UK general election FX scenarios

FX Analysis for GBP/USD GBP/EUR

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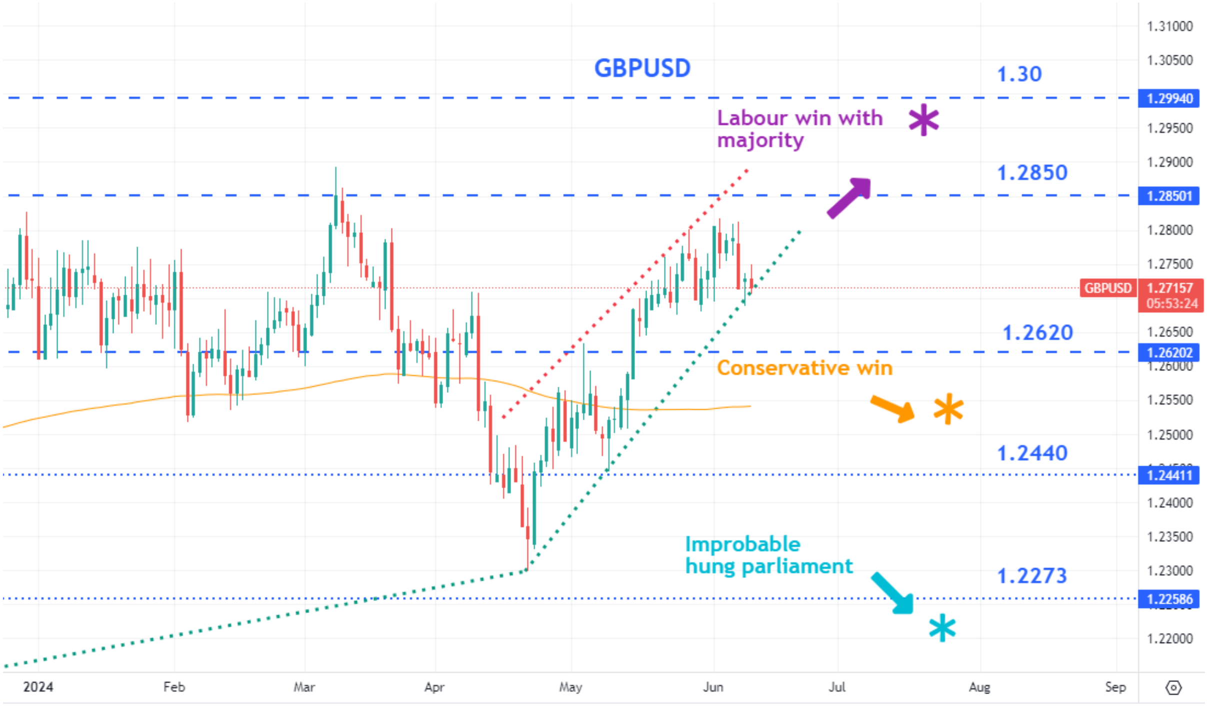
June 2024

GBP/USD

Possible election scenarios



Comment

We expect a low-volatility election, given the outcome is unlikely to surprise markets. However, it is useful to consider alternative scenarios.

The 'fiscally responsible' Labour party may engender some confidence in sterling.

GBPUSD gains could broadly mirror those made in the run-up to the New Labour win in 1997, the details of which are shown later in the document.

A conservative win would dissipate the optimism surrounding a Labour Government and could unwind some recent gains.

Higher volatility would be seen with a hung parliament, risking a move toward 1.23.

We expect interest rate policy to remain a more influential factor over the long term.

GBP/EUR

Possible election scenarios

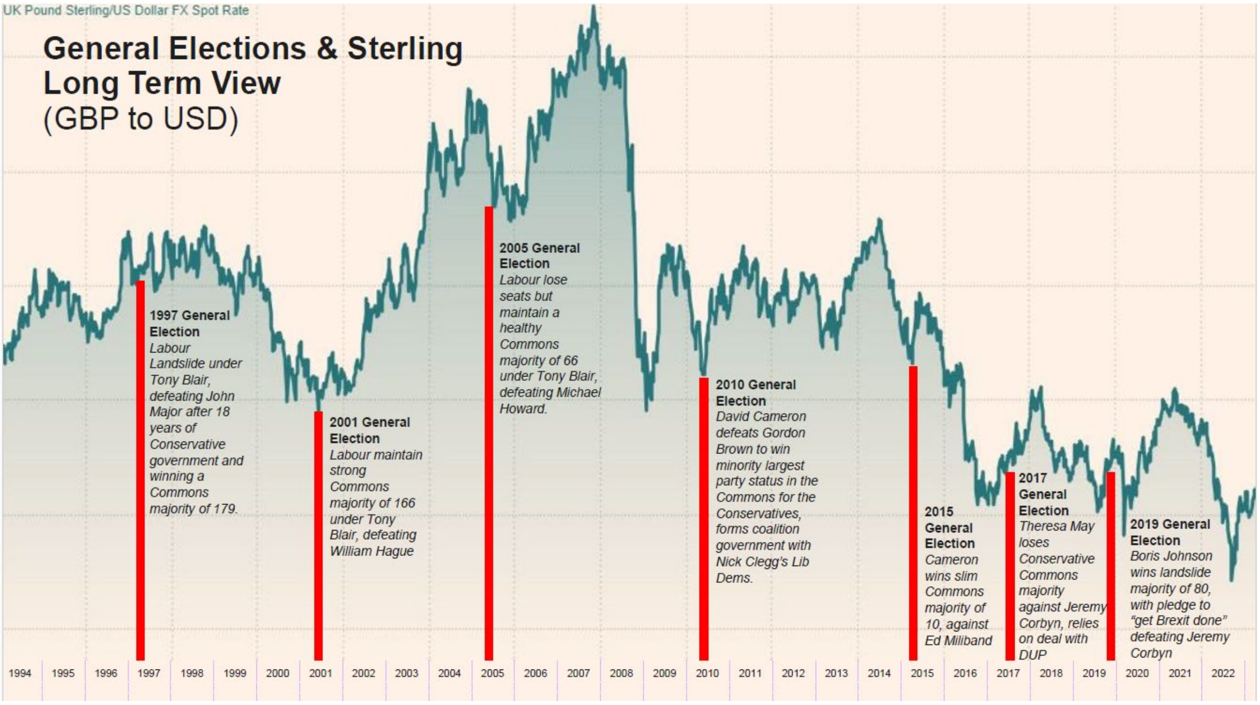
Comment

Sterling may test the 1.1923 level on a Labour majority, again predicated on some certainty provided to the market and the commitment to fiscal responsibility promised by a labour government. Price action has already seen a relatively strong move on the French snap election news (euro weakness), meaning a sterling positive reaction to the election occurs from a higher base than in recent months.

Some modest sterling downside is possible on a conservative win, the reversion to the 'status quo' of the last few years, and the removal of some of the sterling positive themes implied by an inbound Labour Government.

GBP/USD

Sterling reaction to various general election outcomes since mid – 1990's



Observations

There have been various election outcomes over the last 30 years, from a New Labour win after 18 years of conservative government, to the Conservative / Lib Dem coalition in 2010.

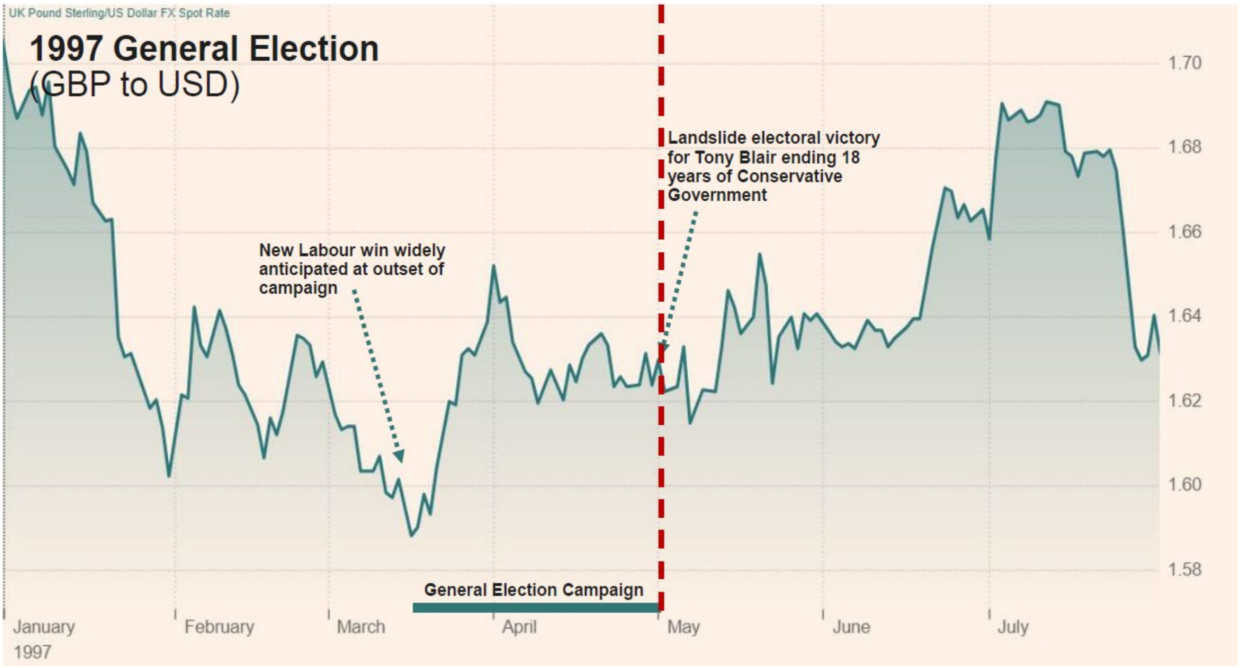
The New Labour win in 1997 created very little volatility, and one of the more volatile outcomes was the 2010 election as the initial outcome was a hung parliament.

In general, it is not elections that create large FX swings. Large moves, seen above, have been driven by major fundamental events e.g., the 2008 financial crisis and the 2016 EU referendum result.

In the above context, given the combination of the 2024 election having a prior result heavily priced in, as well as elections themselves not driving significant volatility, we can dismiss the chance of a meaningful GBPUSD reaction in early July.

GBP/USD

The 1997 New Labour market action



Similarity to 2024

The above occurred after 18 years of conservative government, ushering in a new Labour Government with a majority.

We can draw parallels between 1997 and this forthcoming election, with an expected inbound Labour Government after 14 years of Conservatives in power.

Gains are made in the run-up to the election, as manifestos are pledged, and debate is active. As themes are priced in, the election day itself initiates very little volatility. This can be seen above in the 1997 scenario, where gains were made pre-election, but very little movement was seen on the delivery of the actual result.

GBP/EUR 2010

Hung parliament

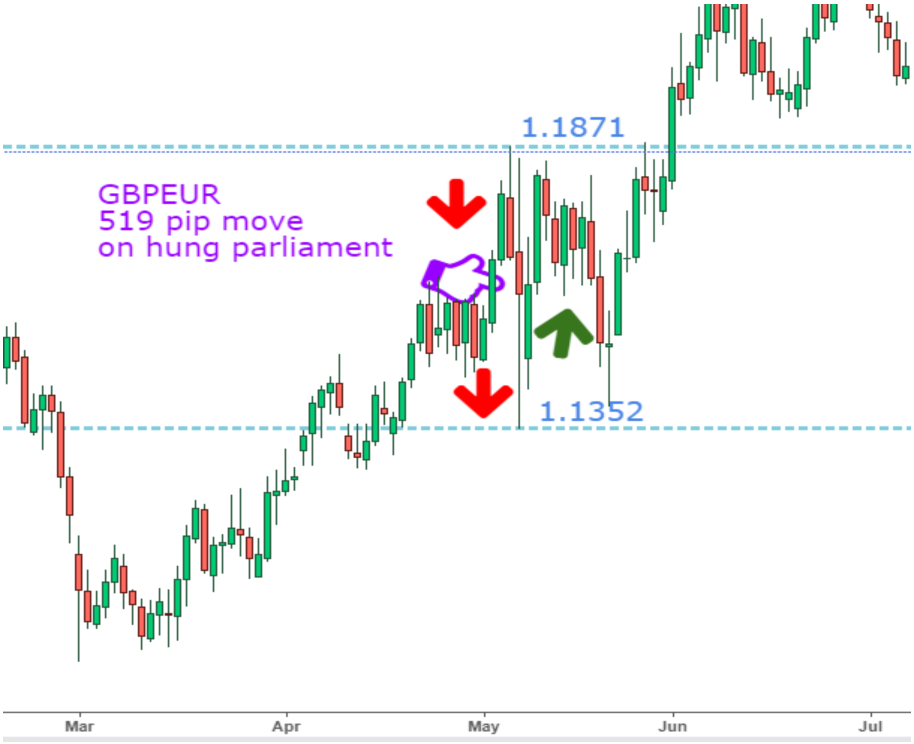
In the 2010 election, one of the more volatile in recent years, Labour lost the 66-seat majority it had previously enjoyed. The conservatives won the most votes and seats but still fell 20 short of a majority. This led to a hung parliament.

The hung parliament was broadly anticipated in the run-up to the election, so the fallout from it was less than in 1974. The outcome was a coalition government which was the first to result directly from a UK election.

The FX market reaction is illustrated below. It shows a high-to-low election result move of 519 pips before sterling strength resumed thereafter.

As such, we would assume a sterling downside move of circa 350 to 400 pips given current market levels and conditions (if the same occurred in 2024).

GBPEUR 2010 reaction



Implied volatility in options suggests a limited market reaction

Reuters June 11th

FX options are forward looking and thrive on FX volatility, but their current pricing suggests that traders aren't expecting the July 4 UK election to create too much in the way of additional GBP volatility.

Volatility is an unknown yet key parameter of an FX option premium, so dealers use implied volatility as a stand-in. Any increase in implied volatility reflects an increase in FX realised volatility, or expectations of an increase, and vice versa.

The benchmark 1-month expiry now includes the UK election result and any subsequent GBP reaction, but its implied volatility gains have been relatively tame. GBP/USD 1-month expiry implied volatility is 6.1 from 5.8 and EUR/GBP 1-month now 3.8 from 3.4 before its expiry included the UK election result.

For context, when 1-month option expiry first included the December 12 2019 UK election, its implied volatilities were marked significantly higher. GBP/USD 1-month went from 7.2 to 11.5 and 1-month EUR/GBP from 6.2 to 10.2.

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