a small majority and an increase in Brexit uncertainty, then government revenues will decline and expenditures increase bringing about a larger budget deficit than is currently forecast;
- Although it has stabilised recently, the UK current account deficit is close to the largest ever (as a % of GDP) experienced during peacetime;
- Futures positioning indicates there is plenty of room for the market to re-instigate short trades.

Conclusions

Although the gap has narrowed recently, the UK general

election polls are unanimous in putting the Conservatives ahead. As we are all acutely aware from experience of the past couple of years, the polls are not always a good guide to the outcome. However, on this occasion we believe there are good reasons for believing that the Conservatives will win the largest share of the vote. A more important issue relates to the size of the Tory majority: if it is deemed insufficient to allow Theresa May to implement smoothly her mandate this would then be damaging for UK assets. Regardless, we see downside risk to sterling over the medium term, not least because of the potential negative impact of Brexit negotiations on the UK economy and foreign investor sentiment.

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