

ECONOMICS: EUROPEAN PERSPECTIVES—MARCH 5, 2010

Gilts, Political Risk and the UK Election

■ **Darren Williams**
 Senior European Economist—Global Economic Research

Recent opinion polls suggest that the outcome of this year's UK election is still in the balance and this has led to a widening of the spread between UK and German bond yields. Having been consistently negative on gilts over the last year, we now think this spread is subject to two-way risk depending on the actual election result.

For two decades, with the main political parties broadly agreeing on the general thrust of economic policy, UK elections have been of limited interest to financial markets. Ultimately, this may be the case with this year's vote. But opinion polls now point to the possibility of an inconclusive result, the public finances are in a parlous state and the two biggest parties disagree on the timing of fiscal adjustment. Political news is again moving UK markets.

The general election must be held by June 3. The precise timing will be decided by the Prime Minister, Gordon Brown, and is therefore uncertain. However, the most likely date is May 6, to coincide with local elections across much of the country. Until recently, opinion polls (**Display 1**) suggested that the opposition Conservative Party (center right) would secure a comfortable majority. But the latest polls point to a pickup in support for the incumbent Labour Party (center left).

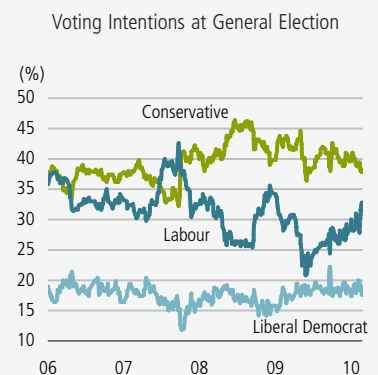
With the exception of a few rogue polls, the Conservative lead over Labour has fallen from

over 10% at the beginning of the year to about 6% now (**Display 2**). The vagaries of the UK electoral system make it difficult to convert this into an accurate election prediction. Still, most experts believe that this type of result would make the Conservatives the biggest party in Parliament but leave them slightly short of an absolute majority. To form a government, they would have to rely on the help of the centrist Liberal Democratic Party which, so far at least, has indicated that it will support the biggest party in the new parliament.

There are several other scenarios. In all likelihood, the election result will be determined by voting in around 100 marginal seats.* Having focused their resources, the Conservatives are widely expected to do well in these. This means their current share of the vote might still be sufficient to deliver a small majority. But the situation is so tight that even a modest narrowing of the gap between the parties could tip the scales in favor of a minority Labour government. At this stage, we cannot even rule out the possibility of a majority Labour government.

*There are 646 seats in Parliament but the majority of these are securely held. This means the outcome of the election effectively depends on voting in a relatively small number of seats.

Display 1
Conservative Lead Starts to Narrow



Rolling average of five most recent opinion polls.
Source: UK Polling Report and AllianceBernstein

Display 2
Conservative Lead Starts to Narrow



Rolling average of five most recent opinion polls.
Source: UK Polling Report and AllianceBernstein

The bottom line is that, two months ahead of the most likely polling day, the election is wide open. Moreover, hung parliaments are unusual in the UK—the last one, in 1974, lasted less than a year—and, with no formal constitution, there is uncertainty about what happens if no side gains an absolute majority. How long will it take to form a government, who will the Liberal Democrats actually support and, crucially, will the resultant government be stable?

In normal times, these questions might not matter all that much (at least for financial markets). But these are not normal times. The economy is only just emerging from the deepest slump since the 1930s and the budget deficit is at a peace-time high. In addition, markets are beginning to focus on fiscal exit strategies and sovereign risk. If the UK elects a weak government that is unable to take difficult decisions, there could be a sharp sell-off in the gilt market.

There are also key differences in the way in which the two main parties will approach fiscal consolidation. The Labour Party has promised to cut the deficit, but its plans rely heavily on optimistic assumptions and it has postponed any tightening until next year, fearing a more aggressive approach would jeopardize the recovery. Labour is also likely to favor tax rises over spending cuts, a bias that could weigh on long-term growth.

The Conservative Party has promised to

tighten fiscal policy as soon as it takes office. This is because it believes a delay could lead to a sovereign debt crisis. Given recent events in Greece, there is some justification for this. Indeed, the major rating agencies have already warned that the UK's triple-A credit rating is at risk if a credible fiscal program is not soon put in place.

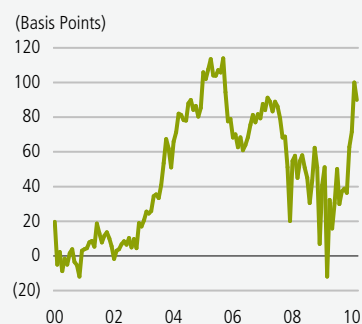
Whether governments should tighten fiscal policy now or later, when recovery is more secure, is currently the subject of a furious debate in many countries. A detailed analysis of the pros and cons of each approach is beyond the scope of this note. Clearly, though, if early fiscal tightening sends the economy back into recession it could prove counterproductive. However, it's important to note that putting off fiscal tightening until growth returns often results in no tightening at all, with the government instead relying on cyclical factors to reduce the deficit. To some extent, this type of approach has contributed to the current crisis in Greece.

Moreover, this debate presupposes that the government actually has a choice. Given recent developments in Greece, the next British government may have no option but to tighten fiscal policy after the election in order to maintain investor confidence. Promises of jam tomorrow may no longer be enough to placate gilt investors.

There is little doubt that the best election outcome for the gilt market would be a

Display 3
Gilts Have Underperformed

UK 10-Year Yield less Germany 10-Year Yield



Source: Bloomberg and AllianceBernstein

majority Conservative government. Indeed, such an outcome would probably give a short-term boost to gilts. However, an inconclusive result, particularly a minority Labour government, could lead to a sharp sell-off in the gilt market and the pound. The problem for investors is that it is now impossible to know which outcome is most likely.

Over the last year, we have been consistently negative on gilts relative to other markets. During this period, the 10-year yield differential between the UK and Germany has widened by roughly 100 basis points and is now close to the highs of recent years (**Display 3**). As the possibility of a hung parliament has now been digested by the market, we think the spread is subject to two-way risk depending on the actual election result. ■

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

Note to Canadian Readers:

AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

Note to UK Readers:

UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Taiwan Readers:

This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

Note to Singapore Readers:

This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers:

This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.