

# UK election: Five reasons why markets seem relaxed

UK Prime Minister Rishi Sunak has launched a high-stakes gamble to hold onto power. But after years of political turmoil, this election campaign has the potential to be much less volatile for UK markets



UK investors have become accustomed to political drama over the past few years, and we're inclined to think that July's election shouldn't be particularly volatile for markets

## Markets have barely reacted to the election announcement

UK Prime Minister Rishi Sunak has caught the country by surprise and called a snap election for 4 July, setting the scene for a short and swift campaign.

But you wouldn't know it looking at UK markets, where the impact so far has been minimal. UK investors have become accustomed to political drama over the past few years. Here are five reasons why this election has the potential to be less exciting and volatile in markets.

### 1 Labour is miles ahead in the polls

Firstly, the election result looks like a foregone conclusion in the minds of investors and has done for some time. The opposition Labour Party is more than 20 points ahead of the ruling Conservative Party in the polls, and so far the improving economic backdrop has failed to move the dial.

Headline inflation may have only just returned to within a whisker of the 2% target, but the economic news has been improving for some time. Even before April's drop, household energy bills were already almost 20% below their peak. Food prices have also been rising much less rapidly for the past six months, though the food price level is still some 25% higher than it was at the start of 2022.

Since the autumn, we've also had two sizeable tax-cutting budgets. All the while, Labour's lead has continued to rise sequentially, despite consumer confidence in the economy having picked up appreciably since 2022.

Polls can, of course, change quickly. You only have to look at former prime minister Theresa May's ill-fated campaign in 2017 to see how a badly-received manifesto pledge can change the narrative. But with Labour currently so far ahead in the polls, it's likely that the party will adopt a fairly defensive manifesto that risks neither boxing itself in upon election victory, nor jeopardising its extensive lead among voters.

## 2 Unlike 2019, Brexit is no longer a major unknown

Secondly, and in sharp contrast to the last election in 2019, July's vote carries no major implications for the country's relationship with the EU. Back in 2019, the Brexit question was far from resolved; options ranged from a second referendum to 'no deal' – and the sharply divergent economic outcomes those scenarios could potentially entail. But the country's economic relationship has since been settled and none of the major parties are keen to reopen the debate.

Labour are likely to be more pro-EU than the Conservatives, but Sunak has been more pragmatic than his predecessors when it comes to dealing with the practical implementation of the Trade and Cooperation Agreement.

## 3 Scottish referendum remains unlikely

Thirdly, the scale of Labour's lead means it can likely govern with an absolute majority, and that reduces the likelihood that the issue of Scottish independence returns to the fore.

That would be more likely if Labour were to rely on other parties for a working majority as part of a coalition. In years gone by, that would more than likely have had to include the Scottish National Party (SNP), given its relative size in parliament. This was one of many uncertainties for investors back at the 2019 election.

However, the SNP is projected to have lost more than half the seats it won five years ago, according to [recent YouGov projections](#). That follows recent turmoil in the party.

## 4 Neither party is promising radical fiscal policy shifts

Fourth – and perhaps most importantly – with the 2022 mini budget crisis still fresh in the nation's political memory, none of the major parties are promising a radical departure from existing economic policy. Both Labour and the Conservatives have emphasised that they'll stick to the existing fiscal rules, overseen by the independent Office for Budget Responsibility.

That doesn't mean there aren't going to be hard choices. Quite the opposite. Higher inflation has helped tax revenues but squeezed public spending over recent years. The Chancellor has banked the benefit of the former in successive budgets, giving away some of the windfall to households in

tax cuts. But so far, public spending has largely gone unadjusted despite a period of high inflation.

This is a key challenge for the incoming government, and the room for manoeuvre is limited under existing fiscal rules. And while rules can be changed – and they may well be to accommodate more public investment – they are not seen as particularly strict by historical standards.

Still, we have to remember that this challenge is far from new. Financial markets have long since factored this in.

Our fair value model suggests ten-year Gilt yields have already been trading at a premium for much of the year, and the 5s10s slope is around 10bp, contrasting the slightly negative (inverted) slopes for USTs and Bunds. Both indicate that a term risk premium is already built into the curve, which captures some of the upcoming macro uncertainty.

We don't expect the risk premium in gilts to increase materially over the campaign, and we therefore retain our downward bias for UK bond yields.

## 5 An election doesn't shift the Bank of England outlook

Finally, barring any fiscal fireworks, the election doesn't change the story for the Bank of England. Stubborn services inflation figures released this week favour an August rate cut over June. Markets are pricing just a 9% change of a cut next month.

Still, don't assume the Bank won't move in June just because there's an election coming. BoE independence is a well-established and respected principle among the major parties, and a rate cut has been telegraphed long before the election was called.

## FX: Election may generate noise, not direction

Sterling's implied volatility has risen following the election announcement, with the pound facing some mild pressure. GBP/USD two-month vols jumped around 20bp on the news, but at 6.20 they remain nowhere close to the 7.30 April peak.

We agree that there may be some GBP noise in the run up to the July vote. That could be generated from pre-election policy pledges by Labour. Any news concerning plans on future relationships with the EU could also generate some GBP noise. The most impactful news would probably be on a new Scottish referendum which, as we note above, looks unlikely.

However, this would likely just be noise, and the direction will still be dictated by monetary policy in the UK and the US. As we don't see the BoE changing its policy plans due to the election, the overall implications for sterling should be limited.

We retain our view that EUR/GBP will grind higher as the BoE delivers 75bp of easing this year, which is more than markets are currently pricing.

## Authors

### James Smith

Developed Markets Economist

[james.smith@ing.com](mailto:james.smith@ing.com)

### Michiel Tukker

Senior European Rates Strategist

[michiel.tukker@ing.com](mailto:michiel.tukker@ing.com)

### Francesco Pesole

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

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