What You Need to Know Ahead of the May 6th UK General Elections

UK Politics have become a key driving force in the sterling market over the past couple of months, with the increased risk to see a hung parliament seen as further ammunition for sterling bears. At this point, a hung Parliament appears to be the most likely outcome on May 6th. This is basically priced in the market, the remaining uncertainty regards the shape of the coalition. A **Conservative majority outcome would now come as a major positive surprise for sterling.**

Contradictions in the UK Electoral System

The UK electoral system is highly contradictory and badly needs reforming. The House of Commons is formed of 650 MPs who will be elected on May 6th. A party needs 326 seats to obtain an overall majority. With the current system, the shaping of MPs seating at the House of Commons is not in line with each party's share of the national vote. This is because of the large number of seats in cities and because of the Labour strong presence in inner cities. At the moment, the system is biased in favour of the Labour: at the 2005 general elections, the Labour won 35% of the votes, with the Conservatives at 32% and the Lib Dem at 22% and yet 55% of MPs were were labour, 31% Conservatives and 10% Lib Dem. **All this implies that we could well end up in a contradictory situation where the Tories win the largest proportion of votes but do not win a majority at the House of Commons**. **The Tories need a 10 point lead to win an overall majority.**

Monitoring Recent Opinion Polls

Opinion polls have been volatile over the past few weeks but a few points should be emphasized here: i) **most polls have shown the Conservatives in the lead**, but ii) **short of the 10 points needed for a majority at the House of Commons**. The most recent opinion poll (April 26th) showed the Conservatives still in the lead, but by a small majority (at 34 points), followed by the Lib Dem (at 30 points) and the Labour (at 28 points) iii) the two TV debates between the three main parties' leaders have largely favoured Lib Dem's Clegg, **with the improving Lib Dem ratings the most surprising development so far in this campaign**.

Macro Environment and Parties' Policy Orientations

This year's general elections come as the UK just comes out of the worst recession since the 30s depression and with **the subsequent explosion in the deficits and debt representing the biggest macroeconomic challenge facing the UK economy in a very long time.** The UK economy has emerged out of recession in Q409 (growing by 0.4% on the quarter) and despite the poor weather seen in early January-February, positive GDP growth was also ensured in Q110. However, the UK economy contracted by nearly **5% in 2009** and the budget deficit to GDP ratio is expected to reach almost **12% this year** (not far from Greece). **The net debt to GDP ratio** is expected to reach at 75% of GDP this year (IMF forecast) and to climb to a high 83% of GDP by next year and to a worrying 92% of GDP by 2014 (all IMF figures).

In this context, the near-term fiscal policy outlook has become a central macroeconomic policy point of debates. **While all parties agree on the need to address the UK fiscal predicament, there are divergences of opinions regarding timing and on how to tackle the issue.**

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The conservatives' fiscal plans broadly match the government's ambition to halve the UK budget deficit by 2014 and to eliminate the structural deficit by next year.

Regarding timing, the Conservatives will be more inclined to initiate measures to reduce the deficits **as soon as possible,** while the Labour (and most likely the Lib Dem) **will be more inclined to favour a more Keynesian approach and allow for the UK economy to regain further momentum before tightening fiscal policy.**

Regarding the methodology, much energy has been spent discussing the merits of the government's plan to rise national insurance from April 2011. This is effectively a tax on jobs and is highly unwelcome in the business community. The Tories would favour a further £6bn (which is what would be raised by a hike in NI) in efficiency savings in the public sector instead. None of the major party has set a very clear agenda as to how to halve the deficit within four years and the **plans rely on optimistic growth assumptions** (for example, the govt assumes a 3.25% GDP growth rate in 2011) **so there is risk for disappointment here**. **There will be a need to announce further tightening measures at next year's budget** (a VAT hike is a plausible scenario). Whoever is elected after May 6th should be expected to announce extra tightening measures at the next PBR.

Hung Parliament, Market Implications

A hung parliament seems the most likely outcome if you believe in opinion polls and this has been a source for concern for the market over the past few weeks**. In theory, one would assume that a coalition government may find it difficult to implement the necessary policy measures required to cut the UK deficits, ultimately putting the UK's AAA rating at risk.** These fears may be exaggerated though: after all, both the Connservatives and the Labour openely recognize the need to cut the deficits (the greatest divergence relates to timing) and the Lib Dem recently recognized the depth of the UK fiscal problems**. A responsible approach can be expected given the scale of the UK fiscal predicament and given that rating agencies have already threatened to cut the UK's ratings**.

Historically, the UK Gilt market , stock market and sterling initial reaction is positive on a Conservative victory scenario (see 1970, 1979 or again 1992), while the last time that we had a hung Parliament (in 1974), UK assets underperformed, with the British pound trading nearly 10% lower one year after the elections. **This time may be different though:** sterling's sell-off on a hung Parliament scenario has already happened and is priced in**, so the downside may be limited.** In fact, if one believes that all three parties will endorse a responsible approach to committing to a reduction of the debt, **any post election sterling weakness must be seen as a good buying opportunity.** After all, it would appear that the sterling bear trade is showing signs of fatigue already: a hung parliament scenario is priced in, the economy has started to show marginally more encouraging prospects and a higher inflation environment could well bring a slightly more hawkish tone at the MPC. **It feels like the sterling bear trade is yesterday's trade.** Moreover, the room for a sterling rally on a surprise Conservative majority victory would be much greater given current expectations.

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