

May 18, 2015

(NB: Due to Memorial Day, the next report will be published June 1st)

The U.K. Elections

The May 7th elections in the U.K. shocked pollsters, who had predicted a hung parliament. Instead, the Conservatives (Tories) won an outright majority of seats in the legislature, allowing the party, led by David Cameron, to form a government without a coalition.

In this report, we will begin by recapping the election results and discuss the campaigns and what they may indicate for future U.K. policy. An examination of the impact of the election will follow, beginning with an analysis of the geopolitics of Britain and ending with how the election affects the country's geopolitical situation. As always, we will conclude with potential market ramifications.

The Election Results

Going into the election, pollsters were nearly unanimous in their prediction of a hung parliament, which occurs when no single party establishes a majority. In a parliamentary system, such an outcome usually leads to a coalition government, although minority governments sometimes result. If no party had won an outright majority of seats, the most likely situation would be weeks of the Tory and Labour parties trying to woo smaller parties to piece together a voting bloc of 326 seats in order to gain a one-seat majority in Parliament. The 2010 elections did not produce a clear winner but David Cameron, the head of the Conservatives, was able to create a

government in coalition with the Liberal/Democrats. In the British system, the government has a term of five years but can call elections at any time before the deadline, taking advantage of high approval ratings.

As the votes were counted, exit polls began signaling a strong showing by the Tories. The initial response by party leaders (other than the Conservatives) was disbelief. Several comments from various party officials suggested that if these exit polls were correct they would "eat their hats." By night's end, the exit polls had actually underestimated the Tory win.

The final results showed the Conservatives won 331 seats, giving the party a six-seat majority in Parliament. The Labour Party finished second with 232 seats, the Scottish National Party (SNP) came in third with 56 seats and the Liberal Democrats won eight seats. The remaining 23 seats were won by regional and fringe parties. Most notable was the single seat captured by the U.K. Independence Party (UKIP), which ran on a platform opposing immigration and the European Union (EU) membership.

The differences compared to the 2010 election were stunning. The big winners were the Tories, which picked up an additional 24 seats, and the SNP, which added 50 seats. The losers were Labour, which saw a decline of 24 seats, and the Liberal/Democrats, which lost 48 seats. The changes from 2010 offer important insights into how the campaigns were managed and what this election portends for the U.K.'s future.

The Campaigns

The U.K. electorate had the following characteristics:

- The U.K. is comprised of four former sovereignties, England, Scotland, Northern Ireland and Wales.



(Source: Projectmapping.co.uk)

The national parties are Labour, Conservatives, Liberal/Democrats, Greens and the UKIP. Most of the others are either very small or regional parties.

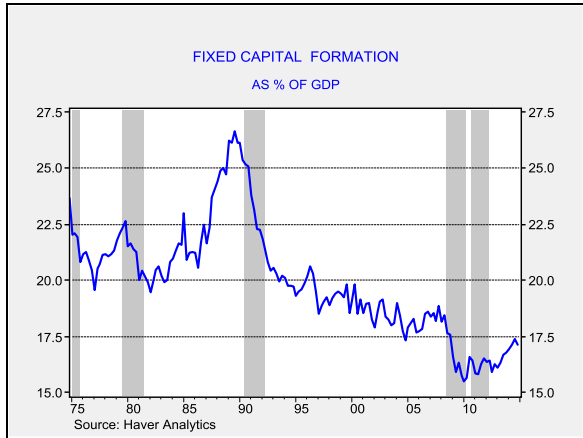
- Since the 1990s, there has been growing pressure for devolution. Last year, Scotland held a referendum on independence that failed but, given the SNP’s strong performance, the issue will likely return. The last time the U.K. faced this degree of devolution pressure was during 1885-1921, when Ireland pressed for independence.
- The U.K. uses a “first past the post” system for winning a district. The district goes to the party with the most

votes, even if the difference is only one vote. This method is also used in the U.S. Many European parliamentary systems use proportional representation. Under this method, parties win seats by the proportion of the vote they gather in the national election. In a “first past the post” system, if a party wins numerous close elections, they can end up with greater representation than another party which may actually capture more votes but win fewer districts. This election showed this issue clearly; the UKIP won 12.7% of the national vote but only one seat; the SNP won 4.7% of the vote but won 56 seats. The secret to the SNP’s success was that its votes were completely concentrated in Scotland, whereas the UKIP competed nationally.

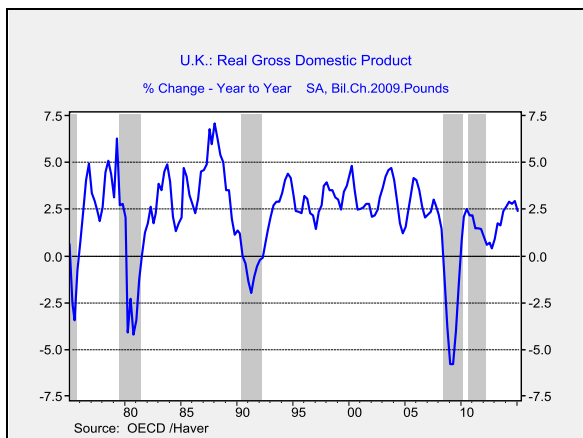
David Cameron, the prime minister and leader of the Conservatives, faced a number of issues in this election. First, the economy was growing but not robustly. His administration had implemented austerity measures during his five-year term in a bid to bring down the budget deficit. Austerity programs have been very controversial; left-leaning economists vehemently oppose them while right-wing economists laud them. The theory behind austerity is that large fiscal deficits depress investment. There are two reasons; public sector spending can “crowd out” private sector spending, and high deficits raise worries about future tax hikes and weaken the “animal spirits” that drive investment. Left-wing economists deride these worries; Paul Krugman has suggested that austerity requires a “confidence fairy” in order to work.

In any event, austerity has distributional effects. Social spending cuts tend to hurt the less affluent, while reduction in public investment hurts the users who rely on it (often the poor) and weakens the

construction sector that depends on public investment spending. Thus, there is a natural opposition to austerity; politically, the key worry is whether a candidate can overcome the opposition.



The economic record over the past five years is actually somewhat mixed. The above chart shows investment as a percentage of GDP. Note that the U.K. suffered a “double dip” recession after the Great Financial Crisis. This likely occurred due to austerity. However, investment has recovered strongly since the last recession, bolstering Cameron’s case.



Real GDP didn’t decline all that much during the follow-on recession from 2010 to 2012, but GDP growth is now just barely at the lower end of the range seen prior to 2008. Thus, the economic record is

something of a mixed bag. Given that the Bank of England was running aggressively accommodative policies (mimicking similar policies in the rest of the developed world), it would be difficult to suggest that austerity worked. As a result, Cameron had to defend his economic record that was often perceived as helping the already well off at the expense of the less affluent.

Second, Cameron was facing rising devolution pressures. To procure a “no” vote in Scotland’s independence referendum last year, the prime minister made unspecified promises on autonomy to Scotland. These promises did not go over well with the English. They see an asymmetry with devolving powers, in that the semi-autonomous states have influence in the British Parliament, and thus over English affairs, but the English have no say in the Scottish Parliament, for example.

Third, all of Europe is seeing a rise in nationalism and a rejection of transnational organizations, such as the EU.¹ The U.K. has always had a somewhat standoffish relationship with the continent (which will be discussed in more detail below); the English have grown to see the EU as another source of interference in their lives. The flow of immigrants, who seem to mostly live in England, are seen as a drain on the exchequer² and undermining British culture. In response to this anti-EU sentiment, Cameron has promised a referendum on EU membership by the end of 2017. Interestingly enough, as England has become jaded by the EU, Scotland has become more strongly committed to the continent. The UKIP, which ran on a platform that was anti-immigration and anti-

¹ See WGR, 1/12/2015, [European Populism](#).

² Cameron described it as “benefits tourism”; see: Münchau, W. (2015, May 11). What Cameron’s win means for Europe. *Financial Times*.

EU, threatened to peel off Tory votes on the EU issue.

Cameron's campaign strategy was twofold: tout the economic recovery and paint the leader of Labour, Ed Miliband, as unfit to lead. Cameron's campaign assumed that his promise for a referendum on EU membership would neutralize the UKIP.

Although the economy may not have benefited all of the U.K. (very few policies make everyone happy), they were likely good for the majority of Tories, who tend to be in the upper income brackets. By running personalized campaigns against the UKIP leadership, especially Nigel Farage, the head of the party, the Tories were determined to undermine that threat. The economy has been improving and most of his supporters were uncomfortable with changing leadership.

Furthermore, his tactics against Labour were brilliant. Ed Miliband had ousted his older brother, David, from the leadership role in Labour. His older brother had supported Tony Blair, who had won three terms as PM by turning Labour away from its trade union roots and toward the center. Blair's transformation of Labour is considered similar to what Bill Clinton and the Democratic Leadership Council did for the Democratic Party in the U.S. Ed disagreed with that policy stance and supported a leftward turn to Labour's pre-Blair position. The "Blairites" in the Labour Party strongly opposed this decision by Ed Miliband, but to no avail.

Ed Miliband believed that the austerity policies run by Cameron were widely unpopular and that by moving Labour to the left, the party's popularity would rise. If the election had been held a year or two sooner that position may have been defensible.

However, with the economy doing better, the anti-austerity stance became narrowly focused on Labour's "true believers" and the stance made it difficult to attract centrists.

Cameron's masterstroke was to tie the SNP to Labour. By arguing that the only way Labour could govern was with a coalition with the Scottish separatists, he forced Miliband to vow not to join the SNP to form a government. Given the drubbing Labour suffered in Scotland, not forming a coalition with the SNP virtually guaranteed a loss for Labour. All in all, Cameron ran a solid campaign. However, he must now govern from the positions he campaigned on, which may prove to be very difficult.

The Geopolitics of Britain

To fully understand the monumental task Cameron faces, it is helpful to consider Britain's geopolitical situation. Historically, it has had three imperatives:³

- The British Isles must be unified. If Wales and Scotland are independent, a foreign power could use these two sovereignties to launch attacks on England. English kings have fought several wars to unify the Isles.
- The state must prevent a hostile naval force from gaining safe harbor near the Isles. This led the English to conquer Ireland so as to protect the English Channel.
- Britain must build an empire. Even a united Britain could not dominate the European continent. To prevent Britain from being economically dominated by Europe, Britain built a massive empire that became the economic foundation of Britain.

³ Friedman, G. (2015, May 5). How British Elections Represent the State of Europe. *Stratfor*.

To protect the empire, Britain must be the world's preeminent naval power. A large navy meant Britain could, at will, prevent foreign nations from projecting global power. In addition, it could establish naval blockades to economically strangle most nations. This allowed Britain to be the world's superpower at a relatively low cost.

In general, the British subjects bought into these imperatives. Only the Irish persistently wanted to leave, and much of this was due to harsh British subjugation and religious differences. Even when Ireland became independent, the predominantly Protestant northern counties remained in the U.K. Protection from European wars and the benefits of membership in the empire trumped the gains from independence for England, Scotland and Wales.

WWII weakened the incentives of remaining united. As the empire gradually contracted, one of the key benefits of staying in the U.K. was undermined. In its place, Britain created a foreign policy that allowed it to “punch above its weight.” This new policy essentially allowed the U.K. to closely ally with both the EU and the U.S. without becoming fully dependent on either.

First, it maintained a “special relationship” with the U.S. Various British leaders joined the U.S. in global hegemony missions, including the Persian Gulf War and the Iraq War. Intelligence was often shared.⁴ This special relationship closely linked Britain to U.S. power. In return, British participation in U.S. hegemonic activities gives a form of European approval for American actions.

⁴ Britain is part of the “five eyes” group that also includes the U.S., Canada, Australia and New Zealand. This group agrees to share surveillance.

Of course, there are costs. At times, Britain must acquiesce to U.S. policy goals. For example, President Eisenhower forced the U.K. to withdraw from Egypt during the Suez Crisis in 1956. In addition, President Reagan was not very supportive of the British decision to retake the Falkland Islands. The British maintain a nuclear deterrent; most other European nations “free ride” on the U.S. Many British also opposed Tony Blair's support of President Bush during the Iraq War.

Second, Britain wants to tap into the economic power of the EU without becoming fully absorbed by it. Thus, Britain joined the EU but managed to “opt out” of the euro. Britain's massive financial services industry needs access to the EU for customers. At the same time, joining the Eurozone would make the Bank of England rather superfluous, which would weaken British power.

Thus, Britain's post-WWII and post-empire geopolitics were to inhabit a “netherworld” between the EU and the U.S., which gives it some power over both without being completely dominated by either. This policy is exercised in a number of ways. The decision not to enter the EMU was a significant way of maintaining distance. The recent decision to join the AIIB over the Obama administration's objections is another way Britain exercised its geopolitical power.⁵ The special relationship with the U.S. gives Britain power over the EU, and the U.K.'s relationship with the EU makes Britain valuable to the U.S.

Scotland's drive for independence and the UKIP's threat to leave the EU threatens Britain's geopolitical imperatives. Scotland is strongly supportive of EU membership

⁵ See WGR, 4/20/2015, [The AIIB](#).

and would try to join the Eurozone if it left Britain. Leaving the EU would hurt British business by reducing its influence with its largest trading partner and likely harm its financial services industry. Both the SNP and the UKIP represent serious threats to Britain; if either gets its way, the U.S. and the EU would likely no longer be interested in Britain.

To some extent, Cameron's campaign strategy exacerbated this problem. By promising a referendum on EU membership, he blunted the UKIP threat; at the same time, he now must try to wrest some minor concessions out of the EU and try to convince the UKIP sympathizers within his own party that he has changed EU policy in Britain's favor. That task will be very difficult; the EU already has its plate full dealing with the southern tier nations and won't have much bandwidth to negotiate with Cameron. Given that the U.K. isn't in the Eurozone, its departure would be less disruptive.

At the same time, by effectively promoting the SNP against Labour, Cameron has actually created a separatist monster. The leader of the SNP, Nicola Sturgeon, is immensely popular in Scotland because she backs separation. She wants to run a traditional "tax and spend" Labour agenda (which the English fear they will have to fund), and wants to remove Britain's nuclear deterrent, the Trident-bearing submarine base, from Scotland. To placate the SNP, Cameron may have to give up so much that he won't be able to control his own party.

Ramifications

This election may end Britain as we know it. If Scotland leaves, the English may simply decide that they want to go it alone as well. Wales may be forced to become independent and Northern Ireland may face its greatest

nightmare, being absorbed by the Catholic rest of Ireland. Britain will no longer be a reliable partner to the U.S.; England will be too small to matter and probably can't maintain a first-class military.

We doubt Cameron will fall into this geopolitical vortex without a fight. London's financial industry does not expect Britain to exit the EU; the fact that the pound rallied after the vote suggests no one expects the U.K. to leave the EU. However, if Cameron doesn't extract major concessions from the EU, which he hasn't yet specified, we suspect his backbenchers will revolt and bring down his narrow majority.

At the same time, there are limits to how much autonomy he can give to Scotland. The SNP will try to expand social spending on the back of the British tax base; Cameron would be a fool to accept such a deal. However, once Scotland leaves, the whole British geopolitical imperative will be called into question.

If Britain devolves, we expect financial assets tied to the U.K. to fall. The British pound might become the English pound. Scotland would pine to join the EU, although given the large number of separatist movements in the Eurozone, we suspect it would force the Scots to wait and prove they can function as a country independent of the U.K.

At present, there is great optimism that David Cameron can "thread the needle" between the UKIP anti-EU groups and the separatists best exemplified by the SNP. We hope this optimism is warranted. Unfortunately, European populism, which has become jaded with globalization, free trade and international responsibilities, is spreading. In our opinion, Cameron won

this election by co-opting the UKIP and tagging Labour with the SNP. Although both moves were brilliant politically, they are hard positions from which to govern. If the U.K. slips into the abyss that populism may represent, then the U.K. will become less stable, as will Europe.

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