HOW WILL THE ELECTION AFFECT THE HEALTH OF THE UK ECONOMY?

Why this election could be the turning point for the pound

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Latest Opinion Polls*:

- Conservative: 33%
- Labour: 35%
- Liberal Democrat: 8%
- UKIP: 14%
- Green Party: 5%
- Other: 5%

*Latest YouGov/ Sunday Times poll, results from 20th March

Section 1: The UK political landscapes

The UK election scheduled to take place this May is one of the most uncertain elections in British history. Unlike the last election in 2010 when the two main parties, Labour and the Conservatives, garnered the majority of support, this time around we have seen a fracturing of the UK’s political landscape with smaller parties coming to the fore. As you can see above, although Labour and the Conservatives have the largest amount of support, it may not be enough to give them the 326 MPs needed to form a majority government. Instead we have seen support for UKIP, a far-right party, and the Green party, a leftist party, surge in recent months. The other political development has been a large increase in support for the Scottish Nationalist Party (SNP), with 43% of adults in Scotland pledging to vote for them.

The challenges faced by the two main parties make this election particularly difficult to predict. Both Labour and the Conservatives have a fairly equal share of the vote, making it hard to say which of the two parties could gain the most support.

A 101 on UK elections:

- General elections are held following the dissolution of parliament
- The UK has 650 MPs, which represents the 650 geographical areas, or constituencies, in the UK
- Each constituency elects one MP (one single seat in Parliament)
- The UK operates a first-past-the-post (FPP) electoral system, whereby the candidate has to win more votes than any other
- The FPP single seat system tends to favour larger parties over smaller parties
- Traditionally, the FPP system encourages tactical voting, as voters are pressured to vote for a candidate who could win rather than the candidate they actually prefer
- The UK voted on its electoral voting system at the last election, so FPP is here to stay
Section 2: Potential outcomes

Due to the high levels of uncertainty around this election, we have decided to come up with four potential outcomes and analyse what they may mean for financial markets.

A “stable” coalition:

A coalition government could come in two guises. The first is a relatively “stable” coalition like the one that we have seen for the past five years between the Conservatives and the UK’s “third party”, the Liberal Democrats. A “stable” coalition this time around could be between the Conservatives and the Lib Dems or between Labour and the Lib Dems. This would probably be the most market-friendly outcome as the Liberal Democrats are considered a neutralising force as they tend to sit in the political centre. This could stop the next UK government from lurching too far to the left or the right. It is also a pro-EU party, so if it held the balance of power in this election then we could see the Brexit (EU exit) fears dissipate.

A fractious coalition:

At this stage, the chances of a “stable” coalition are fairly slim, as the Lib Dems have seen their support eroded in recent years and they may not win enough seats to hold the balance of power. If this happens then we could find the party with the most votes struggle to form a coalition. A fractious coalition could also require more than two parties, which could draw out the negotiation process and risk a prolonged period of political uncertainty.

There are two potential scenarios for a fractious coalition:

1. **Conservatives, UKIP, independents**: This would cause a shift to the political right. UKIP is an anti-EU party, so the prospect of a Brexit could rise dramatically. We would expect that a Conservative-led coalition would stick to its fiscal path to eradicate the UK deficit by 2018/19. While this could be pound positive, we believe that uncertainty about the UK’s position in the EU could lead to long-term pound weakness (see more in the EU section).

2. **Labour, Greens, Lib Dems potentially SNP**: This would cause a shift to the left. We believe that the Lib Dems would not form a coalition with the Conservatives if it included UKIP due to their contrasting stances on EU membership. A shift to the left could throw the UK’s fiscal and economic plans into disarray, although it would dramatically reduce the prospect of a Brexit, as all three parties are pro UK EU membership. While this would be pound positive, we think the good news could be diluted by Labour’s economic policy, which could delay fiscal consolidation plans and introduce policies which may be considered market-unfriendly. Although Ed Miliband, the Labour leader, has ruled out a coalition with the SNP, if he falters and invites them to join a coalition government then Scottish independence could be back on the agenda, which could also weigh on the pound and UK assets.

We think that a fractious coalition is the most likely at this stage, if the latest opinion polls are to be believed.

A single-party win:

Due to the nature of UK politics this would most likely mean a win for the Conservatives or the Labour Party. The same problems as above would persist. While the market may initially react positively, we think that any upside would be short-lived. As we mention above, both the Conservatives and Labour could cause concern for the markets and weigh on sterling in the months after an election.
A hung parliament:

This would happen if neither of the main parties could form a coalition and would ultimately lead to a re-election. However, expectations for a hung parliament have receded in recent weeks as the Fixed Term Parliament Act of 2011 makes it harder for the prime minister to call a snap re-election to try and form a majority government the second time round. However, it could happen if there were a vote to repeal the act or if Parliament were dissolved. These options would require a majority of MPs to agree, which could be tough to achieve in a very mixed parliament. If we do get a hung parliament we would expect large losses for the pound, due to the prolonged period of uncertainty this may cause. Of note, the UK Treasury has said that a government needs to be formed by August or it won’t release further funds. So, on the bright side, there is pressure to form a government in the event of a hung parliament.

Aside from the opinion polls, it is also worth looking at what result the bookmakers are pricing in. Currently, the bookmaker Paddy Power believes that Labour will lead a minority government, with an approximate 25% chance of a Hung parliament.

Section 3: Does sterling prefer a Conservative or Labour-led government?

We have decided to take a look at how GBP/USD has performed over the last five elections. We have also investigated how the UK GDP performs under various parties by analysing the last five governments. See the results below; it is worth noting that past performance does not guarantee future performance.

Figure 1:

Source: FOREX.com and Bloomberg. Please note that this chart does not represent the prices offered by FOREX.com.
Overall, it looks like the FX market is fairly immune to UK elections, with GBPUSD dropping under both the Conservatives and the Labour Party. In 1992 the UK went through a recession, which weighed on the pound, and likewise in 2008-2010, during the Great Financial Crisis. It appears that external circumstances, rather than who is in power, usually determines how well the pound performs.

Factors other than politics may also influence UK GDP, as you can see in figure 2. However, the Conservatives now have a track record of bringing the UK out of deep recessions, whereas the Labour Party had the misfortune of leading the UK into its worst period for GDP since the 1930s. We will have to wait and see if this can help the Tories come May 7th.

Section 4: The UK election and the EU

Although European equities started 2015 on the back foot amid the so-called “Grexit” worries, the markets have since bounced back. Sentiment has been lifted by speculation that the ECB will unveil a full-scale QE stimulus programme at its January.

One of the hottest topics during this election could be the future of the UK’s position in the EU. The rise of UKIP, an anti-EU party, has focused minds on whether the UK should stay in the European Union. The Conservatives, which has a powerful anti-EU faction, has promised to hold an in-out EU referendum in 2017 if it wins power. However, if it was to join a coalition with UKIP, a potential referendum could be pushed forward. The Labour party has not committed to a referendum on UK EU membership, so this may only be an issue if we see a Tory government or a Tory-led coalition.

This could be the biggest concern for the FX market in the aftermath of the election. Since a referendum is unlikely to be scheduled for a few years, it could lead to a protracted period of weakness for sterling.
Our concerns for the pound that may arise from the uncertainty around the UK’s EU membership is:

- Its large UK current account leaves it vulnerable to a shift in international sentiment towards the pound and UK debt. Right now the international market is happy to fund the UK’s deficit, but this may not be the case if it looks like it is going to leave the EU.

- The FTSE 100 is also a major hub for international companies to list. Part of the UK’s attractiveness is its proximity to Europe and membership of the EU. If it leaves the EU this could reduce the desire of foreign firms to list in the UK and others could try and move to a different index, which could weigh on UK stock markets.

As we mention above, the Conservatives are traditionally seen as the “pro-business party” and are thus good for UK assets, although this is not always the case for the pound, as you can see above. However, this time around, a Tory government set on an EU referendum could weaken business in the UK and weigh heavily on UK asset prices.

But this does not mean that a Labour victory would trigger a rally for UK assets. Instead, we think that a Conservative/Lib Dem coalition or a Labour/Lib Dem coalition would be the best outcome for UK asset prices. The Lib Dems could keep UK politics fairly centrist which may avoid any lurches to the left or right.

If there is uncertainty around the UK’s EU membership then we may see UK risk premia rise, which could push up UK bond yields. A rise in bond yields, even from historic lows, is unlikely to benefit the pound, which would also come under pressure from uncertainty about the UK’s position in Europe.

**Figure 3:**

Source: FOREX.com and Bloomberg
Section 5: Case Study

The Impact of Contentious Political Landscapes on the US Dollar and S&P 500

While coalition governments are unlikely in the United States' two-party system, Americans have had plenty of experience with sharply divided governments over the last two decades. Given the significant impact of politics on markets, the performance of the US dollar and US equities during these periods could provide a useful template for what to expect if the UK is forced into an uneasy coalition.

Over the last two decades, there have been three major periods when at least one Congressional body (the House of Representatives or the Senate) was controlled by one party while the US Presidency was controlled by the other. The 2007-2009 period, when Republican President George W. Bush was matched with a Democratic House of Representatives and Senate, was relatively amiable by necessity (the onset of the Great Financial Crisis), so we'll focus on the two more fractious periods:

1995-2000

Over this six-year period, Democratic President Bill Clinton governed in concert with a Republican-controlled House of Representatives and Senate led by Newt Gingrich and Bob Dole respectively. Similar to the present political situation in the US, the two parties were sharply divided over a number of major issues, including funding for Medicare, education and healthcare, eventually leading to a 27-day government shutdown in late 1995/early 1996.

Market Reaction: Of course, US equities were in the midst of their massive run-up to the tech bubble peak in the late '90s, so it appears that the divided government did not negatively impact stock performance, though the rally did briefly stall while the government was shut down in late 1995. In all, the S&P 500 gained over 25% per year over that period, more than tripling in the process.

The performance of the dollar index over this period was more mixed, but still generally positive. The index initially pulled back about 20% from nearly 100 to 80 before finding a bottom in 1995 and rallying by nearly 50% all the way up to 120 by 2001. Over this period, the economy was humming along, spurred by the transformative power of the internet. With the economy operating near full employment and inflation subdued, all the government had to do was stay out of the way.

2011-Present

Over the last few years, Democratic President Barack Obama has been paired up with a Republican-controlled House of Representatives (and now Senate too) with a radically different view of the role of government. Just like in 1995, the US government was forced to shut down for a couple of weeks when the Senate and House were unable to agree on an appropriations bill for the 2014 fiscal year, and the two parties have not grown any more cooperative since.

Market Reaction: Unlike the mostly nonchalant reaction to the 1995/6 government shutdown, US equities sold off sharply in Q3 2013, with the S&P 500 dropping roughly 20% before turning higher. To this day, that drop remains the largest selloff since the financial crisis trough in March 2009 and the index has risen at an annualized rate of nearly 13% since the start of 2011. In a curious parallel to the 1995-2000 period, the dollar initially dipped before turning higher and eventually rallying over 30% off its lows in the mid-70s so far, though much of this move has been driven by the consistent, but not excessive, improvement in the US economy, especially relative to its peers.
Figure 4:

Source: FOREX.com and Bloomberg

Figure 5:

Source: FOREX.com and Bloomberg
Section 6: Technical View

Technical View: GBPUSD

To paraphrase author Charles Dickens, 2015 has been “the best of times and the worst of times” for the British pound. Q1 was the proverbial “winter of despair” for the UK currency, with GBPUSD shedding nearly 1,000 pips from 1.5600 to a five-year low near 1.4600 in mid-March. Looking to the weekly chart, this selloff did substantial technical damage: the 1.48-49 zone represented the double bottom from mid-2013 as well as an unusually tight confluence of major Fibonacci retracement levels from the 61.8% retracement of the entire ’09-’14 rally (AD) converges and the 78.6% retracement of the ’10-’14 upswing.

The medium-term technical bias still remains lower. One method of gauging the strength of a market’s buying and selling pressure is to measure the depth of the counter-trend moves: in a strongly trending market, a currency will typically retrace only a small portion of the previous move (23.6-38.2%), while in a more balanced market it’s common to see deeper retracements (61.8-78.6%). In this case, GBPUSD’s January-February bounce barely reached its shallow 23.6% Fibonacci retracement before reversing and quickly falling to new lows in March, showing that there is little appetite to buy the pair.

In the short-term though, the chart is sending out mixed signals. As a possible sign for optimism, the pair’s weekly RSI has put in potential bullish divergence at the most recent low, suggesting that the selling momentum may be fading. That said, previous support in the 1.48-1.50 zone should now provide resistance on any near-term rallies in GBPUSD, as could the downward sloping 10-week (50-day) moving average near 1.5100. As long as rates remain below those levels, we believe the path of least resistance will remain to the downside, especially as the political uncertainty swirls in the run-up to the election. If we do see a pound-negative election result (a hung parliament or, to a lesser extent, a fractious coalition), GBPUSD could resume its downtrend for a possible test of the next level of converging previous / Fibonacci support in the 1.42-1.43 area, where the 127.2% Fibonacci extension of CD, May 2010 low at point B, and 78.6% Fibonacci retracement of AD all converge.

Looking at these two parallels, there are some common themes that could apply if we see a fragile coalition form in May’s UK election.

• Contrary to orthodox belief, uneasy political pairings are not necessarily a negative factor for the domestic currency; indeed, the US dollar’s two largest rallies in the last 30 years kicked off during split-party regimes.

• The evidence when it comes to stock market performance is also generally encouraging, with strong returns as long as there is no imminent threat of essential government activity grinding to a halt.

As always, UK investors should still be wary of the potential for an unforeseen economic or geopolitical shock, but the States’ experience with fractious political parties over the last few decades may suggest UK assets could remain supported even if a more fractious coalition forms, even though the question of the UK’s EU membership could still bite.
Technical View: EURGBP

On the other hand, 2015 has been the “best of times” for the pound against its mainland neighbour to the South. EURGBP has dropped off a cliff so far this year, collapsing from around 0.7800 at the start of the year to a seven-year low below 0.7200 as of writing. From a technical perspective, the big Q1 drop has actually pushed the pair through the bottom of its six-year bearish channel.

As we go to press, EURGBP is testing the 161.8% Fibonacci extension of the H2 2012 rally around 0.7100, so a near-term pause is definitely possible as the risks of the UK election become more salient (the oversold RSI indicator supports this perspective). In saying that, we do not expect a major long-term reversal in favour of the euro: even if EURGBP manages to break back into its six-year bearish channel, it would still likely find resistance at 0.7425 or 0.7680, the 23.6% or 38.2% Fibonacci retracements of the drop off the 2013 high.

Given the established trend, EURGBP may be the currency pair to play if the UK election results in a pound-bullish outcome (a stable coalition). In that case, EURGBP could break through key psychological support at 0.7000. From a longer-term perspective, there is not much in the way of significant support until down around 0.6600, which marks repeated support in 2004 and 2007, as well as the 78.6% Fibonacci retracement of the entire 2000-2009 rally. It is worth noting that past performance does not guarantee future performance.
Section 7: The outlook for UK stocks

Although the FTSE hit a fresh record high recently, this came after a laborious two years of trying. It has underperformed compared to some of its European peers so far this year, including the German DAX index. The commodity-heavy FTSE index has been held back by the slump in commodity prices which has weighed heavily on the share prices of energy and mining companies. The relatively small number of technology stocks – a sector which has given the US markets a major boost recently – has also held back the UK index. Nevertheless, we think that the ECB’s QE programme and the record low interest rates across many developed economies, including the UK, combined with a much weaker oil price will spur economic growth in the Eurozone – the UK’s largest trading partner – and help push the FTSE to much higher levels in the coming months. We also think that oil prices may bottom out around the middle of 2015 as US shale producers are forced to cut back production due to oil prices remaining weak for a prolonged period of time. This could be good news for the London-listed energy stocks. But the ongoing uncertainty surrounding the UK election is likely to hold some investors back for the time being. Once the elections are out of the way, and depending on its outcome (see above for details), investors may decide it is time to pile into the UK stock market. That said, the FTSE is comprised mainly of large multinational corporations and as such the outcome of the election may not have a lasting impact on the FTSE, though certain stocks or sectors could be affected nonetheless.
Heading into the elections, the FTSE is looking strong from a technical point of view. After all, it has breached the psychologically important level of 7000 for the first time ever. It has therefore also cleared the 6900 hurdle which had provided stiff resistance for the best part of two years. With these levels finally broken, the FTSE could be gearing up for a major rally as fresh would-be buyers may decide now is the time to come into the market. As the FTSE is trading in unchartered territories, there are no prior reference points for traders to keep an eye on. This is where Fibonacci extension levels come handy. On the chart we have plotted the Fibonacci extension levels of the last three notable price swings, from point X to A, B to C, and D to E. These extension levels could potentially turn into resistance as some speculators would use them as their long profit targets or short entry points. Our short-term view would turn bearish on the FTSE upon a potential break below 6900 or the bullish trend line. Should that happen then the index may make a move towards support at 6715 before deciding on its next move.

Figure 8:
FTSE’s performance one year after past elections

The table below shows the FTSE’s performance a year after each of the past six elections.

Figure 9:

<table>
<thead>
<tr>
<th>Election Date</th>
<th>Winning Party</th>
<th>FTSE’s closing level at end of month after election (t)</th>
<th>FTSE’s closing level a year later (t+1)</th>
<th>Change (points)</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/06/1987</td>
<td>Conservative</td>
<td>2291</td>
<td>1858</td>
<td>-433</td>
<td>-18.9%</td>
</tr>
<tr>
<td>09/04/1992</td>
<td>Conservative</td>
<td>2572</td>
<td>2813</td>
<td>241</td>
<td>9.4%</td>
</tr>
<tr>
<td>01/05/1997</td>
<td>Labour</td>
<td>4621</td>
<td>5870</td>
<td>1249</td>
<td>27.0%</td>
</tr>
<tr>
<td>07/06/2001</td>
<td>Labour</td>
<td>5642</td>
<td>4656</td>
<td>-986</td>
<td>-17.5%</td>
</tr>
<tr>
<td>05/05/2005</td>
<td>Labour</td>
<td>4964</td>
<td>5723</td>
<td>759</td>
<td>15.3%</td>
</tr>
<tr>
<td>06/05/2010</td>
<td>Conservative (coalition with Lib Dems)</td>
<td>5188</td>
<td>5990</td>
<td>802</td>
<td>15.5%</td>
</tr>
</tbody>
</table>

Source: FOREX.com and yahoo.com

At first sight, it is difficult to draw any conclusions from the table above. But looking at the average performance of the FTSE a year after the elections, the data shows a surprising result:

Figure 10:

Source: FOREX.com and yahoo.com
Despite the perception that the UK markets would perform well under the Conservatives, which is deemed a more business-friendly party, the FTSE has actually performed much better in the first year under a Labour party. In the past six elections, the FTSE has gained an average of 1022 points in the first year after a Labour win. In contrast, it has fallen by an average of 192 points during the first 12 months under a Conservative government. Though the FTSE’s gains under the Conservatives improves when you take into account their current coalition with the Lib Dems, the overall average gain of 6% at the party’s one-year anniversary in power is still well below Labour’s 24.8%. Thus, if this trend continues then a Labour win, all else being equal, would be better for the FTSE – at least in the party’s first year anyway. However, the above findings have not taken anything else into account. Even if the UK elections do play a big part in the FTSE’s direction, it could be that the outcome was already fully or partially priced in. What’s more, the FTSE’s components have changed over these years and not only that but the companies themselves have become more internationally focused and less dependent on the UK economy, let alone politics. That being said, the biggest risk for the FTSE could be if we get a hung parliament. Even if this potential outcome has no economic impact, the uncertainty that comes with it may well undermine the appetite for risk.

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Understand the risk involved
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Manage risk
Make sure you monitor your open positions when trading in volatile markets and take advantage of stop-loss and limit orders. You can also lower the leverage on your account from your trading platform and ensure your account is adequately funded to cover your open positions.

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