



Macro

No room for complacency

Upcoming UK and French elections are far less predictable than you might think. The data suggests a wide range of plausible outcomes.

In 1805, the Scottish novelist and playwright Walter Scott won literary fame overnight. Scott's narrative poem, "The Lay of the Last Minstrel," tells the story of an old wandering bard and an ancient feud. Before the minstrel recites his lay, he hesitates:

"And scenes, long past, of joy and pain,
came wildering o'er his aged brain."

This is a little how we feel, as we weigh in once more on upcoming electoral events. Like the minstrel in the story, we may well be the last of a dying breed in remembering the lessons from Trump and Brexit. As we noted in our March 13th CIO View Special, introducing our European election watch, "polling can actually be quite useful, if used wisely." At the time, we argued that the widespread skepticism towards opinion polls ahead of the elections for the Dutch House of Representatives and the French presidential elections was overdone. However, blindly taking comfort from reassuring polling results can be equally dangerous. "Polls are only a snapshot and even the ones published just before an election are usually a few days old by the time you read about them. A lot can still change in those final days."

It pays to be especially cautious when different forecasting methods yield widely different results. This may "point to systematic biases. Until the vote takes place, however, you cannot know for sure which sources of data will prove reliable this time around. (...) The key is not getting into the business of trying to predict the direction of the suspected polling error. Instead, all you can say is that a broader range of outcomes is possible." This, alas, is exactly where we are a few days ahead of the general election in the United Kingdom (UK) and to a lesser extent in France.

The UK general election

Not so long ago, the outcome of the UK snap election looked like a foregone conclusion. Indeed, our base case remains the return of a government led by the Conservative Party (the Tories). The Labour Party has rapidly been gaining ground in the opinion polls, leaving the Conservatives only a few points ahead in some of the latest ones. As we noted in our March 13th Special, that might still be enough to ensure a Tory win: "Thanks to the UK's first-past-the-post electoral system, a plurality in the popular vote can translate into whopping majorities in the lower house (House of Commons)." Indeed, it is a fairly typical pattern for British election campaigns that the opposition party gains ground, only to go down in defeat in the end.

Stefan Kreuzkamp
Chief Investment Officer



Expectations in a nutshell

- Among the many concerns of global investors, worries about European politics appear to have rapidly receded in recent weeks.
- Ahead of parliamentary elections in the UK and France, fairly market-friendly outcomes remain our base case.
- However, we caution that uncertainty is very high. Politics remain in flux in both France and the UK. Meanwhile electoral systems may exaggerate last-minute trends.

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There are nevertheless plenty of reasons why we are cautious. The main ones are:

- In terms of economic fundamentals, this should be a close race. While the feared Brexit recession has not materialized, voters may already be feeling the pinch in their pocketbooks. Following the Brexit vote, the British pound fell sharply. As a result of this and the recovery in oil prices, inflation has accelerated. Wages have failed to keep pace. This would usually augur badly for the prospects of the government retaining, let alone increasing, its parliamentary majority.
- Prime Minister Theresa May has proven a surprisingly gaffe-prone campaigner. Her government was supposed to run as a steady pair of hands - "strong and stable" in uncertain times. Instead she was forced into a series of embarrassing u-turns, notably on plans to change the funding system for social care. The opposition labelled this a "dementia tax." Plans to do away with school lunches for the first three years of primary school earned her the nickname "lunch snatcher." Animal lovers were dismayed by the decision to drop the commitment of putting in place a complete ban on ivory trading. All of this has shifted attention away from policy areas such as immigration, government finances and corporate tax cuts, where Ms. May might have had a more popular story to tell.
- The policies of her Labour opponent Jeremy Corbyn may well be unaffordable, but have nevertheless proven to be crowd pleasers. Mr. Corbyn and his team may not have a full grasp of some of the finer details of their own policies. In terms of messaging, they seem to have done a surprisingly good job, however. For the Tories, time is running out in painting Mr. Corbyn as unsuitable for higher office – indeed, his personal poll numbers have steadily been improving.
- The British political system is in flux. At the start of the campaign, winning over supporters of the UK Independence Party did wonders for Conservative poll numbers. Labour's resurgence initially owed much to winning over support from smaller parties, such as the Greens and the Liberal Democrats, as well as many young voters. A critical question is whether these groups will actually show up to vote in the numbers pollsters are assuming. Another is whether Labour can continue to gain at the expense of the Tories, as some of the more recent polls suggest.

All this suggests plenty of uncertainty in terms of national vote shares. Indeed, it is worth keeping in mind that we have already seen a fairly big miss by the pollsters this year. Ahead of the French presidential election, Emmanuel Macron was expected to beat his far-right opponent Marine Le Pen by about 20% points. Instead, he ended up winning 66% to 34%, a whopping 32% margin. Keep in mind that British pollsters have had a far patchier track record than their colleagues across the channel (i.e. in France), particularly when it comes to calling winners. Which takes us to our biggest concern.

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The vagaries of first-past-the-post

Under the UK's first-past-the-post electoral system, a plurality of the vote in any given constituency determines who gets sent to Westminster. To win a majority, you need to win over voters in the right sort of places. Last time around, the Tories and the Scottish National Party (SNP) were the main beneficiaries of this electoral system, requiring fewer votes than Labour for each of their seats, and far fewer votes than most of the smaller parties. As constituency boundaries were left unchanged for 2017 snap elections, this would augur well for the Tories to retain their majority. Until 2015, however, the same boundaries had tended to favor Labour. In part due to tactical voting, it is very hard to predict how things will turn out this time around.

The degree of uncertainty can readily be seen by glancing at the wide range of results from various seat projection models. These generally try to supplement national polling data and the usually very limited constituency survey data with other potential pointers on local voting behavior (such as the demographics and location of each constituency, as well as past voting behavior, regional effects, and local attitudes).¹ All this is quite promising, but also fairly new in the UK. Figuring out which statistical tweaks to use will probably take a few more electoral cycles.

For what they are worth, most seat projection models still point to an increased Tory majority. However, a hung parliament, in which no single party has an absolute majority in the House of Commons, is increasingly being seen as a distinct possibility. And so, we end up where we started. There is plenty of uncertainty in the polls and in seat projections. As always, that uncertainty cuts both ways.

Our UK base case and the alternatives

Our base case remains a stable or increased Tory majority, strengthening Theresa May and facilitating a hard but orderly Brexit. As this is in line with market expectations, the financial-market impact is likely to be limited. The pound would probably strengthen.

However, Tory losses of the sort implied by some of the recent projections could fatally undermine the position of Ms. May as prime minister and party leader. Tory infighting could then easily result in a hard Brexit candidate taking over, increasing the risk of a Brexit with no alternative arrangement in place. In such a scenario, the immediate market turbulences might prove limited even for UK financial markets and as short-lived as after the Brexit vote. In the longer term, it might well prove a drag on sentiment towards both Britain and Europe in general.

And if Labour were somehow to emerge sufficiently strengthened to form a government, for example in coalition with the SNP and the Liberal Democrats? From a market perspective, that might sound appealing in theory. For one thing, a soft Brexit, including access to the European single market in return for concessions on the free

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¹For an introduction to the methodologies used, see Chris Hanretty, Benjamin Lauderdale and Nick Vivyan (2016), "Comparing Strategies for Estimating Constituency Opinion from National Survey Samples", Political Science Research and Methods, available online at <https://www.cambridge.org/core/journals/political-science-research-and-methods/article/comparing-strategies-for-estimating-constituency-opinion-from-national-survey-samples/60701055350642BFA9BD5FF6EE469BC2>



movement of EU nationals might be back on the table. It would be very tricky, however, for such a government to operate in practice. Apart from the difficulties in managing the coalition government, Labour itself remains split on many issues, while Mr. Corbyn and his allies lack government experience. Last but not least, such an outcome might reverberate across the channel, strengthening far-left opponents of Emmanuel Macron.

A sneak French preview

Based on the campaign for the French parliamentary elections so far, we remain pretty confident in the prospects for meaningful market-friendly reforms. Both polling and recent French political history suggest that, as the newly elected president, Macron will secure sufficient support for his movement "République en Marche" to enact his agenda.

However, we would conclude with a few words of caution. The French electoral system, with its two rounds, makes it even trickier to translate national vote projections into seats in the National Assembly. If no candidate wins an absolute majority in the first round, all candidates gaining at least 12.5% proceed to the run-off. Traditionally, this has tended to mean two candidates. This year, there is a risk of plenty of three-way contests. Based on the 2015 regional elections, this might happen in as many as 150 out of the 539 constituencies on mainland France.² First-round results of the presidential elections suggested a similar picture. By contrast, recent predictions of a hefty majority for Macron's movement appear to be mainly driven by its strength in recent polling. So, relatively small polling errors or last-minute scandals ahead of the first round on June 11th could produce markedly different results. Moreover, past parliamentary elections suggest that the local profile of candidates appears to have a significant impact on results.³ This could potentially hurt the prospects of recently recruited candidates of the République en Marche. Turn-out could also prove a challenge, especially in the second round.

Conclusion

In short, do not discount the potential for surprises from the French elections just yet either. Election fatigue among investors notwithstanding, both the UK and the French parliamentary elections should certainly be worth watching. As Walter Scott's last minstrel might put it come election eve:

"The present scene, the future lot,
His toils, his wants, were all forgot."

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²Study by OpinionWay and la Lettre de l'opinion (Septembre 16th, 2016), "Législatives 2017 : vers une recomposition inédite ?", Objectif 577 – L'Observatoire des législatives 2017

³Sylvain Brouard and Éric Kerrouche (2013), "L'effet candidat lors des élections parlementaires - L'exemple des élections législatives" Revue française de science politique. Vol. 63, pp. 1113-1136



Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

European Union (EU)

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Pound sterling (GBP)

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