U.K.:
The solid Conservative majority would lead to higher growth

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EXECUTIVE SUMMARY

- The polls were right this time: In the UK elections, the Conservative Party won a solid majority of 74 seats - the party's largest since Thatcher's election in 1987. -This will allow them to "get Brexit done" in 2020, reducing the uncertainty in the UK economy. Risks of early elections are rather low in the next three years.
- As a result of lower uncertainty and higher fiscal spending, we revised on the upside our 2020 growth forecast for the UK from +0.8% to +1.0% and we expect growth to continue to recover into 2021 (+1.6%).
- What does this mean for companies? Stronger domestic demand would be positive in a context of slowing turnover growth. However, downside pressures on prices should prevail, given the still "above normal" levels of inventories post contingency stockpiling throughout the year. We expect business insolvencies to slow down to +3% in 2020, after +6% in 2019. In 2021, a moderate fall of -2% is likely.
- What does this mean for markets? The sterling should continue to appreciate (GBP/EUR at 1.25 at end 2019) and stabilize in 2020. Domestic equity markets should benefit from the outcome. The combination of upside pressures coming both from the real and inflation Gilt components should result in a clear upside risk to the back-end of the Gilt curve. Our proprietary model currently computes the upside risk as a +10bps possible increase in 10-yr Gilt.
- However, the hardest is yet to come: the trade deal with the EU is unlikely to be completed before 2022, given the challenges of implementing the border controls in the Irish sea.

The polls were right this time: the Conservative Party won a solid majority in the UK general elections, which will allow them to "get Brexit done" in 2020. The Conservatives won 74 seats - the party's largest majority since 1987. PM Boris Johnson's party is projected to have won around 44% of the vote and 364 seats (up from 318 in the 2017 election), with Labor's performance falling from 262 seats in 2017 to 203 this time - the lowest since 1935. SNP obtained 48 seats (+13), the Liberal Democrats obtained 11 seats (-10) and DUP 8 seats (-2). The Brexit Party have 0 seats in the Parliament.

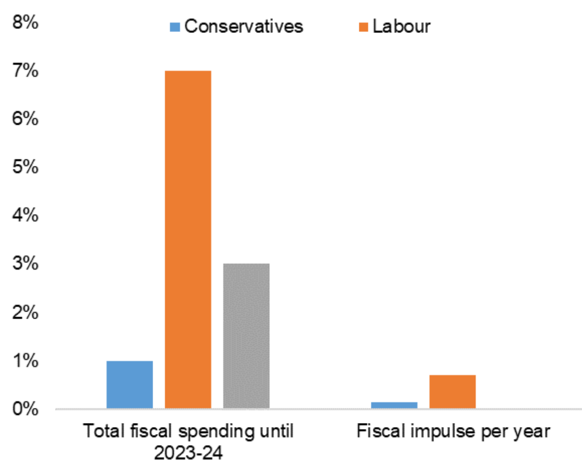
All manifestos promised future fiscal stimulus

In their manifestos, all three main parties have in common more fiscal spending, notably on education, health and families. A text analysis of the manifestos shows that the preferred words of the Conservatives are people, UK, support, country, world, work, Brexit.They have pledged to pursue a policy focused on trade (Global Britain) but also to protect national interests. They also most often mention infrastructure in their manifesto, along with the Liberal Democrats.

The Conservatives have pledged to implement a modest fiscal stimulus - largely from already announced measures, plus up to GBP20bn a year in extra investment spending. In total, this would amount to more than 1% of GDP by 2023/24. Public

sector investment should rise to 3.0% of GDP by 2023/24. The additional cut in the corporate tax rate to 17% in April 2020 (from 19% currently) would be replaced with more investment for the public health system (NHS), equivalent to GBP6bn. In terms of Small and Medium Enterprises (SMEs), PM Boris Johnson announced a cut in employer national insurance contributions (NICs) for SMEs and an increase in the amount of annual research and development (R&D) tax relief. During the campaign, Johnson had also raised the prospect of a "buy British" policy and state aid for struggling UK companies.

Figure 1 – Fiscal spending plans by party and expected economic impact



Sources: Manifestos, Euler Hermes, Allianz Research

What does a solid Conservative majority mean for the economy, Brexit, companies and markets?

Having avoided a hung Parliament means "business as usual" will follow, along with receding uncertainty from very high levels. This should help the economy recover in H2 2020, notably through more business investment and domestic sectors. Indeed, the Conservatives planned a fiscal stimulus starting in 2020. The government will then turn its attention to a budget, expected in early February, which will enshrine the September spending review and the manifesto pledges into law.
The fiscal stimulus is expected to boost GDP growth by around +0.2pp per year (against +0.7pp for the Labor). Hence, **we revise on the upside our 2020 growth forecast from +0.8% to +1.0%,** and we expect growth to continue to recover into 2021 (+1.6%). Amid higher growth and below 2% inflation, the Bank of England should remain on hold into 2020 and start normalizing with one rate hike (+25bp) into 2021.

For **Brexit**, a Conservative majority would mean bringing the EU Withdrawal Agreement back to Parliament before Christmas. As a reminder, the Bill has not yet passed the House of Lords which is 85% in favor of the EU and is likely to ask for amendments (incl. staying in the EU Customs Union). In addition, the final stage of Brexit deal ratification is the European Parliament and the next plenary session is planned for 13-16 January 2020. Hence, another "technical" extension of Article 50 is expected before the end of January as there is little time for both the UK and European Parliaments to ratify the deal. However, a solid Tory majority means a very low probability of a second referendum, indicating that the Brexit deal will be ratified by June 2020.

For **companies**, stronger domestic demand would be positive in a context of slowing turnover growth. However, downside pressures on prices should prevail, given the still "above normal" levels of inventories post contingency stockpiling throughout the year. This means that the stock adjustment is not finished and we should still see weak GDP growth in Q4 2019 and Q1 2020. Industrial confidence remains weak, the balance of opinion still being strongly negative (-16.7%), close to 2009 levels. The order books are also still depressed. We expect business insolvencies to slow down to +3% in 2020, after +6% in 2019. In 2021, a moderate fall of -2% is likely.

The **sterling** should continue to appreciate (GBP/EUR at 1.25 at end 2019) and stabilize in 2020.

Domestic equity markets should benefit from the outcome. If history is any guide, the outcome of the general election in the UK should not significantly move equity markets in the UK. In the past, the winning party (Conservative vs Labor) showed little influence on the performance of the FTSE All Share Index one year before and after elections (see Figure 2 below). What is more important for the UK equity markets is the outcome of the Brexit attached to one or another party. As the Labor party

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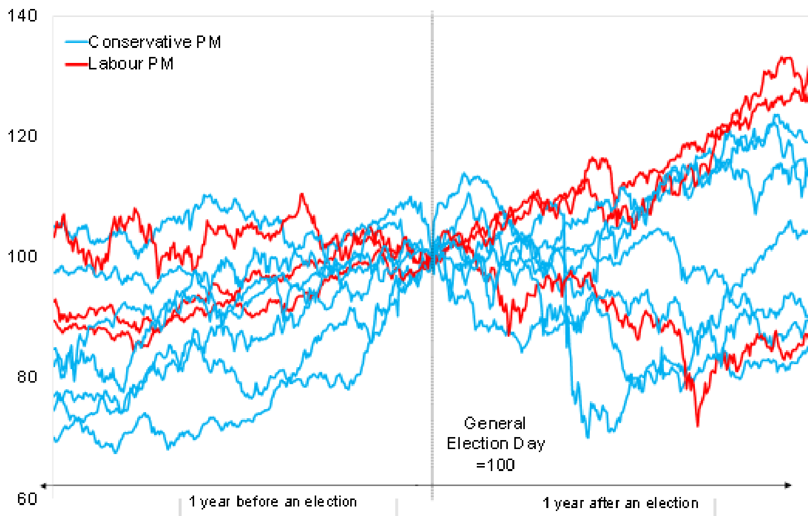
has dropped out, Brexit with a deal, the outcome associated with the Conservative party, will benefit local names. Large international corporations would feel headwinds coming from the stronger GBP and lower commodity prices. All in all, this election should not be a turning point for equity markets. It is the result and the length of Brexit that would steer some indices to the north or south.

Figure 2 – Equity market performance one year before and after general elections in the UK



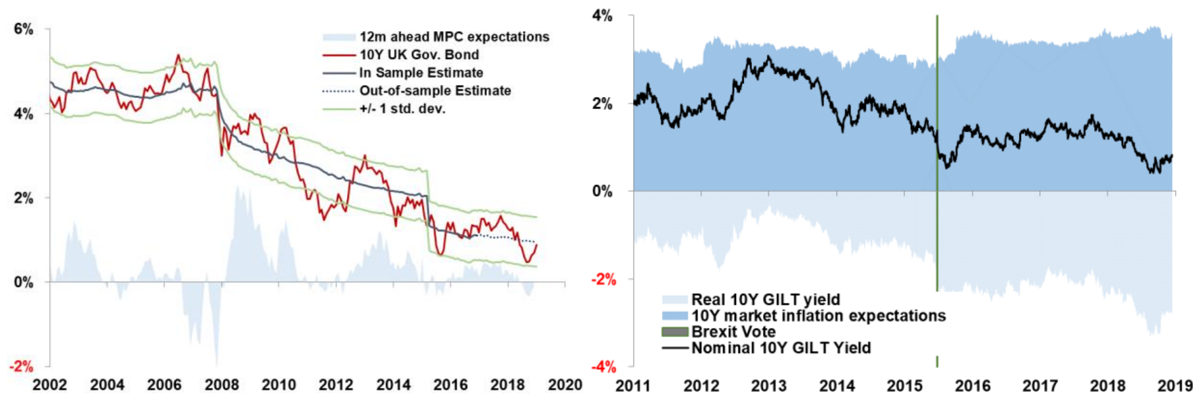
Sources: Bloomberg, Allianz Research

In this new political landscape, the prospect of a more likely resolution of the Brexit impasse, paired with the prospect of a mild uptick in economic activity, should gradually lead to the unwind of some volatility buckets that were exerting downside pressure on the long-end of the Gilt curve, anchoring it to the lower range of our valuation model. Altogether, the disappearance of the two volatility dampening factors may directly contribute to a market repricing of both monetary policy expectations and bond risk premia, leading the UK to be the lead long-term rates underperformer in 2020. Additionally, some part of the Brexit "tax" on yields (-60bps permanent impact since the Brexit vote) may finally be reversed, adding more upside pressure on the back end of the Gilt curve.

Interestingly, when it comes to the inflation component of UK nominal yields (Gilt), the British market remains one of the lone inflation markets with a clear positive inflation risk premia. This has generally been the case since the Brexit vote, with 10y RPI swaps averaging 50bps over underlying inflation over that time frame. However, as the BoE is unlikely to move aggressively via tighter monetary policy, inflation swaps are likely to remain at current levels or to take a timid lift.

All in all, the combination of upside pressures coming both from the real and inflation Gilt components should result in a clear **upside risk to the back-end of the Gilt curve**. Our proprietary model currently computes the upside risk as a **+10bps possible increase in 10-yr Gilt**.

Figure 3: UK 10y Gilt Model & Decomposition



Sources: Bloomberg, Allianz Research

The hardest is yet to come: the trade deal with the EU, and not before 2022. Mind pockets of volatility again!

Once the Brexit deal is fully ratified (by June 2020) we think the debate will quickly shift from the risks of a "no deal" Brexit to the risks of a "no trade deal" one. Even if PM Boris Johnson doesn't want to extend the transition period for now, we think this would be inevitable given the technical challenges in implementing custom checks in the Irish sea. An extension of the transition period until end of 2021 is likely.

As a reminder, the Brexit deal stipulates that Northern Ireland would be treated differently from the rest of the UK as an entry point to the EU, aligning with the EU's regulatory arrangements for goods while remaining in the UK's customs union. A customs border in the Irish Sea would be set up between Northern Ireland and the rest of the UK, and customs declarations on goods sent from Great Britain to Northern Ireland would be needed. Goods imported to Northern Ireland and the Republic of Ireland from other countries (non-EU, including the UK) would either face a UK tariff or the EU's Common External Tariff, depending on their final destination. As an example, let's imagine that a car is imported from the U.S. into Northern Ireland. If this car would stay in Northern Ireland, the UK import tariff would apply (10% if there is no Free Trade Agreement with the U.S. or less in the contrary case); if it is re-exported to the EU, then the EU tariff will apply (10%).

In the longer run, we see a low probability of the UK turning into the "Singapore" of Europe

Given the Conservative focus on domestic policies and social spending, we see no fiscal space for a more corporate-friendly policy. The corporate tax rate is already uncompetitive compared to other EU countries, which lower their corporate taxes, notably for SMEs. Meanwhile, further tax cuts would be tough to implement given the Conservatives' plans of fiscal spending. In addition, exiting the EU Single Market would remain a drag on future incoming foreign investment.

Economically, the UK is a welfare state, with government spending at 40-45% of GDP, compared to Singapore's 16-17%of GDP. Politically, Singapore's economic model is largely incompatible with a democratic state aiming to promote social welfare. While being one of the best states for businesses, Singapore ranked amongst the worst performers in the 2018 Commitment to Reducing Inequalities index (149 out of 157).

PM Boris Johnson's free ports proposal poses a possible regulatory concern due to the ports being situated in already problematic areas, regarded by the EU commission as potential havens for money laundering. The proposal also poses concerns from an employment protection perspective.

Finally, Singapore's model has also relied heavily on a pro-immigration policy, which has been one of the most contentious Brexit issues.

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