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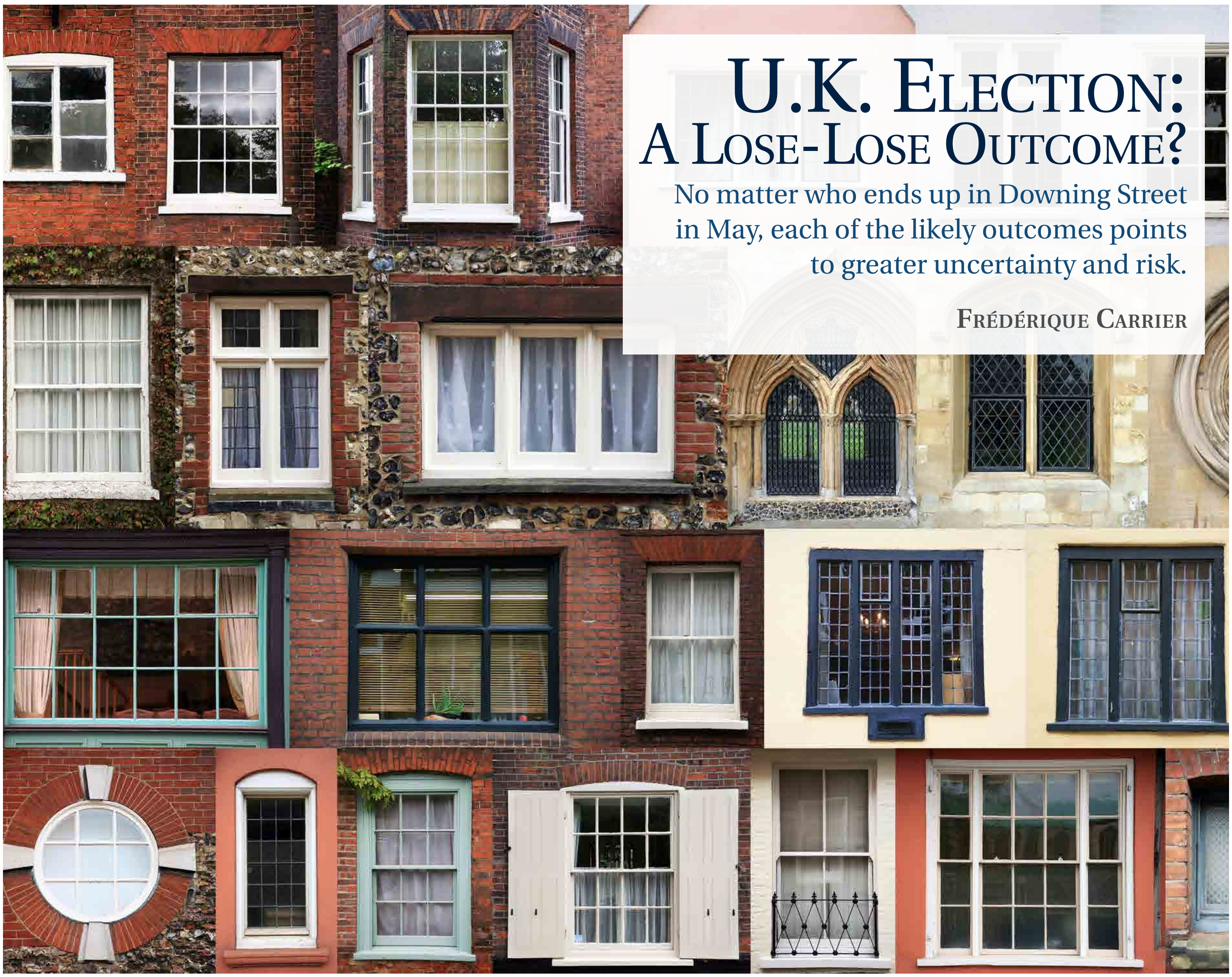

U.K. Election: A Lose-Lose Outcome?

No matter who ends up in Downing Street in May, each of the likely outcomes points to greater uncertainty and risk.

Frédérique Carrier

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Focus
Article

U.K. Election: Lose-Lose Outcome?

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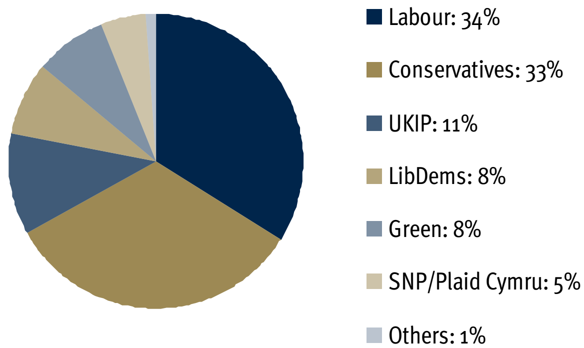
The rise of "minority parties" has turned the May UK general election into a complicated horse race. Britain's continued membership in the European Union could become an open question and raise economic uncertainty in the UK and on the continent. This would almost assuredly catch the attention of global financial markets, which have yet to price in the risks, in our view.

The New Six-Party System



Source - Ipsos MORI, poll of voting intentions as of January 2015

Unprecedented.

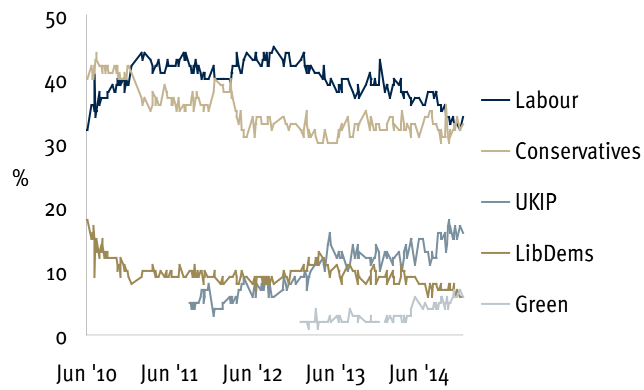
The prospect … is for a less stable government

The lack of wage growth, among other things, has meant the ruling Conservatives/Liberal Democrats (LibDems) coalition is not getting much credit for the comparatively robust economic recovery the UK has been enjoying. For the first time in electoral history, five parties have entered the campaign with more than 5% of the voting intentions, according to polls. The prospect following the election is for a less stable government.

The main threat to traditional parties comes from the UK Independence Party (UKIP), whose main platform planks of leaving the European Union (EU) and more restrictive immigration has eroded Labour and Conservative bases, though mostly the latter. The Scottish National Party (SNP) has gained at the expense of the Labour base there; the Conservatives have only one seat in Scotland. In addition, the Greens have gathered some 8% of voting intentions so far.

It is difficult to translate the current polls into potential seats in parliament, but observers suggest that as things stand, neither the Labour nor Conservative parties would likely have a majority, which requires 326 out of 650 seats. Furthermore, the LibDems have been dwindling in popularity. Any future coalition would likely have to rely on at least one of the emergent minority parties.

An Unpredictable Race



Source - YouGov UK plc; data through 12/15/14

More "European" than ever.

Centrist policies are likely to be replaced or ... influenced

Coalitions of more than two parties are inherently more fragile, less likely to last a full five year term. Centrist policies are likely to be replaced or, at the very least, influenced by a range of issues as coalition partners demand concessions in exchange for their support. While it is difficult for small parties to win seats under the first "past the post" electoral system, the rise of non-mainstream parties will likely be, at the very least, disruptive.

You Can't Tell the Players Without a Program

Among many possible outcomes we set out four potential scenarios:

A Labour/LibDem coalition. Current polls suggest Labour/LibDem would barely have enough for a parliamentary majority and might need to include the SNP, raising the issue of the legitimacy for a party focused on Scotland's interests as part of a Westminster government.

A Conservatives/LibDem coalition. The LibDems would have to agree to a referendum on European Union (EU) membership, a difficult concession for them. This coalition might include Northern Ireland's Democratic Unionist Party, and /or seek UKIP support for certain votes.

As UKIP is peeling voters from the Conservatives, we see a Conservatives/UKIP coalition difficult to achieve, particularly as the LibDems are unlikely to want to offer the balance of power to such a combination given widely divergent views. Moreover, the prospect of a Conservative/UKIP coalition might, according to pollsters, push voters into Labour's camp.

A minority government. This would occur if a party wins the most seats but does not get the majority and it chooses to try to run the government without entering into a formal coalition. Such a government would rely on partnerships for certain votes and would be inherently fragile.

New elections. If a new government does not get a vote of confidence at the state opening of parliament and no other party leader is able to form a government, parliament would be dissolved and a new election called.

Those last two scenarios would considerably stretch out the period of political instability.

As polls stand today, the most likely outcome is a Labour-led coalition. Changes in opinion are possible, including the potential influence of upcoming live TV debates and unfolding macro-economic data.

No Good Outcome?

Party manifestos are not out yet, so definitive policies can only be inferred from party leaders' speeches and conferences. Broadly, a Labour-led government would dent the UK's reputation as a relatively low tax, business friendly economy. By contrast, a Conservative-led government would raise the spectre of the U.K. exiting the EU. The party has committed to an in/out referendum on British membership by 2017. The prospect would likely weigh on household and business confidence, at a cost to economic momentum.

"Brexit" Risks Not Priced In

To fend off UKIP, Conservative Prime Minister David Cameron has adopted a tougher stance on the EU. His vision is to renegotiate the terms of the UK's relationship with Europe. He aims for increased cooperation on foreign policy and less burdensome red tape, and would like the UK to have more say over its own affairs. He recently suggested a cap on EU immigration and has promised to hold a referendum by the end of 2017 on whether the UK should remain a member of the EU under new renegotiated terms.

"... The uncertainty of [an EU membership] referendum could affect economic prospects"

The UK may be well placed to cope with some degree of political disruption thanks to the comparative strength of its economic recovery. However, the uncertainty of a referendum could affect economic prospects markedly.

Uncertainty would weigh on investment sentiment in the two-year run up to the promised vote. We would expect a loss of economic momentum as businesses and households become more cautious, as well as pressure on asset prices and the currency. In turn, this may lead the Bank of England to adopt a more accommodative monetary policy.

Were the UK to depart the EU, those UK companies no longer regarded as compliant with EU standards and regulation would lose preferred access to the EU market. Trade would suffer, particularly if the EU develops its planned single market for services. The UK's attractiveness as a trade partner and as a destination for foreign investment would diminish if its access to EU becomes constrained. Any such scenario would likely have repercussions for the labour market.

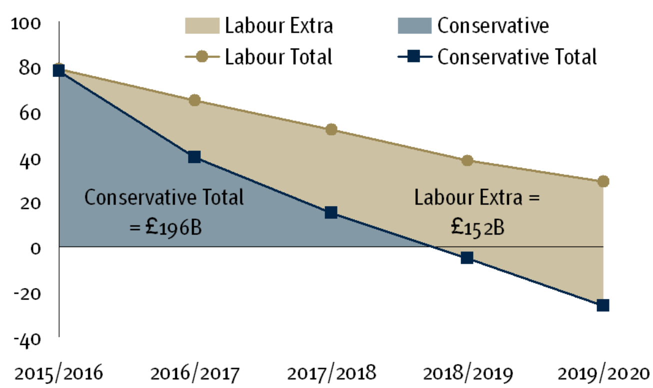
Reassuringly, a recent YouGov poll showed 43% of people would vote to stay in the EU in a referendum, while 38% would vote to leave, based on the current relationship. Should PM Cameron negotiate better terms with Brussels, a tall order given existing privileges the UK enjoys, support for the EU may well increase further. However, sentiment on this issue has been volatile and could be eroded by renewed eurozone instability.

Higher Taxes

A Labour-led government would likely negatively affect corporate profitability and the environment in which certain industries operate. Labour would prefer to reduce the stubbornly high fiscal deficit through targeted tax increases, as opposed to spending cuts. The key for the economy is whether these potential increases would inhibit future job creation and the rate of economic growth.

With less strict spending cuts, government borrowings would be larger under a Labour-led coalition than under a Conservative-led government, implying higher deficit financing than currently expected by markets. This could increase government borrowing costs, impacting the Gilt market.

Extra Borrowing Under a Labour-Led Government



Source - Office for Budget Responsibility, Conservative Party, Labour Party, RBC Capital Markets estimates

More debt, anyone?

Minimum Wage Hike

The most high-profile Labour proposal is the minimum wage increase to GBP 8.00/hr from the current GBP 6.50/hr level. This would affect those industries with a large percentage of minimum wage earners, such as retail, restaurants, hospitality, and cleaning. It is difficult to assess whether this additional disposable income would get spent (a positive for the economy) or whether it would lead to increases across the broader wage scale, potentially inhibiting job growth and reducing export competitiveness.

Utilities, banks, and real estate at risk

Impact on Key Sectors

Other Labour measures target specific industries including utilities, banks, and real estate.

Potential energy price freezes were unveiled at the Labour party conference in 2013. Subsequently, the Conservative/LibDems government signalled it would act to reduce the pressure of higher bills on households. We remain, therefore, cautious on the UK utilities sector given the risk of lower allowed returns and diminished overall profitability.

The banking sector is already contending with increased regulation and higher capital requirements. With some 15 billion shares in Lloyds and 9 billion shares in RBS (combined value of £40B) still in government hands, there would seem to be little incentive to reduce the sector's profitability. Banks, however, remain highly unpopular and an easy political target. The introduction of a threshold on banks' market shares, an increase in the bank levy, and creation of a banks' bonus tax all represent risks for the sector's profitability.

The real estate equity sector is bracing for possible mansion taxes on luxury houses and/or rent controls. It is still unclear how negative a mansion tax would be for residential property prices, but the number of transactions is likely to drop. Rent controls would not improve the housing supply problem but do represent a risk for UK real estate investment trusts.

Volatility Ahead

The uncertain outcome of the UK elections is likely to increase volatility of the FTSE 100 equity index and of sectors that could be the target of political parties' campaigns. Other sectors, however, have low operational and sales exposure to the UK, and some stocks could present attractive entry points were all UK stocks to correct in response to a hung parliament or weak coalition.

All the likely outcomes may present challenges for the UK economy and financial markets, but, in our judgment, the prospect of an EU referendum in the event of a Conservative-led government poses a threat for the equity market and in particular for sectors highly exposed to European revenues that is not yet discounted in share prices.

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