Investment Update

UK Hung Parliament - What it means

In another political shock, especially to pollsters' credibility, the Conservative Party have failed to secure an outright majority. However, assuming the 10 Democratic Unionist Party MPs side with the Conservatives, and Sein Fein do not take up their seats, the Tories should be able to form a Government.

There is plenty of rumour that Theresa May will have to step aside, but it is not clear who would succeed her – Amber Rudd only scraped by with a victory in her constituency. A leadership vacuum and a reduced mandate add new clouds of uncertainty to the economic landscape.

Election result brings more uncertainty, but could increase chances of softer Brexit or less austerity
We had already warned that a deteriorating outlook for household consumption expenditure had made revised expectations for UK GDP growth this year difficult to beat. Additional uncertainty reinforces our view. That said, if today's results can be interpreted as a reduced mandate for 'hard' Brexit, growth in 2018 may be better than expected. Further, if today's result can be interpreted as a vote against austerity – or at least the current level of austerity – a change of policy would also improve prospects in 2018.

Past hung parliaments had little long-term economic or market impact
Only two general elections have resulted in a hung parliament since the Second World War. The first was in February 1974 and the second in May 2010. February 1974 does not offer a paradigm relevant to today. The economy was mired in crisis: an oil shock had sent prices spiralling upwards, and the introduction of the three-day working week in December 1973 made the recession considerably deeper. That said, the pound actually appreciated against the dollar during the seven months of Harold Wilson's minority government and fell only slightly against the Mark.
2010 offers a more appropriate case study, although the economy was on much shakier ground than today. The hung parliament only lasted 6 days before a Conservative-Liberal Democrat coalition was cemented. The pound fell 2% against the US dollar the day after the polls closed, and continued to fall a further 2% even after the Liberal Democrats announced their approval of the coalition deal. After two months, the pound was back above its initial level. That reaction was rather a subdued one, and indeed followed the pattern typical after all general elections. It should be noted that the pound had fallen 10% in the six months preceding the election, during which polls had indicated that a hung parliament was on the cards, but this was arguably more a function of the relatively more robust recovery of the US economy.

Sterling most vulnerable, other assets less affected
Although our research has found no evidence that any general election since 1964 diverted the economy from its existing course, Brexit means much more is at stake for the economy this time. This makes the exchange rate reaction particularly hard to gauge. In early trading the pound has fallen 2% against the dollar and 2% against the euro. From here, political disarray could lead investors to lose confidence and withdraw funds; or investors may assume that European negotiators will capitalise on the UK's weakness, play hardball and so raise the risk of a 'hard' Brexit, to which the pound would react poorly.
Of course, the loss of Conservative seats could also be interpreted as a vote against Brexit, and if investors raise their estimated probability of a soft Brexit as a result the pound may benefit. Although the pound remains very undervalued relative to economic fundamentals, we had noted that it had already lost some medium term support from interest rate differentials and a reversal of short positioning before the election.
Other asset classes are rarely affected by general elections, even when the election outcome was not clear before polling day. In 2010, the performance of the FTSE relative to the global equity benchmark weakened into the general election and continued to do so for another two weeks, before beginning a sustained period of outperformance. But these moves were not large.
If the pound stays weaker, the FTSE 100 should benefit (based on recent correlations) due to effect of translating overseas earnings into sterling (c.80% of the FTSE's revenues are earned abroad). In early trading, the FTSE 100 is up 1.0%, the FTSE 250 down 0.5% and 10-year gilt yields are up a fraction at 1.06, largely driven by inflation expectations. Interestingly, equity and exchange rate volatility are usually lower than average during election years. That said, we have uncovered an increasing sensitivity of investments to economic and policy 'uncertainty' over the last two years.

As always, if you would like to discuss the above, please contact either Andrew or Alan on the contact details below.

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