INVESTMENT research

1 April 2015

by David Page
Research & Investment Strategy

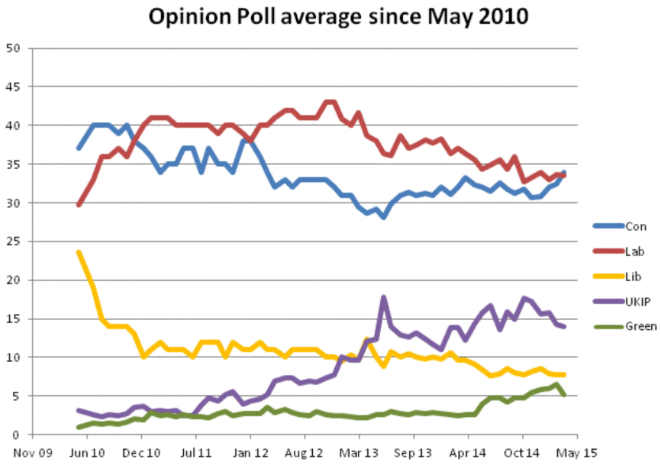
UK Election Preview

Rise of 'the Others' Creates Political Uncertainty

Key points

- May's election looks likely to deliver the fewest seats to Westminster's main political parties since 1945. It is likely to be an election of "the others".
- This creates a highly uncertain outlook. Polls and betting firms currently suggest no clear outcome.
- We concentrate our analysis on five electoral scenarios that we think cover the majority of the likely outcomes. These are Labour- or Conservative-led coalitions with the Liberal Democrats in either majority or minority governments, with or without an arrangement with the SNP for Labour.
- In macro terms, an EU referendum under a Tory-led majority would likely have an adverse impact. A likely fiscal relaxation under Labour-led combinations would likely lift short-term activity but see interest rates rise more quickly.
- Markets would also likely react adversely to an EU referendum. We think markets would react most positively to policies that were closer to the political centre ground.

Exhibit 1
Opinion polls, 2010 – April 2015



Source: Electoral Calculus, 1 April 2015

The General Election on 7 May promises to be one of the most uncertain in a generation. Not only does it present uncertainty over the number of votes and seats that each party will receive, but there is a wider uncertainty as to how those votes will combine to produce a government and how financial markets will react to different combinations of government.

We review the current political background. The polls currently appear to lean slightly towards a Labour-led government. Betting firms suggest a Conservative-led one. Quite how the parties might combine with other parties to achieve working majorities is more nuanced. Moreover, there is still plenty of time for polls to shift before the election.

Given the uncertainty, we present a framework to analyse a number of electoral scenarios that we think covers the majority of the probable universe of outcomes. We look at the key differences that are likely to emerge from governments of different combinations. We then rank these in terms of both expected macroeconomic and market outcomes.

We conclude that minority governments are likely to be among the most positively received by financial markets. This is in keeping with the intuitive interpretation that minority governments are likely to stray less from the political centre ground and policies closest aligned with global capitalism. We also conclude that an EU referendum would likely have the most adverse impact on the economy and financial markets.

Political Polarisation

In 2010, the Tories polled 37% of the vote, Labour 30% and Lib Dems 24%. This translated into 306 seats for the Conservatives, 20 short of an outright majority. The Tories thus formed the first coalition government since World War II with the Liberal Democrats, who in turn achieved 57 seats. Labour won 258 seats.

At the time of writing, UK political polls show the three main Westminster parties polling at stable levels since end-2014 with the Conservatives (Tories) and Labour around 33% and Liberal Democrats (Lib Dem) around 9% (Exhibit 1). This is markedly different from 2010. Exhibit 2 illustrates the difference between 2010 and 2015 and uses a number of online seat predictors to indicate the range of seats each party looks set to achieve on current poll readings.

What is apparent from *Exhibit 2* is that not only is no single party close to achieving an outright majority, but how difficult it will be for any party to form a working majority even in coalition. The current polls suggest the present government would fall short of an outright majority by some 22 to 59 seats. By comparison, Labour's gains in the polls are likely to see it take 265 to 309 seats, but still leave it unable to form a majority coalition with the Lib Dems in all but the rosiest outcomes for both parties. Only a coalition including the Scottish National Party (SNP) could achieve a near certain majority on these figures. Yet with the SNP ruling out working with a Tory government and suggesting it would only work with a Labour government on a "vote-by-vote" basis, this outcome looks remote.

Exhibit 2

Political polls and seats, 2001 and estimated

	2010		2015	
	% votes	Seats	Polls (%)	Seats
Conservative	37,0	306	33-34	250-279
Labour	29,7	258	32-34	265-309
Lib Dem	23,6	57	8-10	17-25
DUP	-	8	-	8
SNP	1,7	6	4	48-55
Plaid Cymru	0,6	3	1	3
UKIP	3,2	0	14	1-2
Greens	1,0	1	5	1
Others	-	11	-	10
Total		650		-

Source: Polls: UK Polling Report and Electoral Calculus, polls as at 1 April 2015
Predicted seats: UK Polling Report, Electoral Calculus, May2015 (New Statesmen)
Abbreviations DUP (Democratic Unionist Party), Others (Independent, Speaker, Alliance Party, Sinn Fein, SDLP)

Polls can still change over the coming five weeks. Chancellor Osborne's Budget 2015 was a balance of voter-friendly measures (including some £13bn in give-aways to the household sector) and fiscal responsibility: Budget 2015 was fiscally neutral overall; it projected the debt: GDP ratio falling and austerity ending one year earlier; and indicated total spending as a proportion of GDP would 'only' fall to 2000 levels. So far polls have seen little consistent reaction to this Budget, but this may yet emerge.

Other events can also influence the polls. TV debates were a catalyst for change in 2010 and may have an impact again this time. Moreover, in the past incumbents have tended to enjoy a rise in the polls in the run-up to elections. This may have reflected that incumbents historically chose the timing of elections, but the Tories are currently enjoying a modest pick-up in the polls. Finally, the campaign trail can be unforgiving and throw up events that can influence the polls. The last election saw Gordon Brown have difficulties after a gaffe over that "bigoted woman". Hence there is still time for a more decisive shift in the polls. Indeed, a Mori poll on 11 March stated that a record 44% of "certain" voters were undecided for whom they would vote.

Betting firms reflect the anticipation of future changes. In contrast to the polls, these suggest that the Tories may emerge as the largest party, although still suggest a Tory-Lib Dem coalition would fall short of a majority, by 10 seats.

The rise of 'the others'

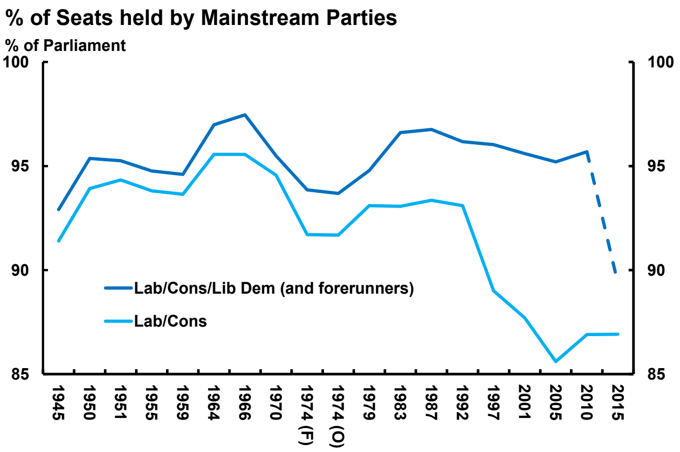
Yet without a more decisive shift in the polls towards the mainstream parties, the 2015 General Election is likely to be a story of the other parties, primarily the UK Independence Party (UKIP), the Scottish Nationalist Party (SNP) and the Green Party. This is the culmination of a long-term trend.

As *Exhibit 3* shows, in the early 1950s the Conservative and Labour parties constituted nearly 100% of the seats in Parliament. In 2010, this had fallen to 87% and just one-third of the popular vote. This looks likely to be similar in 2015, but this time the Liberal Democrats, who accounted for 24% of the popular vote in 2010, now look likely to see a much lower popular vote deliver far fewer seats. 2015 looks likely to deliver the fewest seats to mainstream parties since 1945.

Mainstream parties have been squeezed by the rise of the other parties. The demise of the main parties is the culmination of a number of factors, including a lack of voter engagement with current Westminster leaders. But an overriding theme reflects a loss of faith in the global capitalist model that has dominated the political centre ground for at least the last thirty years.

This polarisation of politics motivated by sustained declines in living standards is a trend emerging beyond the UK and across most Western democracies. It accounts for some of the populist moves to the left in Greece (Syriza) and Spain (Podemos) and to the right in Germany (Alternative für Deutschland) and more extremely so in France (Front National). Such trends can also be seen in the rise of the Tea Party within the US Republican Party.

Exhibit 3
Dominance of mainstream parties wanes



Source: UK Political Info, AXA-IM Research

In the UK, the Great Recession, the associated fall in living standards and the polarisation of the labour market have left large numbers of the population dissatisfied with the political status quo. Many seek alternatives to the economic proposals of the traditional parties. A common feature of the ascendant insurgents is that each purports to offer an alternative to global capitalist economic policies, by: restricting or reversing labour flows/immigration (UKIP); running the economy isolated from global forces (SNP); or eschewing traditional economic targets (Greens).

In terms of gaining seats, the ascendancy of the SNP in post-referendum Scotland is likely to have the biggest impact. Some political analysts translate the SNP's current poll readings to an almost universal coverage of Scottish seats. The SNP is predicted to take 39 to 46 seats. This is likely to make the SNP the third largest party in Westminster. It is also likely to deprive Labour of an outright majority in the UK.

The rise of UKIP has caught the most media attention. Polling now at 14% to 15% (down from recent highs, where some polls recorded levels in excess of 20%), they represent the third largest party by popular vote. However, because of a widespread base (rather than geographically focused like the SNP and Lib Dems) this popular vote is not likely to translate to a similar share of seats in a first-past–the-post election system. Estimates suggest UKIP are likely to hold only 1 or 2 seats. The main UKIP impact is thus likely to be indirect, splitting the traditional Tory vote and creating Labour gains in marginal seats, although this impact is not one-way and may also impact some Labour marginal.

The Green party is also likely to have the most influence only indirectly. While the Greens are only expected to hold their one seat, they have increasingly become a destination for disaffected Lib Dem voters. Two years ago, 6% of those voting Lib Dem at the last election were choosing to vote Green, with 45% remaining Lib Dem and 31% voting Labour. In January, 33% planned to remain Lib Dem, but only 26% were likely to vote Labour: 15% were now likely to vote Green. This increasing alternative for Lib Dem voters looks set to deprive Labour of support in key marginal seats.

With these new dynamics pulling the electorate in different directions the outlook for the upcoming election is highly uncertain. An outlook where no one party will be able to achieve a majority and even two-party coalitions struggle suggests there is likely to be a protracted period of negotiation after May's election before a new government can be formed. This could take much longer than the 5 days it took to form the basis of the current government in 2010. This in itself will likely heighten uncertainty, weigh on financial markets and increase volatility.

Economic consequences

Defining the scenarios

We divide the two broad sets of election results – a Labour- or Tory-led government – into five distinct scenarios. We assume either major party is likely to form a coalition with the Lib Dems. Lib Dem policies straddle Tory and Labour policies and the Lib Dems appear open to forming a coalition with either party. We thus consider four scenarios to be Labour or Tory plus Lib Dem coalitions that either form majority or minority governments. In the case of a Labour-Lib Dem minority government we consider an additional scenario, where the coalition has some arrangement with the SNP, whether a "confidence-and-supply" or an even looser "vote-by-vote" arrangement.

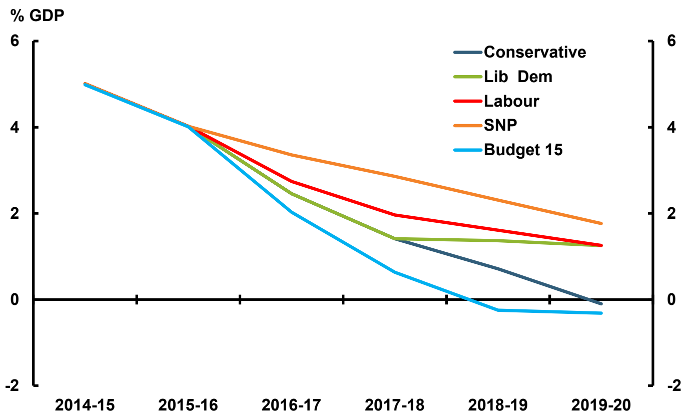
The economic characteristics of the scenarios

The economic outlook under the next government can be considered by looking at just a few major economic characteristics, varying in importance in each scenario: the speed of deficit reduction; an EU referendum; business friendliness; and the economic cost of political uncertainty.

Speed of deficit reduction. The first characteristic is how quickly a new government would attempt to reduce the outstanding 5% of GDP budget shortfall. Based on a recent assessment by the Institute for Fiscal Studies (IFS)[1] and imposing an assumption that each party would follow the same investment plans, *Exhibit 4* illustrates the range of deficit profiles as suggested by different parties' public spending commitments. In reality differences in investment programmes would likely exacerbate these differences.

Exhibit 4

Medium-term fiscal outlooks differ dependent on election



Source: IFS, Resolution Foundation, OBR, AXA-IM Research

EU referendum. This could be the defining feature of this election. We believe that an EU referendum would create a significant drag on economic growth. This is not an assessment of the relative merits of longer-term EU membership. Rather it reflects an assessment of the costs associated with the uncertainty over the UK's future, both before and potentially after the poll. We expect this uncertainty to slow inward foreign direct investment and weigh on domestic investment. Whether or not such a referendum would be held will likely be of critical importance for the economic outlook.

Business friendliness. A number of proposed policies will have a negative impact on key businesses, for example Labour's proposed minimum wage increase, energy tariff freeze and tobacco company windfall tax. We think these measures will create concerns over how business friendly a government would prove. The less friendly, the more the perceived risk of additional costs being imposed on business over the life of the Parliament, which in turn would incur an economic cost, weighing on business sentiment and investment spending.

Political uncertainty. Two of our scenarios are minority governments, which would create political uncertainty reflecting the greater chance of a government unable to pass key legislation and resulting in a follow-up election. Economic costs are associated with such uncertainty, although on balance these should prove second order.

Labour-centric scenarios

Labour look to a range of headline policies to define the path they would take in government.

- Close the cyclically-adjusted current budget by the end of the Parliament
- No EU referendum
- Increase the minimum wage to £8/hour by 2020
- Freeze energy prices
- Introduce a mansion tax
- Increase the upper rate of income tax
- Impose a windfall tax on tobacco companies
- Scrap winter fuel payments for high earners
- Reduce the cost of tuition fees
- Increase the number of apprenticeships

A major consequence of any Labour-led government would be the absence of an EU referendum. The scale of deficit reduction would likely be the key variant depending on the composition of such a government. A Labour-Lib Dem coalition that has a close arrangement with the SNP would likely see a looser fiscal framework. SNP leader Nicola Sturgeon said the SNP would not enter into any sort of alliance that passed Tory-style spending cuts – a jibe at Labour's adoption of Tory spending plans for 2015-16. By comparison, a Labour-Lib Dem minority government that did not form an alliance with the SNP would likely see a relatively tighter fiscal framework, closer to the Lib Dem outline, in an attempt to secure Tory support to pass the finance bill. Costs associated with heightened political uncertainty would be incurred under this Labour-Lib Dem minority collation scenario.

We also deem that Labour-led governments would be considered less business friendly. An IPSOS/MORI poll in February suggested that 77% of chief executives thought the Tories would be "best for their businesses".

[1] "Fiscal aims and austerity: the parties' plans compared", Institute for Fiscal Studies, Briefing Note 158, December 2014.

Conservative-centric scenarios

The predominant question for a Tory-led government would be whether it would be able to hold an EU referendum. The Lib Dems have not ruled out holding a referendum and would likely accept a one in return for key concessions elsewhere. However, to hold a referendum a Tory coalition would have to pass a raft of enabling legislation. With Labour and the SNP opposed to such a referendum, the government may not be able to summon sufficient support to pass such legislation as a minority coalition. We assume that a minority coalition would not be able to pass such legislation and that a referendum would not be held in such a scenario.

Otherwise, we think a new Tory-Lib Dem coalition would see the following developments from the current government.

- Structural budget surplus by 2018 (a £30bn adjustment, broadly £13bn departmental spending cuts, £12bn in welfare cuts and £5bn in reducing tax avoidance).
- An increase in the personal allowance to £12,500 and the upper rate threshold to £50,000 by 2020.

Beyond the EU referendum, a Tory-led coalition is likely to be deemed more business friendly. A minority Tory government may concede more to the Lib Dems and Labour for cross-party support. This would likely see a slower deficit reduction. Such a government would also be subject to the costs of political uncertainty.

Macroeconomic consequences

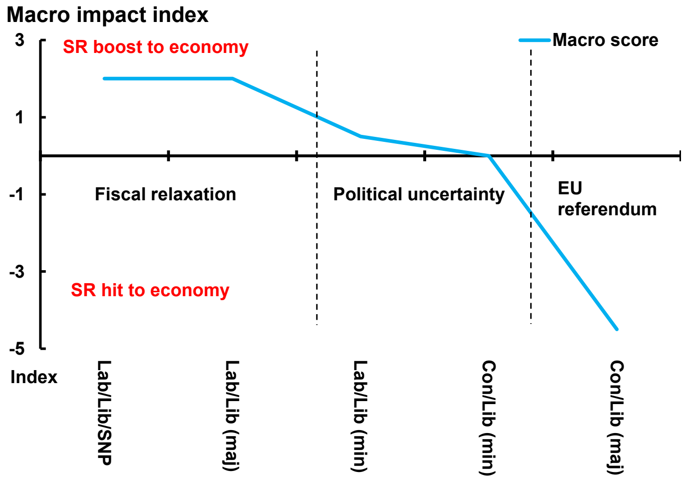
In an attempt to simplify the outlook under different electoral scenarios we have constructed a macro impact index that attempts to synthesise the many and sometimes contradictory economic impulses in the first years of a new government, based upon the differing characteristics we have identified.

In broad terms, we see the fiscal relaxation expected with a Labour-led coalition majority or alliance with the SNP as providing a short-run boost to GDP. We see little difference between these two scenarios in macro terms, suspecting that a softening in business confidence and private investment would broadly offset the additional fiscal easing we expect from an arrangement with the SNP. In the longer term, beyond the outlook of this index, we would expect such an initial boost to GDP to result in a quicker tightening of monetary policy (and rising gilt yields and sterling) to reduce the initial boost to GDP in the latter stages of the parliament. The net effect would be a higher share of government spending in the economy, relative to investment, consumption and net trade.

We expect the minority government scenarios to involve less fiscal relaxation, particularly a Tory/Lib Dem coalition. This provides less of an initial impulse to economic activity. Additionally, these outcomes are likely to incur the costs of political uncertainty on business sentiment, weighing on business investment. Over the longer term, a more subdued initial boost would likely see little additional monetary policy tightening and allow the Bank of England to follow the “gradual” path of rate increases it has described since early 2014.

Exhibit 5

Gauging the initial macroeconomic impact of different electoral outcomes



Source: AXA IM research
Macro index constructed as a function of expected changes in fiscal stance, business sentiment, monetary policy and sterling.

As described above, only a Tory/Lib Dem majority would likely lead to an EU referendum. We think this would have a marked, adverse impact on confidence and investment, which we expect would weigh on UK economic activity in the short run. We expect this slower pace of growth to result in an even slower pace of monetary tightening than the “gradual” pace indicated.

While any number of differences in initial conditions and second round effect makes it difficult to quantify different electoral scenarios in terms of GDP over the whole period of the next Parliament, we suspect that a Conservative/Liberal **minority** government is likely to be the closest to neutral to our current fiscal/monetary policy expectations.

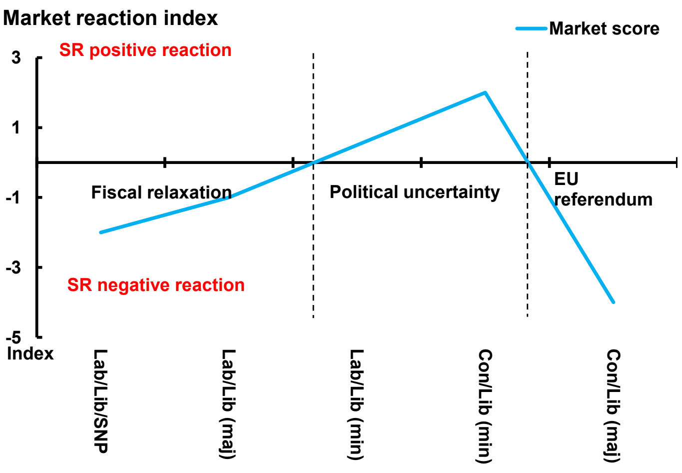
Market impacts

We expect markets to respond very differently to different electoral outcomes. Markets are likely to suffer the sharpest reaction to the announcement of an EU referendum. We expect the uncertainty and slower economic growth associated with such an announcement to result in a marked drop in UK equities, centred around concerns over the financial sector and other euro-zone exporters. The Tory/Lib Dem majority scenario associated with this outcome would also likely pursue an ongoing tight fiscal stance which would likely add pressure on healthcare and support services sectors.

Adverse market reaction to an EU referendum would likely be somewhat mitigated by an expected sharp decline in sterling. This would reflect both the uncertainty over the UK's future international role and a softer interest rate outlook (in turn reflecting softer GDP growth). A softer monetary policy outlook would also likely dominate the outlook for gilts. We consider it likely that gilt yields would fall in this scenario – although concede this may follow an initial, reflexive rise as some gilt holders fear a sell-off in international gilt holdings. We do not consider this likely over the longer-term and do not see the Scotland referendum as a valid test-case for this - a BREXIT (exit from the EU) would not change the constitutional make-up of the UK, as issuer of gilts.

By contrast, the fiscal relaxation associated with Labour-led majorities would likely result in a rise in the interest rate outlook. We expect relatively tighter monetary policy to drive bond yields higher, although would envisage some of the yield increase to reflect a perceived rise in credit risk, particularly under the greater expected public spending in the SNP scenario. Sterling would likely gain in the short run, both reflecting referendum-relief and the rising rate outlook. Faster GDP growth would also likely underpin domestic equities, although rising yields and sterling would neutralise much of this boost. Looking at sectors, healthcare and support services would likely gain. However, energy and tobacco sectors could all suffer in reaction to the perceived risk of regulation. The reaction of financial services would balance the increased regulatory risk against referendum-relief.

Exhibit 6
Outlook for gilt sales to remain elevated



Market index constructed as a function of expected changes in BoE Bank rate (-ve), gilt yields (-ve), £ (+ve), equities (+ve).

Given this analysis, we envisage the most positive/least negative market outcomes to be associated with the minority government scenarios, notwithstanding the political uncertainties these would involve. Intuitively, this accords with our view that minority governments could be held closer to the political centre ground, through necessity of cross-party support for policy. Hence they would be closer to a continuation of global capitalist policies that have provided a bedrock for financial markets.

Exhibit 6 shows a constructed market reaction index, similar to the macro impact index, to illustrate our expectations of market reaction across a number of asset classes to different electoral outcomes.

Conclusions

The current polls provide no clear conclusion to the composition of the next UK government after the election on 7 May. If today's polls translated precisely into the number of seats predicted a Labour/Liberal Democrat minority coalition would appear most likely. Yet betting sites suggest a Tory/Lib Dem coalition is most likely. However, with five weeks before the election, even a minor shift could markedly change the outlook.

We identify key characteristics of five election scenarios that we believe covers the bulk of the probability spectrum of possible outcomes. We then construct macro and market reaction indices to characterise the impacts of different governments on the broader economy and financial markets.

We conclude that the economy is likely to receive the biggest short-term boost from governments that relax the fiscal stance relative to current plans. Although we note, the marginal utility of relative fiscal easing is likely to fall, such that we do not see a material difference in GDP outlook as spending rises beyond expected Labour towards SNP plans. This would likely result in higher interest rates than currently envisaged. By contrast, we see an EU referendum as providing a major headwind to UK economic activity that would likely result in a slower pace of monetary policy tightening.

We expect financial markets to react most negatively to the prospect of an EU referendum. We also expect a modestly negative reaction, defined as a rise in short- and long-term interest rates, with Labour-led majority governments. We envisage markets welcoming minority governments the most, notwithstanding the associated political uncertainty. Intuitively, we suspect this reflects market scepticism of economic policies driven from the more extreme ends of the political spectrum.

AXA IM research is available on line: http://www.axa-im.com/en/research

As well as on our free app

DISCLAIMER

This document is used for informational purposes only and does not constitute, on AXA Investment Managers part, an offer to buy or sell, solicitation or investment advice. It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date.
Due to the subjective and indicative aspect of these analyses, we draw your attention to the fact that the effective evolution of the economic variables and values of the financial markets could be significantly different from the indications (projections, forecast, anticipations and hypothesis) which are communicated in this document.
Furthermore, due to simplification, the information given in this document can only be viewed as subjective. This document may be modified without notice and AXA Investment Managers may, but shall not be obligated, update or otherwise revise this document.
All information in this document is established on data given made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document.
Furthermore, due to the subjective nature of these analysis and opinions, these data, projections, forecasts, anticipations, hypothesis and/or opinions are not necessary used or followed by AXA IM' management teams or its affiliates who may act based on their own opinions and as independent departments within the Company.
By accepting this information, the recipients of this document agrees that it will use the information only to evaluate its potential interest in the strategies described herein and for no other purpose and will not divulge any such information to any other party. Any reproduction of this information, in whole or in part, is unless otherwise authorised by AXA IM prohibited.
Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.
Editor : AXA INVESTMENT MANAGERS, a company incorporated under the laws of France, having its registered office located at Cœur Défense Tour B La Défense 4, 100, Esplanade du Général de Gaulle 92400 Courbevoie, registered with the Nanterre Trade and Companies Register under number 393 051 826.

9/7856