

Deutsche Bank Breaks Down How Tomorrow's Election Will Impact UK Markets

By [Zero Hedge](#)

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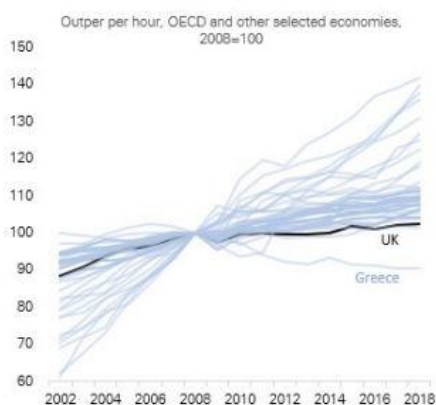
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A team of Deutsche Bank macro analysts led by Oliver Harvey has produced its latest note economic note about Brexit expounding on the bank's near-to-medium-term view on the outlook for British markets.

The bulk of the note is an examination of how the Conservative policy manifesto stacks up against Labour, while also examining how each party's platform might impact longstanding economic trends in Britannia, including weak productivity (since the crisis, the UK has exhibited the most tepid productivity performance of any major economy, according to the OECD's data)...

Figure 1: The UK has experienced nearly the worst productivity performance of any major economy since the crisis



Source: Deutsche Bank, OECD

Figure 2: There is a robust long-term relationship between productivity growth and living standards



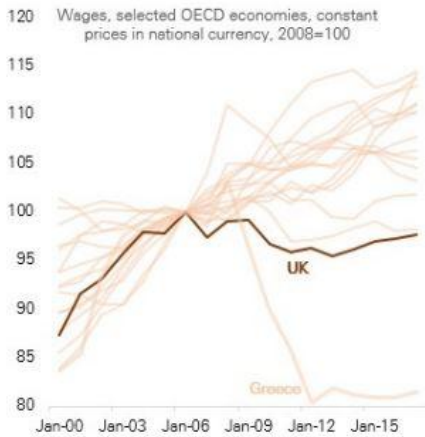
Source: Deutsche Bank, ONS

1 See European Parliament "Regional inequalities in the EU" 2019
2 A caveat to this conclusion is that income inequality has widened in the UK relative to the 1970s. According to Atkinson (2011) the share of the top 1% doubled from approximately 6% in 1976 to 12% in 2000. The increasing share of the 1% appears to have leveled off after 2000, however, with income inequality broadly the same today as two decades ago.

...and a standard of living that hasn't yet recovered to surpass its pre-crisis peak.

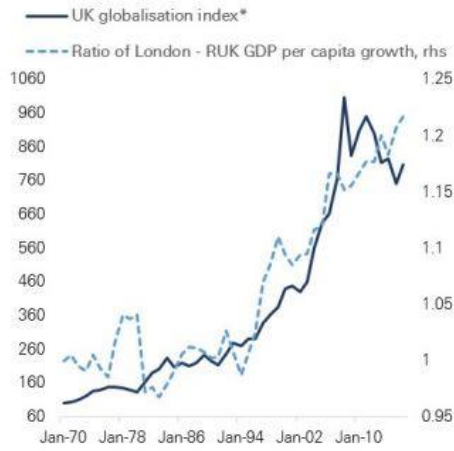


Figure 3: As a consequence living standards have failed to reach their pre-crisis peak and have been weak in an international context



Source: Deutsche Bank, OECD

Figure 4: Regional inequality has also been exacerbated by rapid globalisation in the UK in the last twenty years

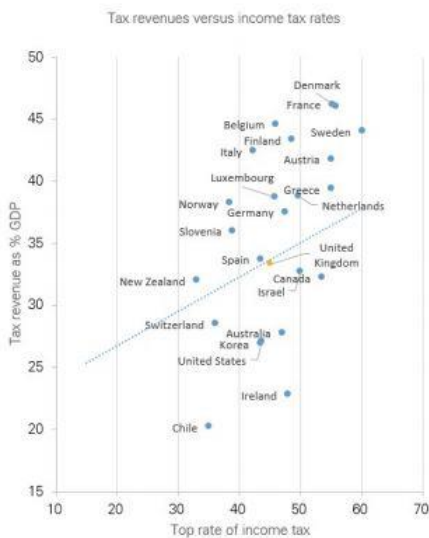


Source: Deutsche Bank Calculations. UK globalisation index measured as equally weighted index of net migration, trade, FDI and cross border bank claims as % GDP

And let's not forget about taxes. Labour hopes to hike the capital gains tax on investment income, while also raising the inheritance tax and several other levies.

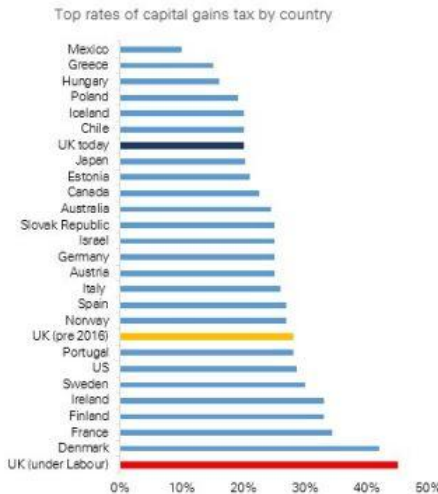


Figure 15: There is a robust correlation between income tax rates and tax revenue collected



Source: Deutsche Bank, OECD

Figure 16: Labour Party proposals will see the UK jump to the top of capital gains tax rates



Source: Deutsche Bank, Tax Resolution Foundation, OECD

Looking further down the road, DB's team said they "find it difficult to be bullish sterling until more detail is provided on Brexit outcome." Strategists are increasingly expressing trepidation about Boris Johnson's insistence that the Conservatives won't allow an extension of the next meaningful Brexit deadline (that is, the Dec. 31, 2020 deadline to finish trade-deal talks)

In the near term, the biggest risks are related to the outcome of Thursday's vote.

Conservatives are ahead in the polls, but it's likely they won't win an outright majority. So, the first question is what kind of coalition will they form? Two possible iterations are: an alliance with the DUP and/or Brexit Party, or a minority government with the support of the Liberal Democrats. In the event of the former we would be very negative on the pound and bullish UK rates.

Neither route is free of problems for the Tories. The DUP (Democratic Unionist Party) has been a persistent thorn in No. 10's side since last summer, and both they and the Brexit Party have criticized Johnson's deal. If they win enough seats, they could try to force Johnson to scrap the deal and push for another round of negotiations, which would probably infuriate both the EU27 and the British public. If the Conservatives end up partnering with the Lib Dems, they might need to commit to a second Brexit referendum in order to pass Johnson's deal. In the short term, at least, this would present a more optimistic outlook for the pound and UK markets more broadly.

In terms of growth, a Conservative majority followed by implementation of the government's Brexit deal in January could trigger a bounce in consumer sentiment, in turn lifting growth in the short term. It probably goes without saying, but however the Tories choose to handle the situation, the composition of the governing coalition will be of critical importance to markets.

For example, DB's team believes business investment would rise if the government (presuming a Tory plurality) agrees to extend the Dec. 2020 deadline, thereby increasing the chances of a lasting trade deal that's agreeable to both sides.

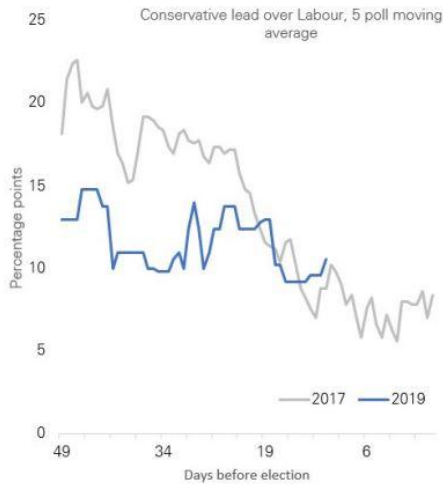
Figure 23: Market implications of different political scenarios

Outcome	Short term view		Medium term view	
	Sterling	Rates	Sterling	Rates
Conservative majority + 30 seats	Moderately bullish, sterling to rally 1-3% initially	Gilts to sell-off at long-end and more moderate sell off at front-end, leading to curve steepening	Sterling outlook contingent on government's approach to Brexit and transition period in H1 2020. A pivot on transition period extension would see further sterling gains (5-8%)	A pivot on transition period extension would also see further sell-off in gilts. Market will also await budget H1 2020 for details of fiscal policy
Conservative majority between 0-30 seats	Mostly priced, sterling to rally ~1-2%	Gilts to sell-off moderately, modest steepening of curve	Sterling outlook contingent on government's approach to Brexit and transition period in H1 2020 but greater uncertainty about ability of government to u-turn on transition period	Similarly contingent on government's approach to Brexit and transition period in H1 2020, but given likely continued economic uncertainty, bullish bias
Conservative minority government with DUP or Brexit Party support	Bearish - sterling to fall 3-5% initially	Gilts to rally both at long and front-end, curve to flatten, breakevens to rally	Bearish on basis that chance of no deal Brexit by end of January increases considerably	Bullish in general and curve to flatten, breakevens to rally, real yields to rally
Conservative minority government with Liberal Democrat support	Bullish, sterling to rally 2-4% initially	Gilts to sell-off at long-end and more moderate front-end sell off, leading to curve steepening	Potentially very bullish if price of minority government support is second referendum, with eurosceptic Conservative MPs marginalised	Potentially very bearish for similar reasons, breakevens to sell-off as FX rallies, real yields to sell-off
Labour minority government with SNP, Liberal Democrat, other parties	Bearish - sterling to fall 2-4% initially	Rates to sell-off, particularly at long-end, breakevens to rally, 10s30s to steepen	Sterling to reverse initial sell-off and rally if second Brexit referendum delivered, fiscal policy becomes more expansionary and Labour party business policies are moderated	Potentially most bearish outcome for rates assuming BoE mandate unchanged: significant sell-off and curve to steepen
Labour minority government with SNP	Bearish - sterling to fall 2-4% initially	Rates to sell-off, particularly at long-end, breakevens to rally, 10s30s to steepen	Lower confidence that Labour business policies constrained, and prospect of second Scottish independence referendum offset positives from Brexit and fiscal stimulus. Neutral	Neutral on front-end, curve to steepen, breakevens to rally
Labour majority	Bearish - sterling to fall 3-5% initially	Twist steepener - front end to rally and back-end to sell off, breakevens higher	Market will await execution of Labour Party policy platform on Brexit and business policies. Difficult to be structurally bearish given fiscal policy if BoE mandate unchanged	Neutral on front-end depending on implementation of policy platform, curve to steepen, breakevens to rally

Source : Deutsche Bank

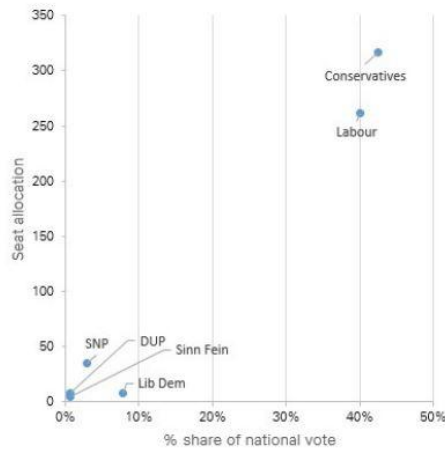
Polls have consistently shown Conservatives with a sizable lead. But as DB shows, there's not much of a relationship between the percentage of the vote and number of seats won.

Figure 21: The Conservative lead has proved more stable than 2017 if at lower levels



Source: Deutsche Bank, UK Polling Report

Figure 22: The relationship between share of the national vote and seat allocation is far from linear

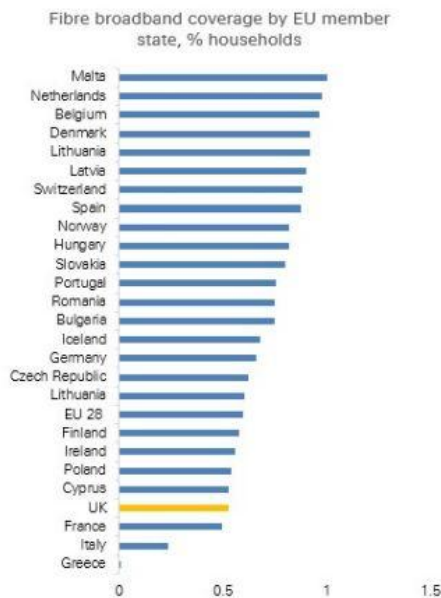


Source: Deutsche Bank

Still, Labour’s program of massive public spending hikes is attractive to the average Joe who is tired of austerity and eager for better broadband access.

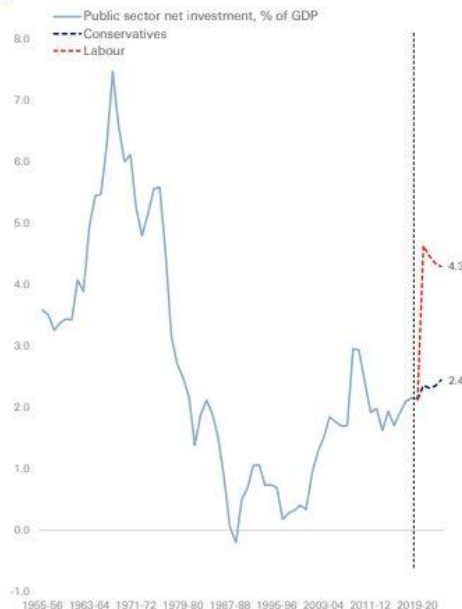
Labour’s party manifesto is ambitious, and includes nationalizing the broadband arm of BT Group (formerly British Telecom) to bring free broadband to all of Britain before 2030. The manifesto also calls for much higher regional investment to help smooth out the stark economic inequalities between various regions.

Figure 17: The UK lags far behind other EU member states in broadband coverage



Source: Deutsche Bank, EU Commission

Figure 18: Labour’s investment plans are significantly more ambitious than the Conservatives’



Source: Deutsche Bank, Labour, Conservatives, OBP

Johnson’s Conservatives are way ahead in the polls. But as investors learned during the Brexit referendum, polls can’t always be trusted.

And anybody who agrees with DB’s long-term skepticism about the pound can probably pick up some OTM puts for a reasonable price.

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