UK Elections, European Disunion and Financial Markets

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On May 7, 2015, the United Kingdom will hold elections that could dramatically reshape its relationship with the European Union (EU). Currency patterns for both the Pound and Euro might be disrupted as trading relationships could be thrown into doubt. To examine the contours of the political landscape, we will start with the two major parties, although, the eventual election outcome might be determined by the growing strength of Britain’s smaller parties.

Labour Party, which last ran the country from 1997 to 2010, generally takes a pro-European stance. Gordon Brown, who served as Chancellor of the Exchequer under then Prime Minister Tony Blair from 1997 to 2007 prior to becoming Prime Minister himself, aspired to have the UK join the Euro. Blair himself attempted, unsuccessfully, to become President of the European Commission after leaving office. Labour’s approach to the EU is to negotiate on behalf of UK interests within the European framework, and the party is generally more favorable to European integration. Labour’s position on the EU is rather straightforward compared to that of its main rival, the Conservative Party.

The Conservative Party (Tories) has a more complicated relationship with the EU. The party has long been split between a dominant pro-European faction and a smaller but vocal Eurosceptic wing. Margaret Thatcher, who identified closely with the Eurosceptics, was ousted as Prime Minister in 1990, in part, because of her opposition to joining the Exchange Rate Mechanism that eventually converged the various European currencies into the Euro. Although her successors, including Prime Ministers John Major and David Cameron, were more pro-European, the leader of the Conservative Party has to spend considerable time managing the Eurosceptics. Recently, this task has been complicated by the rise of the UK Independence Party (UKIP), which has siphoned off more voters from the Tories than from other UK parties. As such, Cameron has promised that if voters return his party to office in 2015, he will call for a non-binding referendum on the EU. If the referendum takes place, it is entirely possible that UK voters would voice their opinion that it is time to leave. Additionally, the Conservatives favor softening financial regulations proposed by the Brussels-based EU which they see as a threat to London’s financial services industry.

The UK’s other parties add complexity. UKIP, of course, opposes continued membership in the EU. The party used to be fairly marginal, garnering just 3.1% of the vote in the 2010 elections, but since then its ranks have swelled. In 2014, UKIP took 27.5% of the vote in UK’s European parliamentary elections, pushing Cameron’s Conservatives into a humiliating third place. Currently, they are running around 15% (Figure 1) in the polls for the upcoming UK Parliamentary elections – not enough to win many seats but possibly enough to undermine the Tories’ chances of winning outright.
The Liberal Democrats (Lib Dems), by contrast, are ardently pro-European. Currently, they govern with the Conservatives as the junior member of the coalition government. For their part, the Lib Dems have collapsed in the polls (to around 7% from 23% in the 2010 elections (Figure 1)) and look set to lose most of their representation in Parliament. This makes it very unlikely, though not impossible, that they will remain in government after May 2015. Lib Dem leader and Deputy Prime Minister Nick Clegg even warned that one-party Tory rule would lead to the break-up of the UK, stating, “As night follows day, if the UK falls out of the European Union, Scotland, in my view, within a heartbeat, will pull out of the UK. We will then have lost two unions in one parliament.”

Finally, there is the Scottish National Party (SNP). The SNP is best known for losing the independence referendum in September 2014. Do not be fooled -- if the polls are to be believed, they appear to be on the verge of wiping out Labour in Scotland (Figure 2). Before the referendum vote, Cameron promised the Scottish people devolution –more local control over their governance. Scottish voters might hold him accountable by electing more SNP members of parliament (MPs), and if so, it will not come at the Tories’ expense because they have only one seat left in Scotland. Rather, it will come exclusively at the expense of Labour’s 41 Scottish seats. If current polls hold, Labour stands to lose approximately half of its Scottish representation –precious seats it will need to retain if it is to secure a majority in Westminster. A SNP rout may deny Labour a majority in Parliament in Westminster even if Labour out-performs the Tories in the popular vote country-wide.

For the moment, the elections appear as though they will be closely contested and it is difficult to privilege one outcome over another. That said, we see three major scenarios as worth examining:

1) Tory Win
2) Hung Parliament
3) Labour Win

These three scenarios could produce significantly different outcomes with respect to the UK’s relationship with the European Union. Let’s explore them one by one.

Scenario 1: Outright Tory Win

This scenario is not as farfetched as it might sound. While the Conservatives have been behind in the polls nearly 100% of the time since the current Tory-Liberal Democrat coalition took office in May 2010, they have a long history of outperforming opinion polls on Election Day. One might also say that the Labour Party has a long history of snatching defeat from the jaws of victory. Either way, Prime Minister Cameron’s Conservatives could win; they have been catching up in the polls.

As previously noted, Cameron has promised that if his Conservative Party wins, he will call for a non-binding referendum as to whether the UK should remain a part of the EU. Moreover, public opinion polls indicate that if such a referendum was held, the UK public would vote in favor of leaving the EU. As such, a Tory win could move markets, possibly putting pressure on UK equities and the Pound while supporting UK fixed income in the short to intermediate term. The Euro relative to the US dollar might also be destabilized.
There is considerable debate over the consequences of the UK leaving the EU. Some consider that it would be a disaster for British businesses and the economy, and would reduce the UK’s influence in Europe. However, others argue that if the UK were to leave, it might not be such a big deal. They point out that the UK could work out an agreement with the EU that resembles the one that Norway and Switzerland have with the group. Although neither Norway nor Switzerland are members of the EU, their citizens move freely within the EU – in fact, more freely than UK citizens currently do. Moreover, Norwegian and Swiss businesses are deeply integrated with their EU counterparts. Finally, as the Swiss have discovered, not having joined the EU does not exempt Swiss financial institutions from the reach of regulators and tax authorities across the continent. UK citizens, banks and other businesses might find themselves in the same boat were they to leave the EU, depending upon what sort of agreement was reached and how disruptive a transition out of the EU would be. It is also worth noting that the UK, like non-EU members Norway and Switzerland, remained outside of the common currency.

Scenario 2: Hung Parliament
By its very nature, this is the most difficult scenario to evaluate because it would depend on how the seats in Parliament are divided among the smaller parties. If it is another Conservative-Lib Dem government, Cameron will likely have to call a referendum regarding EU membership. The outcome would likely resemble Scenario 1, but the Lib Dem’s are not likely to want to be a part of another coalition. As has been observed in many countries, the smaller party in a coalition government often loses popularity substantially at the next election.

If a hung Parliament produces a Labour-Lib Dem or a Labour-SNP government, the outcome would be considerably more pro-European and a referendum would be unlikely during the term of office of any such coalition.

The present coalition aside, hung Parliaments have often proved to be short-lived. The one formed in February 1974 did not make it past October of the same year. The Lib Dems insisted on a full fixed-term parliament as the price for being part of the current coalition with the Tories. The idea of a full fixed-term Parliament may be losing its appeal. In any case, a Labour-based coalition might also spell market volatility even if the UK-EU relationship is maintained, given the policy uncertainties that would accompany such a government.

Scenario 3: A Labour Victory
This is the scenario favored by public opinion polls until recently. The chances of an outright Labour majority, however, appear to be diminishing. If Labour comes to power, it is unlikely that it will call a referendum on EU membership. The UK will continue to have plenty of bones to pick with the EU over matters like financial services regulation but any such dispute would likely be handled within the usual EU framework. This scenario would likely have UK equities breathe a sigh of relief in the short run but might be of little consequence in the long-run.

The UK has often had an uneasy relationship with the EU. In 1967, French President Charles de Gaulle said “non” to the UK joining the European Economic Community (EEC), the EU’s predecessor. Even after the UK joined the EEC in 1973, relations with its European partners were not always smooth. During the 1980s, some of Thatcher’s most famous one-liners had to do with disputes between the UK and the European Community, including her famous “I want my money back” remark (referring to agricultural subsidies) and her “No, no, no” speech to Parliament (regarding the efforts to expand the EU’s powers into health care policy, national security, and the creation of a common currency).

Things have not gotten easier over the past quarter century, most especially, since the financial crisis. The UK is at a fork in the road with respect to Europe. Whichever path voters choose, it will have plenty of short-term consequences for financial markets. How much a decision to leave the EU matters in the long run is a subject of considerable debate that will intensify ahead of a referendum, should one occur.

For centuries, the UK’s overriding foreign policy goal has been to make sure that no one power comes to dominate the continent (see Spain in the 1500s and early 1600s, France in the late 1600s up to the 1870s, Germany from 1870 to 1945 followed by the Soviet Union until 1991). If the UK leaves the EU, it will lose its direct leverage over decision-making in Brussels but could still pursue its divide-and-conquer strategy by setting the remaining EU members against one another on issues of interest to the UK, including financial services regulation, while still cooperating with the EU and its member states in other areas such as national security and intelligence. The EU, however, could do the same, pitting Scotland against England within the UK. Interesting times ahead!