

UK General Elections

A riddle, wrapped in a mystery, inside an enigma

Sir Winston Churchill in October 1939 famously compared forecasting Russia's action to "a riddle, wrapped in a mystery, inside an enigma". He could easily have been describing Russia's actions in the past 18 months or the challenge of forecasting who will be in government after the UK general elections on 7th May. The only certainty, even if eight weeks is a long time in politics, is that these parliamentary elections are likely to be the closest fought and hardest to predict in recent memory.

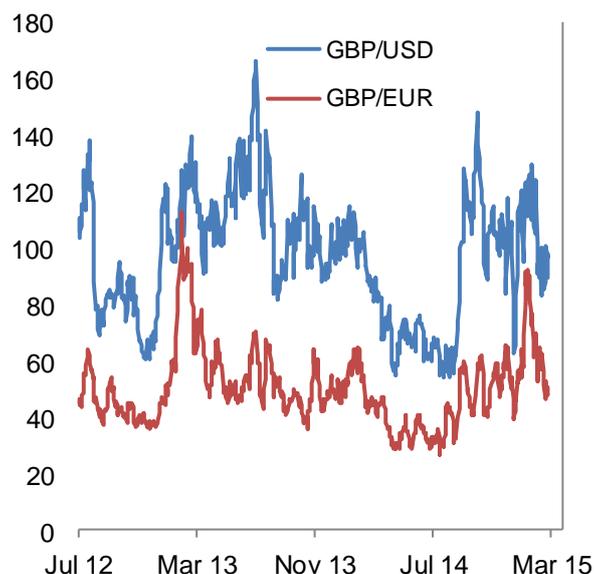
The end of the Conservative, Labour and Liberal Democrat three-party rule, the rise of the UK Independence Party (UKIP) and Scottish National Party (SNP), the quirks of the UK's first-past-the-post electoral system and the multitude of feasible party alliances all contribute to this uncertainty. Even at a micro level, there is little clarity. For example, we still don't know whether or when the party leaders will hold a pre-election TV debate, let alone its format. With Labour and the Conservatives level pegging in the polls around 33%, there is an air of desperation with both parties engaging in negative campaigning.

It is pretty clear that none of the main parties are likely to win a majority of seats, with pollsters attributing a 50-95% probability of a hung parliament. The core scenario is that Labour and Conservatives will win a similar number of seats but the recent up-tick in support for the Conservatives means that this is by no means a foregone conclusion. Beyond that, a spectrum of possibilities opens up including a minority government or a grand multi-party coalition, with the omnipresent threat of fresh elections before the end of the parliamentary term in 2020.

Labour arguably has a greater number of feasible coalition partners (with likely non-insignificant seats) than the Conservatives, namely the SNP and the Liberal Democrats but also, if appropriate, smaller parties such as the Greens, the Irish SDLP and potentially Welsh Plaid Cymru. Consequently, pollsters attribute a roughly 70% probability of a Labour led coalition. In any case this unprecedented second consecutive coalition government would likely enjoy a far smaller absolute majority than the Conservative-Liberal Democrats' current majority of 32 seats and it may take months for a clear joint policy program to be announced.

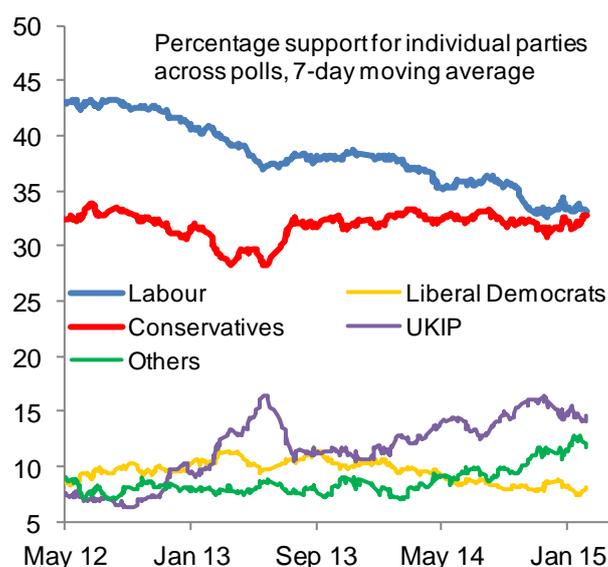
I would therefore expect sterling volatility, which has been somewhat subdued in recent weeks, to rise in the run-up and immediate aftermath of the vote (see Figure 1). Directionally, I see the risk tilted towards sterling weakness almost regardless of the election outcome, but particularly if a minority government is elected and/or Labour is the lead party in a majority coalition. Even a repeat of the familiar Conservative-Liberal Democrat alliance, which has overseen a decent national economic recovery, may not fill markets with great confidence. The Conservatives could come under pressure to dilute some of their market friendly policies and hold a referendum on EU membership.

Figure 1: Subdued intra-day sterling volatility could rise around election time



Source: *Investing.com, Olivier Desbarres*; Note: Daily average true range (ATR) = difference between the high and low of each day over a given period (pips), 14 day moving average

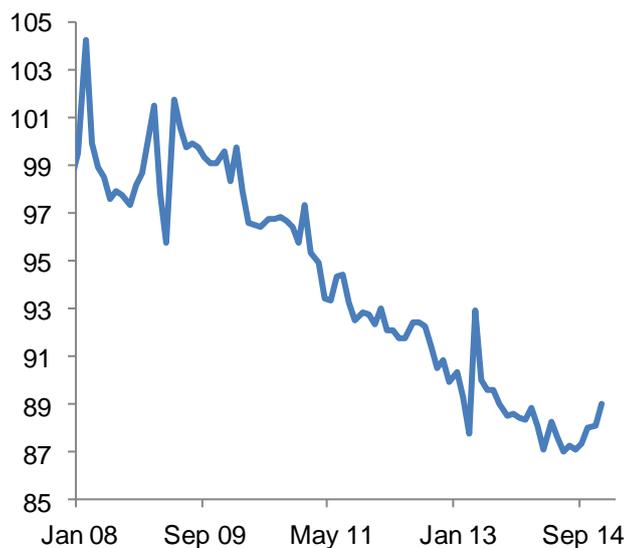
Figure 2: Labour and Conservatives almost neck and neck



Source: *BBC*; Note: These polls, which include ICM, Ipsos Mori, Populus, TNS BMRB and YouGov are of Great Britain rather than the UK as Northern Ireland is typically omitted.

Predicting the percentage of national votes each party wins

Opinion polls have historically been poor predictors of the actual outcomes of UK elections, unlike US polls and election outcomes. As [Electoral Forecast](#) explains “UK polls tend to ask a generic question about support for different parties, rather than asking about the specific candidates in a survey respondent’s constituency. This means they tend to miss the local strategic concerns that arise in multiparty campaign.” Moreover, it is unclear how the surge of support for UKIP and SNP will ultimately dent traditional Labour and Conservative support and how the fall in the Liberal Democrats’ popularity will be divided amongst other parties. But they are the best starting point.

Figure 3: Real earnings have collapsed in past five years and only recently started to recover

Source: ONS; Note: real earnings defined as seasonally adjusted weekly earnings deflated by retail price index

Figure 4: Conservatives & Liberal Democrats currently enjoy comfortable majority...things are about to change

Party	Seats in lower house of parliament	Note
Conservatives	302	In government
Labour	256	Main opposition party
Liberal Democrats	56	In government
DUP	8	Northern Ireland Party
SNP	6	Scottish Party
Independents	5	
SDLP	3	Northern Ireland Party
Plaid Cymru	3	Welsh Party
UKIP	2	
Green	1	
Alliance	1	Northern Ireland Party
Respect	1	
Sinn Fein	5	Northern Ireland Party
Speaker	1	
Total	650	

Source: [UK parliament](#)

Labour still marginally ahead as Conservatives fail to fully capitalise on economic recovery...

On average, the opposition Labour Party is still only very marginally ahead of the ruling Conservatives on around 34%, with support for both parties pretty static according to the main polling agencies (see Figure 2). Support for Labour has eroded from about 42-43% two years ago, due partly to question marks about Ed Miliband's leadership qualities, as well as discontent across the political spectrum with proposed policies such as the Mansions Tax.

The Conservatives have until now seemingly failed to capitalise on Ed Miliband's record low popularity for a UK opposition leader and the UK economy's relative strength (see [UK's solid economic metrics drowned out by EU and immigration debate](#), 1 Dec 2014). I would identify a number of interconnected reasons. For starters, real earnings¹ – a more tangible metric to most households than GDP growth or public debt levels – have fallen over 10% since Q3 2009 (see Figure 3). At the same time social security benefits are perceived (rightly or wrongly) as overly-generous and the overall tax take² as too onerous.

UKIP stole the march in linking these concerns to the EU's unfettered immigration policies and, with some success, reinforced its call for the UK to exit the EU. Prime Minister Cameron tried to take on the EU and Germany (by for example threatening a referendum) but has ultimately struggled to win over hard-core UKIP voters (see [UK Elections, the EU and immigration: Cameron Faces uphill battle](#), 28 Nov 2014). It's clear that Prime Minister Cameron needs to quickly score some big political points to secure a clear-cut

¹ Defined as total pay (regular pay plus bonuses) deflated by the Retail Price Index

² Including income tax, national insurance, council tax and VAT

victory over Labour. With that in mind, the budget which Chancellor George Osborne will announce on 18th March could prove a key turning point (see Figure 5).

...but momentum and electoral precedent seemingly in favour of Conservatives

Recent polls by ComRes, YouGov and ICM, however, have the Conservatives marginally ahead for the first time in recent months, pointing to a slight shift in momentum in favour of the Conservatives. This may be partly attributable to a feel good factor. Real earnings have started to recover (see Figure 3) and the unemployment rate was at a six and a half year low of 5.7% in December (the January employment data are due on 18 March).

Furthermore, previous elections suggest that the Conservatives, Labour and Liberal Democrats tend to underperform when polls indicate gains on previous elections but outperform when polls indicate a loss on the previous election. For example, the Liberal Democrats averaged 27% in the polls on the day before the 2010 election, but only received 23% of the vote. That 4% error is not especially large by historical standards³. If this pattern holds true the Conservatives and Liberal Democrats may actually perform better than suggested by the polls while Labour may underperform. Finally, the new voter registration system may at the margin favour Conservatives. [Election Forecast](#) and [Elections etc](#) indeed predict a reversal of the current polls, with Conservatives winning over 34% and Labour below 32% of the national vote.

Smaller parties real beneficiary of voters' disaffection with main parties

The share of votes cast for parties other than Labour and the Conservatives has increased from under 10% in the 1950s to over a third in the 2010 elections and current polls put this share at around 34% – a sign of the electorate's disaffection with the two, and arguably, three mainstream parties.

The greatest beneficiary has been the nationalist UK Independence Party (UKIP), with its support doubling in the past two years to around 15-17% (see [UKIP has what every other party wants...momentum](#), 30 Nov 2014). But UKIP has seen its credibility and populist platform tested and its support dip to around 14%. It is now arguably sharing the limelight with parties more likely to be real kingmakers such as the SNP and Liberal Democrats and even with some of the smaller parties (Greens, Plaid Cymru) which have seen their support in opinion polls grind steadily higher (see Figure 2).

Support for the Liberal Democrats has been reasonably stable around 8%, with the party now very much fourth in the polls behind UKIP. The SNP is polling around 45% in Scotland, about 17 percentage points ahead of Labour in second.

³ In 1992 both Labour and Conservative actual vote shares were off from the final polling average by that much

Figure 5: The road to the elections is long...as could be post-election negotiations

Date	Event
13-Mar	Liberal Democrat Spring conference
18-Mar	Budget day
18-Mar	January unemployment data released
25-Mar	Final Prime Minister's question time
30-Mar	Parliament dissolved
09-Apr	Deadline for candidates to register their intention to stand
17-Apr	February unemployment data released
28-Apr	Preliminary Q1 GDP data released
07-May	Election day
	Polling ends at 10pm, counting of votes begins; Initial results released
08-May	Counting continues
	Conservatives or Labour could admit defeat

Source: *UK Parliament, ONS*

Predicting number of seats each party wins

Even if we accurately predict the national share of votes won by each party this does not tell us how many of the 650 seats for grabs each party will win due to the UK's first-past-the-post electoral system (a calculation complicated by constituency-boundary vagaries). Therefore a party could win a smaller share of the national vote but a greater share of the seats, as was the case in the 1974 elections when Labour won 301 seats to the Conservatives' 297 despite winning a smaller share of the national vote (37.2% vs 37.9%).

Hung parliament very likely as no party expected to win 323-seat working majority

It is unlikely – about 5-50% probability according to various estimates – that either Labour or the Conservatives will win an absolute majority (326 seats or more). Put differently, there is approximately a 50-95% probability of a hung parliament (75% according to betting exchange Betfair), further evidence of the fragmentation of parliament. The number of seats held by parties other than the Conservatives and Labour increased from under 10 in elections from 1955 to 1964 to over 75 since 1997, reaching 86 at the last general election. Political models forecast an even slightly higher number at the May elections.

The United Kingdom is currently divided into 650 constituencies, with 533 in England, 40 in Wales, 59 in Scotland, and 18 in Northern Ireland (see Figure 4). In practice a party only needs a working majority, which is 323 seats as the speaker and two deputy speakers of the house abstain from voting and I assume

that Sinn Fein will again win five seats as it did in 2010 and 2005 elections and continue to abstain from voting (policy of abstentionism).

Figure 6: Likely big seat winners, Labour and SNP, could potentially form next government

Party	Election Forecast ¹	Electoral Calculus ²	Elections etc ³	May 2015.com ⁴	Average	Swing vs current number of seats	Likely support for Conservatives (Blue) or Labour (red)
Conservatives	293	266	286	286	283	-19	
Labour	271	299	278	259	277	+21	
Liberal Democrats	24	16	22	24	22	-35	
DUP	8				8	0	
SNP	40	46	40	55	45	+39	
SDLP	3				3	0	
Plaid Cymru	1	3			2	-1	
UKIP	1	1		3	2	0	
Green	1	1		1	1	0	
Alliance							
Respect							
Sinn Fein							Has not historically voted in UK parliament
Speaker							Does not vote

Source: [Election Forecast](#), [Electoral Calculus](#), [Elections etc](#), [May 2015.com](#), Olivier Desbarres

Notes: 1. Election Forecast predicts that other parties will win 8 seats; 2. Electoral Calculus predicts that Northern Irish parties will win all 18 Northern Ireland constituencies; 3. Elections etc predicts that other parties will win 24 seats; 4. May 2015.com predicts that other parties will win 22 seats

Labour and SNP likely big winners, Liberal Democrats big losers

Labour and SNP and possibly UKIP are expected to gain seats relative to the current composition of the lower House of Parliament while the Conservatives, Liberal Democrats and Plaid Cymru are likely to lose seats (see figure 6).

- SNP is likely to significantly increase its number of seats from 6 currently to around 40 thanks to the demise of Labour in Scotland after it campaigned against Scottish independence.
- UKIP will likely win far fewer seats than suggested by current polls as its support is spread over a large number of constituencies. Furthermore UKIP has lost momentum in the polls. A number of pollsters forecast that UKIP may actually lose one seat and be left with only one seat in parliament. But there is great uncertainty around this forecast. For starters, UKIP's electoral precedent is limited. Furthermore, UKIP is not far off the tipping point so even a modest rise in its national share of the vote would likely

result in a significant jump in the number of seats it wins. For example, Electoral Calculus suggests that with 20% of the national vote UKIP could win 8 seats.

- Northern Ireland has 18 constituencies which have historically been won by Northern Irish parties, namely the Democratic Unionist Party (DUP), the Social Democratic & Labour Party (SDLP), Sinn Fein and Alliance.

Election models, using current national opinion polls and constituency data, forecast that the Conservatives will win slightly more parliamentary seats than Labour (see Figure 6), a reversal of a few months ago when the consensus forecast was for Labour to win more seats. For example [Election Forecast's](#) core scenario is that Conservatives win more seats (60% probability), not Labour (40% probability). Similarly, Betfair attributes respective odds of about 65% and 35%. But the average difference in seat numbers between the two main parties is forecast to be only six in favour of the Conservatives. The [Daily Telegraph](#) goes as far as arguing that the elections will ultimately be decided on nine key seats.

Note that, due to the first-past-the-post electoral system, Conservatives may need to win a comfortably higher share of the national vote to win a higher number of seats. Put differently, some estimate that the Conservatives could win a share of the national vote 2-3 percentage points higher than Labour's' but still win fewer seats.

Predicting the composition of government

Finally and perhaps most pertinently even if we could accurately predict the number of seats won by each party, the demise of the traditional two-party rule and increasingly tribal nature of UK politics leaves a great question mark over the actual composition of a post-election government. Assuming neither Labour nor the Conservatives win a parliamentary majority, the possible outcomes include:

- A minority government with confidence and supply arrangements for key budget and confidence votes. This would likely require Labour or the Conservatives comprehensively beating the other for a minority government to be constitutionally and practically viable. Precedent, including John Major's Conservative government between December 1996 and the May 1997 general election, and Callaghan's 1977-1979 Labour government suggests that minority governments are unstable and ineffective. Specifically they point to the risk of policy paralysis, dissolution of parliament and fresh elections. However, the recent experience of the minority SNP Scottish government elected in 2007 is more encouraging. In the words of the [IPPR think tank](#), a successful minority party would require "a clear strategy of forging the necessary alliances to get its business through parliament". Furthermore, calling new elections is not straightforward since the passing of the fixed term parliament act.
- A formal two-party majority coalition, albeit with a likely far smaller majority than the current coalition;

- iii. A formal two-party minority coalition with side deals with a third party and/or independents on key votes;
- iv. A three or multi-party government party majority coalition, for which there is effectively no real precedent in the UK.

Cameron has first call on forming government but Labour has more coalition partner options

Prime Minister Cameron will have first call on forming a government regardless of whether Conservatives win more or fewer seats than Labour, according to the Constitution⁴. However the incumbent prime minister can waive this right if the opposition party has won more seats, as then Prime Minister Gordon Brown did after the 2010 elections. The Conservatives' credibility would be stretched if it decided to stay in power having won fewer seats than Labour, particularly if it is unable or unwilling to form a majority coalition government.

Opinion pollsters, including Populus and Electoral Forecast, predict that even if the Conservatives win slightly more seats than Labour, Ed Miliband is mathematically more likely to be the next prime minister than David Cameron. The reasons are two-fold and inter-connected.

First, Labour has a greater number of feasible coalition partners – the Liberal Democrats, SNP, and smaller leftist parties (Greens, plaid Cymru and SDLP) – than the Conservatives which can only realistically count on the Liberal Democrats, UKIP and DUP. Electoral Forecast indeed attributes a 26% probability of Labour forming a coalition government versus only a 6% probability of forming a minority government. Second, the Conservatives' credibility would be stretched if, unlike Labour, it was unable or unwilling to form a majority coalition government. If the Conservatives lost by a big margin, one could realistically expect a change of leadership with Cameron making way for either Theresa May or Boris Johnson. Either way the next Prime Minister is likely to be leader of a party that has only gained about a third of the national vote.

Smaller parties playing it cool but allure of power may be too much

The Liberal Democrats, SNP, UKIP, DUP and SDLP have played their cards pretty close to their chests, knowing they may be in the enviable position of kingmakers. They have toned down their desire to formally join a coalition government in a bid to strengthen their credentials as standalone parties and avoid becoming proxy votes for Labour or the Conservatives. However the allure of power and sitting at the top table may prove too strong to resist, particular if cabinet seats are up for grabs.

- Liberal Democrats may be reluctant to join another coalition government given how much their support has eroded in the past five years but may have little choice in order to remain relevant and not fall into political obscurity – assuming they win sufficient seats to remain an attractive coalition partner. In a

⁴ “The constitutional position in a situation of no [party winning a majority of seats] is clear. When no party holds the majority of seats, the incumbent Prime Minister has the first call on forming a government, either as a minority administration or by building a coalition with another party or parties” ([UK Parliament](#))

recent [poll](#) nearly 70% of Liberal Democrat party members said they were committed to being in government.

- The Liberal Democrats are more likely to join a marriage of convenience with Labour than the Conservatives as Labour's political platform is better aligned. Senior Liberal Democrats, including business secretary Vince Cable, have also made clear their disapproval of Conservative policies including taxation of big business and immigration. Indeed a recent [poll](#) suggests that Liberal Democrat supporters are three times more likely to support a partnership with Labour than with the Conservatives and twice more likely to support a formal coalition than a confidence and supply arrangement.
- [SNP](#) has effectively ruled out a coalition with the Conservatives but left open the possibility of an informal "confidence and supply" arrangement with Labour despite SNP supporters being unhappy that Labour campaigned to keep Scotland in the UK. In exchange for its support SNP has asked for increased government spending and a Scottish veto over an in/out EU referendum and it may push for sweeping new powers for Scotland. But it has abandoned its demand that the replacement programme for Trident nuclear missiles be scrapped, suggesting there is room for negotiation.
- [SDLP](#) is more likely to align itself with Labour than the Conservatives.
- [Greens and Plaid Cymru](#) are likely to win very few seats but have an outside chance of being part of a Labour-led government or at least an informal arrangement for key votes.
- [DUP](#), currently the largest non-English Party with 8 seats, is more likely to align itself with the Conservatives than Labour.
- [UKIP](#) is more likely to align itself with the Conservatives although its leader, Nigel Farage, has not excluded a deal with Labour if it includes at least an in-out referendum on EU membership. Realistically UKIP is more likely to be an appealing coalition partner if it wins a reasonable number of seats.

Labour coalition with Liberal Democrats...or SNP

Pollsters are somewhat divided as to whether Labour is more likely to form a coalition with the Liberal Democrats or the SNP. I think the simple answer is that, all other things being equal, Labour would favour a coalition with the Liberal Democrats if such a coalition had a comfortable majority.

Their leaderships seemingly distrust each other so personnel changes cannot be excluded but their political platforms are reasonably well aligned. Indeed a recent joint study, [Common Ground](#), by the Labour-affiliated Fabian Society and the liberal Centre-Forum, lists the large degree of policy crossover between the two parties: a mansion tax, borrowing for infrastructure investment, a 2030 decarbonisation target,

greater oversight of free schools and academies, an elected House of Lords, the reduction of the voting age to 16 and political funding reform.

If the Liberal Democrats cannot give Labour a majority coalition, I would expect Labour to align itself with the SNP rather than form a minority government or opt for a difficult to operate three-party coalition.

In a scenario whereby Labour and Conservatives win a similar number of seats but fewer than 300 (e.g. 292 and 297, respectively), the SNP's number of seats is at the lower end of its predicted range (i.e. 30) and the Liberal Democrats win a broadly-as-expected 17 seats, both Labour and the Conservatives would fail to form a two-party majority government. As a result, the possibility of a grand "anti-Conservative" Labour-SNP-Liberal Democrat coalition has not been dismissed. The [Financial Times](#) goes a step further, predicting a Conservative-Labour grand coalition and former Conservative party Chairman Lord Baker has pointed out that Germany has a grand coalition uniting Angela Merkel's Christian Democrats and the Social Democrats.

I see both scenarios as one of last resort for either Labour or the Conservatives. Whatever the outcome, the days following the election are likely to see intense horse trading and negotiating, adding to market volatility.
