

UK post-election briefing

Whoever forms the new government between now and the Queen's Speech will be handed a poison chalice. The next few days may be defined by political horse trading but the next five years will be defined by an extremely painful fiscal squeeze, sluggish economic growth and very loose monetary policy.

The waiting is almost over, and then tough choices will have to be made

The most unpredictable election in a generation has now come to an end, but no single party has emerged with an overall majority. So it could be a few days or even a couple of weeks before we know who will be the next Prime Minister. It is unlikely that it will take until the Queen's speech on 25 May to form a new government, but there will be a period of uncertainty as the politicians hammer out a solution. Uncertainty is not welcomed by financial markets at the best of times. And these are not the best of times - there is a £163 billion budget deficit to tackle.

It looks as if Britain will have to learn how to manage coalition politics

The most likely outcome is some form of coalition government led by either the Conservatives or the Labour party. A coalition government would be able to claim that it represents 50-60% of the electorate. This may help with the tough job of selling, to the voters and unions, the higher taxes and very deep cuts in public sector spending needed to sort out the fiscal mess.

The most likely coalition partner for either of the two main parties is the Liberal Democrats. At the time of writing, a coalition between the Conservatives and one of the smaller parties would

not have a majority. The Lib Dems are likely to discuss a coalition with the conservatives first, given that they have won the highest number of seats. The Lib Dems' price for agreeing to team up with another party is likely to be some form of review of the current electoral system, probably a referendum on proportional representation (PR). This may be a price that the Conservatives are unwilling to pay. But not paying that price would open the door for Labour to hold on to power by agreeing to hold a referendum on PR and forming a coalition with the Lib Dems. This is something that Labour has made clear they would be willing to do.

A minority government would usher in a period of instability

There is also the less likely outcome of the Conservatives forming a minority government. A minority government would have to try to persuade smaller parties to support it each time there is a vote. This would make it slow and difficult to pass laws and make it likely that a vote of no confidence would trigger another election before the term of the next parliament is out. This would be an unstable outcome that markets would not react favourably to, not least because it is likely to delay and reduce the size of the coming fiscal tightening.

The overriding task for the incoming government is to reduce the budget deficit

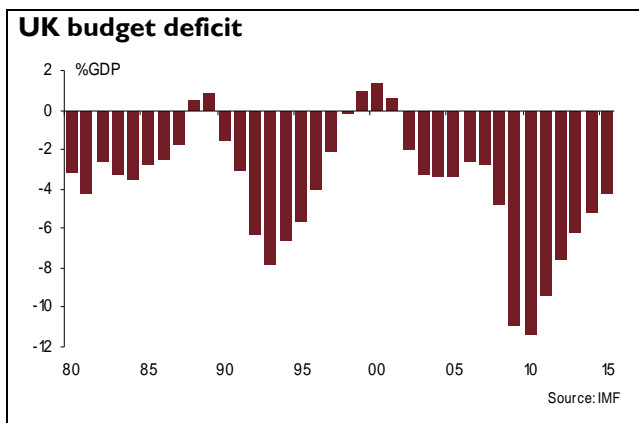
Failure to talk about the gaping hole in the public finances during the election campaign has not made it go away. What little debate there was on fiscal policy was focused on the £6 bn of extra tightening planned by the Conservatives this year, which is small beer compared to the £163 bn budget deficit.

Now that the polls have closed, the politicians will very quickly have to get over their reticence about spelling out the massive scale of the coming fiscal consolidation and how it will be apportioned. But just in case the government is unaware of the seriousness of the situation, the worsening of the Greek fiscal crisis in recent weeks has put into stark relief the dangers of allowing public finances to spin out of control.

Events in Greece have raised the bar for avoiding a downgrade

Greece's rapid demise has substantially raised the bar in terms of the size and speed of fiscal tightening needed to appease the bond market. If a downgrade of gilts is to be avoided, the new government needs to put in train the biggest fiscal tightening for generations, unpopular as that may be. They need to make it clear that they understand the problem and are going to deal with it.

This would have been the case regardless of who won power. The UK is expected to have a deficit of 11.4% of GDP this year, of which around 3-4 percentage points (pp) are structural and hence would not be eliminated even by a vigorous economic recovery. Net debt is expected to be 71% of GDP.



An emergency budget could be held within a matter of weeks

The Conservatives have pledged to hold a post-election emergency budget within 50 days, and the civil service is believed to be planning for an emergency budget in June. The rating agencies will assess the government's fiscal tightening plans before

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deciding whether to downgrade UK gilts or not. A downgrade would be unwelcome because each notch down in the UK's credit rating would increase borrowing costs by around 0.50 pp, slowing economic growth.

The new government's plans will need to be more aggressive and give much more detail of departmental spending targets than either April's budget or their manifesto if a downgrade is to be avoided. Greece's planned fiscal tightening this year alone is around three times as draconian as anything the three main UK parties planned to achieve by 2014-15.

To date, less than a quarter of planned spending cuts have been spelt out in detail, regardless of who forms the new government. History suggests that successful fiscal adjustments – those that have a lasting impact in reducing public debt – emphasise cuts to expenditure, especially public sector wages and transfer payments, over tax increases. Indeed, successful polices usually include structural reforms.

At a minimum, if UK government debt is to keep its AAA rating, the post election budget needs to lay out a clear and detailed plan to eliminate the 7 pp of the deficit that is cyclical in nature by the end of this parliament. And it needs to be done in a way that does not rely on unrealistically high nominal (non-inflation-adjusted) growth assumptions. The UK Treasury's current figures show the deficit coming down to 4.2% of GDP by 2014-15, but this assumes nominal GDP growth of 4.25% to 6.0%. A similar reduction in the deficit, but with a lower nominal growth assumption, would be far more convincing to wary bond investors.

Plans are also needed to eliminate the structural deficit...

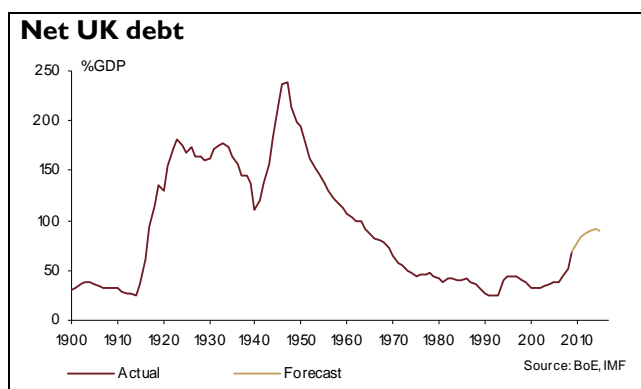
The incoming government needs to spell out, and then implement, reforms to the state and public-sector pensions to help reduce the remaining 4-5% of the deficit that is structural. This could be done by increasing the retirement age more quickly and to a higher level than currently planned. Although this would be politically very unpopular, it does have the benefit of not hitting GDP growth immediately – unlike spending cuts.

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...and substantially reduce the debt-to-GDP ratio, not just stabilise it.

In the longer term, the government needs to plan to start running a fiscal surplus again and hence bring down the debt-to-GDP ratio, rather than merely stabilise it at what is a crisis level. Each 10% increase in this ratio has been found to slow annual GDP growth by around 0.2 pp, showing the importance of reducing it. At a minimum, the new government needs to outline convincing plans to bring the debt-to-GDP ratio back down below 60% - the pre-crisis average of the G20 economies - by 2020.



Governing under a coalition will take some getting used to

Coalition governments in some other countries have succeeded in governing effectively and tackling tough problems. For instance, it was still possible to introduce universal healthcare reforms in Canada in the 1960s, while in Sweden the country's severe budget crisis of the early 1990s was brought under control by a Social Democratic government which did not have an outright majority.

A coalition government can be successful if they do not seek to govern as if they are a single party with a majority. In other words, it becomes necessary to develop good relationships between the parties, and to be prepared to debate, to negotiate and to compromise.

Coalition governments do have their advantages

A coalition government is often seen as undesirable because one party is unable automatically to win votes in Parliament without the help of its coalition partner. This can cause delays in passing legislation.

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However, an alternative view is that under our current system the executive is able too easily to dominate parliament and pass legislation without sufficient scrutiny. From this perspective, the requirement for government to negotiate and compromise, and the greater ability of opposition parties to influence the policy-making process, can be seen as an advantage. This can mean that although it can take longer to reach a decision, this is then based on a broader consensus that will stand the test of time, and avoids the 'flip-flopping' that is sometimes seen when one majority government is replaced with another. Some argue that such consensual styles of government are actually better for tackling big, long-running policy challenges, such as a fiscal crisis.

The market reaction to the UK election so far has been skewed by global dislocation

A substantial correction in risk assets across the globe has obscured the market reaction to the UK election, which has resulted in a hung Parliament as predicted by the pre-election polls. The renewed volatility in global markets generally reflects concerns about the bonds of highly indebted peripheral countries within the euro-zone.

The general sell-off in risk assets has spread to include US blue-chip stocks and triggered a sense of market dislocation reminiscent of the credit crisis. For example, at one stage on Thursday Procter & Gamble shares lost roughly a third of their value before rallying to end the session almost unchanged. In this environment we would expect "popular" or over-concentrated positions to suffer sharp corrections, regardless of the potentially strong economic fundamentals. For example both the Brazilian real and Australian dollar have fallen sharply despite strong domestic economies and attractive financial markets. In this context, as positions are trimmed in general, we can even expect the extremely "unloved" euro to enjoy some short-term relief.

In terms of the UK specifically, we set out below our views on the currency, gilts and equity markets.

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Sterling

Sterling has had its depreciation versus the euro and is now undervalued against a currency with major structural problems. Any further weakness in sterling versus the euro would be a buying opportunity for the UK currency. However there are no valuation issues for the dollar. Our work indicates that sterling is roughly at fair value against the dollar. With the euro likely to continue to drift down against the dollar, we continue to favour the US currency versus sterling.

UK bond markets

UK gilt yields rose last year despite the Bank of England buying virtually all of the net new supply of gilts in 2009, through its quantitative easing program. We expect yields to rise in 2010 without this support, amid what will be a substantial supply of new sovereign debt and given our view that risky assets will renew their solid performance. We remain substantially underweight gilts in our portfolios and at current trading levels our bias would be to reduce this weighting further.

UK equities

As we have seen overnight, the absolute direction of the UK equity market is much more related to global trends and, in particular, the general selling of risk assets. This may more accurately be described as a global margin call.

We see the UK equity market as fairly valued versus global equities, and note that 65% of FTSE 100 revenues are sourced from overseas. Therefore any significant sell-off in UK equities relative to the global markets should be seen as an opportunity to buy UK equities, notwithstanding the global environment for risk assets.

Nevertheless the poor outright and relative performance of the peripheral euro-zone equity markets highlights the risk that a loss of fiscal confidence can have a significant impact on domestic share prices. Consequently, our relative view will be highly dependent on the details of fiscal consolidation proposed by the new UK government.

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