

# UK General Election 2015: Uncertainty in all scenarios!

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In the polls, Labour and the Conservatives are effectively tied. Combined with diverging political agendas between them and the fringe parties, and with the liberal Democrats losing further ground, the formation of possible coalitions, if any, is both highly uncertain and unstable. This political uncertainty is undermining sentiment in UK financial markets, with sterling succumbing to more volatility and (foreign) investors shunning Gilts. Given that the uncertainty of a hung parliament today is far greater than in the 2010 election, the downbeat sentiment in risk assets seen in the two weeks before and after the 2010 election may repeat itself this year, with more vigorous risk-off positioning by investors. Hedging UK equity exposure may be warranted. Buying short ETPs tracking the FTSE 100 and FTSE 250 enable investors to easily and effectively build protection against falling UK equity markets. Souring sentiment in UK risk assets may present an opportunity to position bullishly in UK government bonds. Buying a 3x leverage ETP tracking UK Gilts can enable investors to achieve: 1) higher returns with the same capital committed or 2) similar returns to the underlying but with less capital committed.

UK financial markets are likely to come under increasing pressure as investors weigh up the benefits and risks of the different political outcomes. Indications of downbeat sentiment in UK assets can be found in the poor demand at recent Gilt auctions, with the lowest bid-to-cover ratio in 6 years of only 1.37 for 10 year Gilts (see chart 1). As for the Sterling, it has succumbed to increased volatility relative to the dollar as of late (also shown in chart 1), exceeding levels reached during last year's Scottish referendum and now pushing towards volatility levels seen at the last general election. Unlike 2010, where the coalition parties were bound by their political duty to form a government and save the UK's economy, this year's election comes with no such baggage. As such, there is much more uncertainty this time round with the different political factions under less pressure to strike concessions.

## **A Hung Parliament Headache - Risk and uncertainty to follow**

The BBC's latest poll-of-polls suggest a neck-and-neck race between David Cameron and Ed Miliband for the job at Number 10, with both on 34% of the public vote. In the likely event that no single party can claim an absolute majority of seats in parliament (326 seats needed), a hung parliament will be declared and either a coalition government or minority government will come to power. We believe that the following scenarios best describe the risks to financial markets pre and post the May 7 election.

### **Scenario 1 - A conservative-led coalition takes power with support from the Liberal Democrats and/or other smaller parties**

Key Pledges from the Conservative Party

- Eliminating the budget deficit by 2018

- EU Referendum by 2017
- No rise in VAT, National Insurance or income tax

Under a Cameron-led regime, the Conservatives would have a second term to focus on tackling the budget deficit, with a budget surplus target by 2018 being a key pledge in their manifesto. However, the promise of an EU referendum by 2017 will no doubt be a point of contention, increasing the prospect of an unhappy divorce from the European Union ('Brexit').

Risks - With the EU accounting for 48% of UK goods exported and 46% of UK goods imported, a 'Brexit' would hit the UK's trade and investment prospects hard. £60 billion worth of trade between the UK and EU could be jeopardised with the removal of symmetric trading agreements and the introduction of tariffs. The prospect of favourable renegotiation terms for Britain with the EU is highly unlikely given the potential for EU members to seek similar deals, in so doing threatening the stability of the EU.

### **Scenario 2 - A Labour-led coalition takes power, supported by the SNP and/or the Liberal Democrats and/or other smaller parties**

Key Pledges from the Labour Party

- 'Triple-lock' of responsibility - Fully funded manifesto, cutting the deficit and balancing the books as soon as possible in the next parliament
- Increasing the minimum wage and offering more social benefits
- No rise in VAT, National Insurance or basic and higher rates of income tax

Under Ed Miliband's leadership, working class families would get more support and there would be greater stability with Europe as it seeks not to pursue a referendum. However, Labour's ability and commitment towards fiscal consolidation is questionable, given the lack of clarity surrounding the timeframe of their fiscal targets as well as the means of achieving them.

Risks - Under Labour, the prospect of higher taxes on businesses could pose risks to the UK's domestic-biased equity markets, in particular to small and mid-cap stocks. There is also the risk of an increase in the bank levy putting the likes of HSBC, Lloyds and Barclays, which together make up over 10% of the FTSE 100, at a disadvantage. In the event of a Labour-SNP government, it is possible that significant concessions would have to be made to the Scottish Nationalists, including more devolution of fiscal powers.

### **Its 2010 all over again! Take advantage of uncertainty**

Given the uncertainty, how should investors look to position themselves over the next couple of weeks? Well, the upcoming election bears many similarities to the 2010 election tri-party race between the Tories, Labour and Lib Dems. In the build up to that election, the prospect of the first hung parliament in 34 years contributed to downbeat sentiment across UK financial markets.

We focused on the performance of UK equity and bond markets 10 days before the 2010 election and 10 days after. In the 10 days building up to the election (denoted as '-10' on the graphs above) the FTSE 100 and FTSE 250 both fell by 9%. However, following the election results, investor confidence received

an initial boost with equity markets recovering and gilts weakening. Sentiment in risk assets then soured as talks to iron out the details of the coalition government went underway. As a result, in the 10 days following the election outcome, equities (large and small-cap) shed all their gains and ended even lower than just prior to the announcement of the election outcome. With this in mind, investors who held a 3X FTSE 100 short tracking the FTSE 100 over this 20 day period of uncertainty would have enjoyed a return of 31%. Similarly, investors who held a 3X long position tracking long-dated UK Gilts would have seen their investment increase by 14%. So, it is quite clear that in times of uncertainty, it pays to be hedged. With the upcoming election being even more unpredictable than in 2010, and with each political outcome offering added uncertainty, investors would be prudent to hedge their UK exposure.

- Investors sharing this sentiment may consider the following Boost short and leveraged ETPs
  - [Boost FTSE 100 3x Short Daily ETP \(3UKS\)](#)
  - [Boost FTSE 100 2x Short Daily ETP \(2UKS\)](#)
  - [Boost FTSE 100 1x Short Daily ETP \(SUK1\)](#)
  - [Boost FTSE 250 1x Short Daily ETP \(1MCS\)](#)
  - [Boost 10Y Gilts 3x Leverage Daily ETP \(3GIL\)](#)
- [Boost FTSE 100 3x Short Daily ETP \(3UKS\)](#)
- [Boost FTSE 100 2x Short Daily ETP \(2UKS\)](#)
- [Boost FTSE 100 1x Short Daily ETP \(SUK1\)](#)
- [Boost FTSE 250 1x Short Daily ETP \(1MCS\)](#)
- [Boost 10Y Gilts 3x Leverage Daily ETP \(3GIL\)](#)

*All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.*

## Important Risks Related to this Article

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