Snap General Election – Working Through the Market Outcomes

10th April 2019

After nearly three years of attempting to deliver Brexit on the terms of the Conservative party alone, Theresa May has changed tack and is looking to build a consensus with Jeremy Corbyn. Whether this will deliver results is far from certain with each leader's party up in arms at the prospect of reaching across the aisle. Should these cross party talks fail then the number of options remaining surrounding Brexit are looking increasingly narrow, given the gridlock currently present in the House of Commons.

One route out of the stalemate may be some form of a second referendum, with the idea that MPs would be more willing to follow the mandate given to them by the people after the shape of Brexit has become clearer. This option would be hugely unpopular with much of the leave voting public and so risks the label or betrayal, especially in constituencies which voted leave but who are represented by remain voting MPs.

The other act of democracy that could be seen as a way forward for Brexit is a general election. The argument for this route goes that the current minority government, with its shaky confidence and supply deal with the DUP, is unable to form a workable majority on any matter Brexit related. Therefore another election would allow for a fresh government to be formed which can hopefully command a majority, either outright, or by workable coalition of some form. The two main issues with this argument are: there is no guarantee that a stronger government will be formed, potentially leaving us in a similarly fragile position as we currently are; and second, with today's politics split more down the lines of Brexit preferences than traditional party allegiance, how would either of the main parties deliver a clear and unifying agenda.

Nonetheless, should we see an early general election called it is important to consider what the implications for financial markets could be. Without assigning probability to any scenario we shall consider the possible market impact of the main outcomes: Conservative majority, Labour majority, Minority government.

Conservative Majority

In more normal times a Conservative majority would typically be considered favourable by investment markets. Traditionally being the party of business, low tax rates, light touch regulation and a belief in the free market economy, this would typically create opportune conditions for the corporate environment, and therefore be favourable for the UK economy. A continued preference for relatively tight fiscal

spending, even if the austerity era of George Osborne is diluted, is expected to keep government borrowing relatively low. In such an environment we would typically expect government bond yields and therefore interest rates to stay subdued (although allowing for slight increases from the current extreme lows).

Assuming a benign global backdrop, the business friendly policies of a traditional Conservative government would therefore be expected to allow relatively favourable conditions on the UK equity market as well. However, please note that the assumption of a benign global backdrop is one that could well be tested in the coming years, as the global economy is slowing and is looking closer to the end of the current expansionary cycle than the beginning.

Looking at this argument overall, however, and the caveat that may well render this argument false, in the short term at least, is the question of who will be leading the Conservatives into this next election. With Theresa May's days as Prime Minister seemingly numbered, at this stage it appears likely that she would be forced to step down prior to any election.

Should her replacement be a moderate or centre-ground Tory who is willing to pursue a similar shaped Brexit or softer to Theresa May's objective, then a close relationship with the EU can be assumed and no Brexit related economic shock expected. In this scenario, the previous argument can stand, in our opinion.

However, should the Conservatives win a substantial majority and be led by a politician who favours a clean break from the EU, the pound would be expected to fall significantly and UK economic growth, which is already weak compared to developed market peers may well slow further, possibly to the point of recession. In the short term this reaction would likely see the equity of companies heavily linked to the domestic economy (such as many small and mid cap stocks) suffer the most, but internationally focused companies, such as many listed on the FTSE 100 would experience a cushion from the fall in sterling, which would make their overseas earnings more valuable, such as happened following the initial Brexit vote of June 2016.

Labour Majority

While the leader of the Conservative party going into the next election is unknown at this stage, Jeremy Corbyn is widely expected to be at the helm of Labour. Should he secure an outright majority in the House of Commons then there will be many within investment markets with growing nerves.

If Mr Corbyn becomes prime minister and the path of Brexit is not yet set then it seems likely that he will follow his current stated preferences of securing a customs

union or similar, which will result in a very soft Brexit. UK-EU trade would be expected to continue in a relatively smooth fashion, and therefore we would expect no short term shock to the UK economy.

Once in office, however, a hard left policy agenda may well create conditions less favourable to markets. The exact shape of the manifesto for any upcoming election is, of course, unknown at this stage. But a Labour government with Corbyn at no. 10 and John McDonnell as Chancellor at no. 11 would likely involve a programme of higher social spending, greater regulation across industries, perhaps especially in banking and finance, and re-nationalisation of utilities companies and the rail service. In the latter scenario both equity and bond investors in these companies would be at risk of receiving below market value for their holdings, depending on the methods used in nationalisation.

A larger public sector will be funded in part through a higher tax environment (particularly corporate rates and income tax for higher earners), but also through increased government borrowing, leading to higher public sector debt.

The targeted re-distribution of wealth from the rich to the poor will have positive effects for the economy in that those with less have a lower marginal propensity to save, therefore increasing the circulation of money within the economy.

However, challenges to the economy from such a policy agenda would be created from the higher interest rates that would likely result from more government borrowing. Higher gilt yields will mean that more public money is dedicated to servicing debt, while the private sector may similarly be impacted by any increase in corporate bond yields that resulted from a shift in the gilt yield curve. More borrowing therefore has the potential to hurt bond markets.

In addition, higher interest rates as well as higher tax burdens and greater regulation are all challenges to corporate profitability and therefore equity investors could suffer from the greater strains on the bottom line.

It is typically the view of investment markets that the negative impacts of a hard left government on a country's economy would outweigh the benefits it brings and therefore it is likely that in the event of a strong Labour victory, views for the medium term direction of the UK economy would be negative. International investors may therefore move assets out of the country, causing relative weakness in the pound.

Minority Government

While we have explored the potential directions of majority governments so far, this is far from guaranteed to be the result of any general election in the near future. Neither of the main parties currently have a clear policy agenda and polling data

suggests Labour and the Conservatives are tied in popularity, with third parties showing reasonable strength. Should this public indecision continue and an inconclusive election result be delivered then a coalition government, or similar, would be formed.

To make specific predictions on policies and therefore market reaction is impossible to do without knowing the shape of such a government, but a broad prediction of a watered down version in each case can be made, with perhaps the exception of a resurgent UKIP propping up a Conservative government. A Labour-SNP link up may also muddy the waters, with a Scottish independence vote likely to be a demand of Nicola Sturgeon, in exchange for her support.

But, in other cases, where a coalition partner may act as a pull to the political centre ground, such as occurred during the Conservative-Lib Dem government, then market movements may be expected to be sanguine relative to the impact caused by full-fat majority governments, with both the potential hard Brexit under a Jacob Rees-Mogg/Boris Johnson type Conservative government or the likely public sector spending spree of an Corbyn/McDonnell Labour government effectively curtailed.

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