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Special Coverage:
UK heading to the polls ahead of policy rate cut

Key takeaways

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- In a surprise move, UK Prime Minister Rishi Sunak has called an election. The overwhelming lead the Labour Party has in the polls means that a Labour government is very likely. The bookmakers have a Labour government probability of about 90%, and the predicted outcomes show that a Labour landslide is possible.
- Key issues in the election will be fiscal, immigration, ever-increasing health costs and clean energy, while hotter-than-expected CPI might lead the BoE to postpone its first cut. With April core inflation stickier than expected, Sunak is unlikely to get the boost of a rate cut from the BoE, with our forecast for the first cut now pushed back from June to August.
- With an August rate cut still more dovish than market expectations, we see GBP weakness as more likely. We also like gilts, seeing the policy rate fall to 3.75% by 2025, which is also more dovish than market expectations. We are neutral overall on UK equities as the FTSE 100 is too defensive, but our tilt towards more cyclicality and an improving UK outlook shine a bright light on the attractively valued FTSE 250.

What happened?

- In a surprise move, UK Prime Minister Rishi Sunak has called an election. With Labour over 20 points ahead in the polls, the consensus expectation was that Sunak would wait until late this year, hoping that an easing cost-of-living crisis would improve his standing.
- As April public sector borrowing has topped £20bn for the first time since 2021, Sunak decided that there was more advantage catching the Labour off-guard than there was to be gained in an improved outlook later in the year.
- The overwhelming lead the Labour Party has in the polls means that a Labour government is very likely. The bookmakers have a Labour government probability of about 90%, and the predicted outcomes show that a Labour landslide is possible.
- The latest UK polls give Sunak a net approval rating of -51%. The contenders' popularity has historically been a good guide to elections, and perhaps Sunak is hoping for the summer feel-good factors to swing his way. He may also feel that he can lean into inflation falling to 2.3%. While the top number is certainly something to cheer about, the fall in energy and goods prices masks a core inflation level that was surprisingly resilient at 3.9%. The second quarter will mark the low point for inflation as cheaper goods and energy fall out of the year-on-year CPI number later in the year.
- With inflation stickier than expected, Sunak is unlikely to get the boost of a rate cut from the BoE, with our forecast for the first cut now pushed back from June to August.
- Following the call for an election, GBP has moved a little higher, but the main move higher was following the hotter-than-expected CPI where core inflation stood at 3.9% rather than the expected 3.6%.

- The table showcases the forecasted seat predictions from Electoral Calculus, using a regression model that is adapted depending on the swing of key voter attributes in each constituency. Even in the lower end of the scenario, there is a clear Labour win – 326 is needed for a majority. That said, there has been a fairly consistent level of around 16% of undecided voters, with around half previously voting for Boris Johnson. Sunak may feel that he can swing a majority behind him.
- On policy, Labour has gone for economic stability, and their headline policy is the "fiscal lock". This will be an independent body that will review any significant spending or tax changes – a policy crafted in reaction to the Truss "mini-budget". The market will see this as more of a positive move.

Seat Predictions

Party bnhy	2019 Votes	2019 Seats	Pred Votes	Low Seats	Pred Seats	High Seats
CON	44.7%	376	22.9%	30	85	211
LAB	33.0%	197	43.4%	351	472	545
LIB	11.8%	8	9.6%	19	50	61
Reform	2.1%	0	12.3%	0	0	21
Green	2.8%	1	6.0%	0	2	4
SNP	4.0%	48	3.1%	6	19	39

Source: Electoral Calculus, HSBC Global Private Banking and Wealth, 23 May 2024

- High public debt is going to be the main hindrance for any new government policy formulation as it minimises the scope for further government spending. The economy has recently recovered from a recession in the last year but is still struggling in terms of investment and productivity growth along with a shortage of workers, to the point that the Office for Budget Responsibility (OBR) sees yearly growth of 1.6% on average over the next five years. With the latest public sector net borrowing higher than expected, it seems that there will be little appetite to cut taxes in a large way. The OBR also projects that there is very little room for manoeuvre fiscally.
- More significant is the Labour commitment to allow spending on investment. If Labour were to spend to buy or create an asset, this should be seen as neutral to the overall government balance sheet or even a positive if there is likely growth or income stream in the asset. However, if Labour sticks, as they have said they would, to the five-year fiscal rule, they would be hamstrung on borrowing to invest, even if they can argue that the larger deficit is justifiable.
- Labour has also committed to clean energy. They initially pledged to spend £28bn a year on clean energy, but this was scrapped because they wanted to put fiscal discipline at the top of the agenda. The target to add 650k new jobs in the sector would imply some serious funding. Immigration and the NHS will likely be contentious battlegrounds for the elections. The pool of labour in the UK is facing headwinds from rising inactive workers. The "long-term sick" has risen by almost 1 million in 5 years, to 2.9 million.

Investment implications

- Stronger-than-expected April's CPI data led to lower down the bets on June rate cuts. We believe that sticky wage growth and stronger service inflation data are hard to ignore, and hence, the UK's first rate cut will most likely happen in August. Given that the market is only 50% sure of a rate cut in August, we see now as a clear opportunity to invest cash ahead of a likely weakening in GBP.
- In previous elections, the FTSE 100 didn't outperform on average although there was a greater spread of returns. In recent history, only 1992 was a surprise to markets. As this was a victory by a John Major led Tory party over a Neil Kinnock led Labour party – the market reacted positively as the Tories were typically seen by the market as more pro-business, hence the following strong FTSE 100 performance. Nevertheless, we think the most likely outcome of a Labour win in this election is already in the price.
- We are neutral overall on UK equities as the FTSE 100 is too defensive for us, but our tilt towards more cyclicality and an improving UK outlook shine a bright light on the attractively valued FTSE 250.
- We maintain a bullish view on gilts. The market is assuming that rates fall to a little above 3.5% by 2028; whereas we see the cut to 3.75% by 2025. This translates to an opportunity to lock into gilt yields that assume that rates are too high for too long.

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