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The U.K. is set to head to the polls on December 12. Election uncertainty is high given fragmented polling and the U.K.’s first-past-the-post electoral system. Current polls suggest the Conservatives will win an outright majority. But the numbers are tight, historical poll-to-seat mappings are likely imprecise given today’s political fragmentation, and polls will likely swing in coming weeks. So, on balance, we believe an outright majority for the Conservatives or another hung Parliament are equally likely outcomes.

If the Conservatives get an outright majority, we expect the Parliament to ratify Prime Minister Boris Johnson’s Brexit withdrawal deal. The deal would see the U.K. leave the EU, but stay in a transition period until the end of 2020, or until the end of 2022, if mutually agreed by the U.K. and EU by next summer. After that, the U.K. would likely leave the single market and customs union, with a hybrid solution for Northern Ireland.

In the event of a hung Parliament, uncertainty will likely persist. This outcome could lead to a further Brexit delay, a ratification of Johnson’s Brexit withdrawal deal, or even a second Brexit referendum. In any event, we view a no-deal Brexit as a very low probability event, with only one party (the Brexit party) likely to campaign on a no-deal platform.

Here are our key takeaways for the economy and markets:

1. Limited upside for U.K. growth:
   - U.K. growth has slowed since the start of the year as Brexit uncertainty and weak external demand have weighed on activity. In the event of further Brexit clarity after the election, we may see a rise in investments owing to pent-up demand and delayed projects, together with a boost in business confidence. But we are sceptical the bounce will be long-lasting, sharp, and meaningful. Some uncertainty about the precise future trading arrangement between the EU and U.K. will remain, which may hinder business investment. More importantly, U.K. growth will continue to be
shaped by global developments, especially as the country’s two largest export markets, the U.S. and Germany, are expected to slow down in the coming months (as our colleague Nicola Mai said, Germany is on the brink of recession). Offsetting some of this weakness, a new Parliament may pave the way for more political stability and fiscal loosening in 2020. On balance, while we may see a short-lived recovery in activity after the election, we expect U.K. growth to remain at or below trend in 2020.

- On inflation, domestic cost pressures are elevated, with wage growth close to an 11-year high and subdued productivity growth. Regardless of a Brexit deal, we expect companies to absorb the higher wage bills in their profit margins, as opposed to passing them on to consumers – in line with similar trends we have seen in the rest of Europe. Overall, we expect U.K. inflation to remain somewhat muted, just below the Bank of England’s 2% target, through the remainder of the year and the beginning of 2020. A significant appreciation of the currency on the back of a Brexit deal would increase disinflationary pressures.

- Over the medium term, Johnson’s Brexit deal would likely lower U.K. potential growth somewhat, exacerbating the country’s already weak productivity profile. Outside the single market and customs unions, there will be both tariff and non-tariff barriers between the U.K. and EU, lowering trade between the two regions. The extent of the growth weakening would depend on the nature of the future trading arrangements negotiated in the coming years. That said, productivity has been at depressed levels for some years, and some mean reversion in productivity trends may more than offset any negative impact from the new trading arrangement with the EU.

2. Bank of England on hold:

The Bank of England has recently judged that, in the event of a smooth Brexit outcome, its policy rate would likely have to increase at a gradual pace and to a limited extent. We are sceptical. With both the European Central Bank (ECB) and the U.S. Federal Reserve in easing mode, it will be difficult for the Bank of England to swim upstream without strengthening the pound and cooling economic activity too much. On balance, we expect the Bank of England to be in a neutral wait-and-see stance, keeping the policy rate unchanged over the coming months. In the event of stronger activity, the central bank has signaled that it could tighten policy. But if the external weakness persists and Brexit uncertainty remains, we see a growing risk that the Bank of England will have to join its global peers in easing monetary policy next year.

3. Improving global risk sentiment:

As we wrote in our recent Cyclical Outlook, geopolitical risks are one of the swing factors for our global growth outlook. With the risk of a no-deal Brexit more contained, and with the U.S.–China trade tensions on temporary hold, downside risks look to have receded somewhat in the past few weeks. This could be positive for global sentiment, particularly in the manufacturing sector, one of the main sources of upside risks we identified in our 2020 forecast.

Investment implications

While uncertainty remains high over the short term, we believe the risk of a no-deal Brexit has significantly decreased in the past few weeks. As such, we see the following pockets of opportunity for
investors:

- U.K. banks offer an attractive valuation versus core European rivals and similarly rated non-U.K. banks, in our view. We continue to think – as we have for a long time – that U.K. banks are trading wide to their fundamental value.
- The pound has been the safety valve of the Brexit story, reacting to news fast and efficiently. Despite the recent rally, we still think the currency is fundamentally cheap. That said, it will likely not return to pre-referendum levels in the near term, given ongoing uncertainty over the nature of the future EU/U.K. trade arrangement.
- U.K. sovereign bonds, or gilts, have been trading at a significantly lower yield than U.S. Treasuries since the June 2016 Brexit referendum. We expect that spread to compress over the medium term.

For more on developments that could move economies and markets in the U.K., Europe, and beyond, please see our recent Cyclical Outlook, “Window of Weakness.”

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