Mizuho Market Comment

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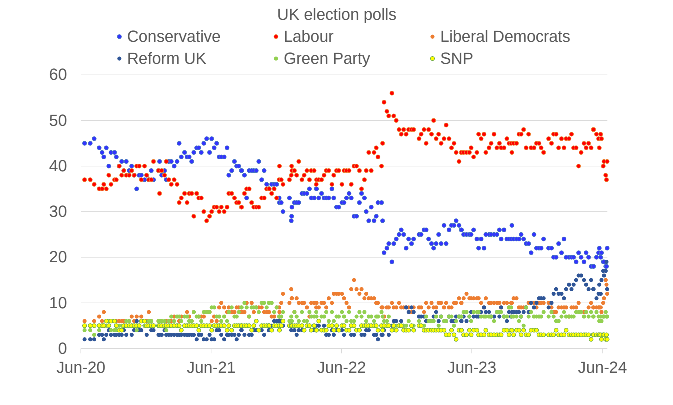
UK – Change in the political weather but limited economic policy change near term

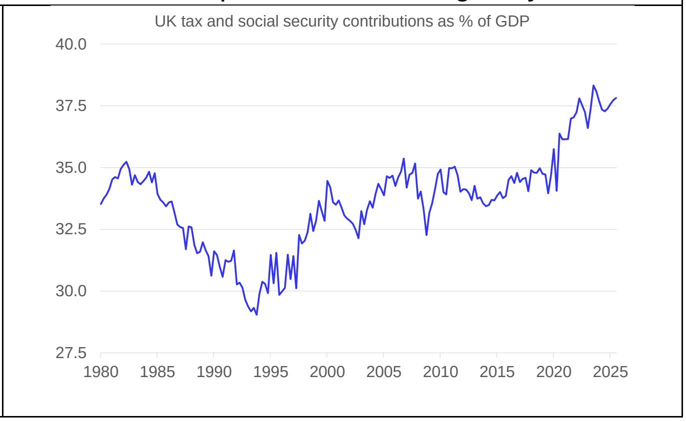
- **The government is almost certain to lose the 4 July election. However, any new government…**
- **…is constrained by the difficult fiscal situation. We do not see major changes in economic policy**
- **The BoE will leave rates on hold this week in the midst of the election campaign…**
- **…but we continue to see a gentle easing cycle starting in August**

BoE to leave policy on hold in midst of election campaign
When the UK election was called in late May, the BoE immediately halted public commentary and as such we haven't heard from any BoE officials in the run upto this week's BoE meeting. The market sees almost no chance of a change in policy. We believe that unless the case for a move is clear cut (and we would argue that it isn't) then the BoE will leave its policy settings unchanged for the duration of the campaign (ie the June meeting). Recent UK data have been mixed but we assume that they will not have caused any change of heart on the part of the MPC. We expect that policy will be unchanged and the vote will remain 7-2.

Labour maintains a vast lead in the polls…



…No reversal in post-Covid tax surge anytime soon



Source: Bloomberg, OECD

Labour to win the election – the only question is how big its majority will be
The opposition Labour Party is on track to win the 4 July election, most likely by a wide margin, although the polls vary by considerably on the size of the majority. The Labour Party has maintained a sizable ~20 point lead in the polls all year. PM Truss trashed the government's reputation for economic competence and PM Sunak has been unable to change the Conservative Party's electoral fortunes. Electoral Calculus, a UK political consultancy specialising in quantitative analysis and modelling of elections, estimates that the Labour Party will win a 272 seat majority. Its analysis highlights the benefits of the first-past-the-post system. The Labour Party is set to see its vote share rise from 33.0% to an estimated 41.4% but its seat total will more than double from 197 to 461. In contrast , Reform (Nigel Farage's party) is expected to see a bigger percentage bump from 2.1% to an estimated 14.8% of the vote and yet this surge is predicted to yield just 1 seat.

Labour's policy platform is broadly centrist – promising only a mild deviation from the status quo
We expect that the polls are broadly correct and that the Labour Party will form the next government. However, we do not expect that this will result in radically different economic policy. The Labour Party has said little. It is winning by virtue of not being the government. Its manifesto is broadly centrist, with the odd left-wing policy thrown in. It has promised not to increase income tax, VAT, corporation tax or national insurance – the main levers of taxation that account for ~2/3 of revenue. Its spending plans are modest too. In general, the Labour Party seems to be positioning itself as a more efficient/effective manager of the economy rather than a radical reformer. Its plans for a more cooperative relationship with the EU, whilst helpful, will yield only minimal gains.

Poor fiscal outlook most likely means higher borrowing

The fiscal inheritance of the new government will be particularly weak in part due to the surge in spending during Covid, which has left the UK with a large debt/GDP ratio and a high tax take as a percentage of GDP. The spending cuts baked into the current government's last budget back in March look too large given the absence of significant fat. Many areas, such as local government or the legal system, are already in crisis and additional spending cuts by the incoming government would be hard and politically unpalatable. This implies more tax hikes, which look difficult given the already elevated tax burden, or higher debt. The latter looks the more likely option.

Fiscal policy not likely to be a big driver of the BoE outlook in coming quarters

We expect only mildly looser fiscal policy on the other side of the election and as such fiscal policy not likely to be a big driver of the outlook. The biggest potential changes would be to the planning system, which could spur a house building boom, as well as helping infrastructure planning but we suspect that any changes will initially be modest and take some time to bed in. The macro data are likely to remain the primary driver of BoE policy. We continue to see a modest easing cycle against a backdrop of economic recovery, undertaken gradually, starting August with a 25bp cut. We see cuts once per quarter until rates hit 4%, when we expect a pause.

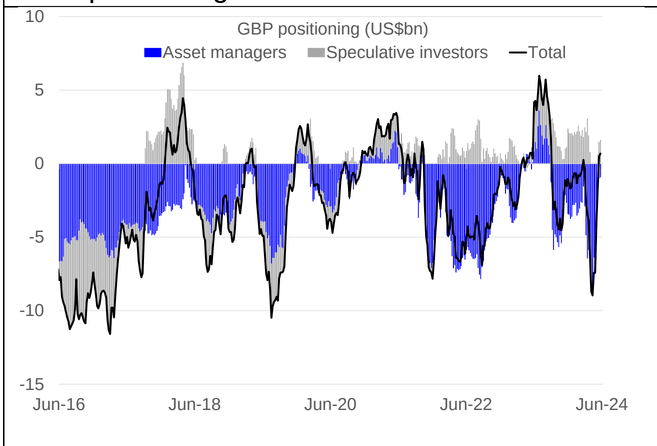
BoE to ease steadily and slowly

The macro backdrop remains reasonable. We see GDP this year at 0.8%, rising to 1.4% next year. The Bank remains a little more downbeat than we are, looking for slightly weaker global activity and slightly tighter fiscal policy, amongst other things. The Bank sees the output gap widening and more disinflationary pressure than we do. The Bank expects that inflation will be 1.9% in 2025 and just 1.6% in 2026. Despite the weak GDP and inflation forecasts, we expect that the Bank will proceed with caution. This is because it will take time for its measures of inflation persistence to give the all clear. Sure, headline CPI is currently at the 2.0% target but core is still elevated and services inflation even more so. It is only when these latter two measures fall closer to the 2.0% target that the Bank will feel more comfortable and may be able to ease faster. Until then we suspect it's a case of "Easy does it". Furthermore, the Bank is operating with a less clear view than usual on the labour market, which is a key driver of inflationary pressures. It may be that in the autumn, when the ONS finally produces its reformed survey, the picture looks different. This will add to the Bank's initial hesitation on moving quickly.

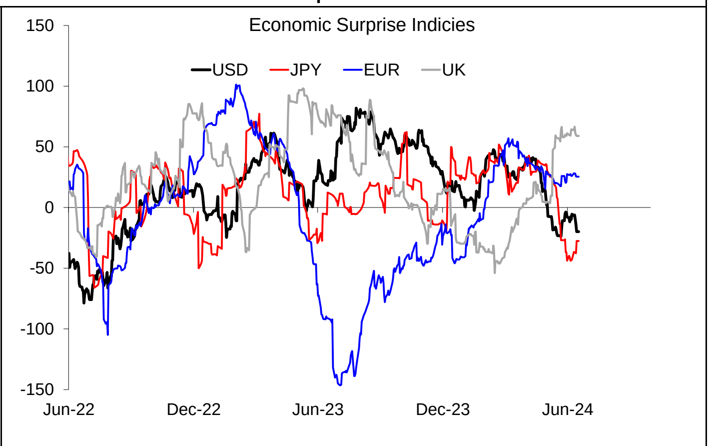
UK data in April and May consumer spending look soft but we attribute some of this to poor weather hitting retail activity rather than deeper-seated problems. Spending should look better in summer after a wet spring.

Whilst our expectations of BoE easing in the coming 12 months are a little more dovish than current market pricing the difference is small. We expect that EUR/GBP will push lower at least until the uncertainty surrounding the French policy dissipates. This uncertainty may drag on well beyond the 30 June/7 July elections, as the direction of policy under a new government may take some time to emerge. In contrast, we see UK political uncertainty easing. We look for EUR/GBP to push down towards the 0.80 level on a 12m horizon. We see Cable edging higher through the year, managing to keep appreciating modestly even after the US election towards the 1.34 level by summer 2025.

GBP positioning not stretched…



…even as GBP data outperform



Source: Bloomberg