

Investment Update

9 June 2017

UK election result: not so 'strong and stable'

A weakened Theresa May will now lead a coalition into a less stable economic future

In another shock to pollsters' credibility, the Conservative party failed to secure an outright majority. However, they have secured agreement with the 10 Democratic Unionist Party MPs to form a government, and together, with Kensington still to declare, have a working majority of at least six.

For now it seems that Theresa May will carry on as Prime Minister, but there is clearly a risk that her leadership turns contentious. A leadership vacuum and a reduced mandate add new clouds of uncertainty to the economic landscape.

We had already warned that a deteriorating outlook for household consumption expenditure had made revised expectations for growth in UK gross domestic product (GDP) this year difficult to beat. Additional uncertainty reinforces our view.

A 'Softer' Brexit possible?

But 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.

The Conservative's manifesto reiterated the proposal to take the UK out of the EU's Single Market Programme and the Customs Union, bring annual net migration down to below 100,000 and end the

jurisdiction of the European Court of Justice.

But this 'hard' Brexit may now need to be softened. Indeed, Prime Minister May has already conceded that freedom of movement may need to continue beyond 2019 as part of a transitional deal. So these key potentially negative effects of Brexit may not begin for quite some time, or be scaled back.

Sterling most vulnerable...

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 fell 2% against the dollar and 2% against the euro; it subsequently recovered to just 1% lower versus the dollar and 0.25% lower 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. Indeed the exchange rate has lost the short term support of relative interest rate expectations between the UK and its trading partners, with which it has had a close relationship over the last two years. If Brexit negotiations begin badly, the pound could fall further.

Of course, the loss of Conservative seats could also be interpreted as a vote against a 'hard Brexit'. If investors now see a greater chance of a 'soft Brexit', the pound may benefit.

...other assets less affected

Other asset classes are rarely affected by general elections, even when the election outcome was not clear before polling day. In 2010, UK equities weakened relative to global shares 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 index should benefit (based on the recent trend of the two moving in opposite directions). This is due to the positive effect this has when translating overseas earnings into sterling (c.80% of the FTSE's revenues are earned abroad).

In morning trading, the FTSE 100 was up 0.75%. The FTSE 250, which derives a greater proportion of underlying revenues from the UK, fell initially before recovering. UK government bonds are more or less unchanged.

Interestingly, equity and exchange-rate volatility are usually lower than average during election years, but our research has shown an increasing sensitivity of investments to economic and policy 'uncertainty' over the last two years. We reiterate a preference for overseas earnings.

What's left of the manifesto?

Compared with the March Budget, there were no major policy changes in the pre-election Conservative manifesto. Given the DUP and Conservative parties are fairly ideologically aligned, spending could be left broadly unchanged from the March Budget, according to pre-election estimates from the non-partisan Institute for Fiscal Studies (IFS). Of course we may see policy change direction in response to the lost seats.

If they follow the manifesto it's back to business as usual, which means austerity. As we noted after the March Budget, lower-than-expected growth and higher-than-expected borrowing were set to push the deficit back up. But in 2018-19 and 2019-20, the austerity earmarked for the day-to-day budget alone is set to drag on GDP by 1% a year, according to the Office for Budgetary Responsibility.

One of the few notable (though far from game-changing) policy shifts in the manifesto was the subtle alteration of the current commitment to eliminating the deficit 'as soon as possible in the next parliament' to 'by the middle of the next decade'. This points to a more protracted but less acute period of austerity.

We would view less austerity as a positive for the economy – especially in the form of investment in public infrastructure. We would not expect bond investors to demand a higher 'premium' for a slower reduction of total debt, but bond yields may move higher as investors upgrade expectations for medium-term growth and inflation. Bond investors so far don't seem to have rewarded the UK government for its relatively more austere budgetary policies when we compare the drivers of yields across major government bonds. But that may not be so surprising when you consider that the UK already has the second lowest debt-to-GDP ratio of the group. The sanguine reaction to US President Trump's profligate

stimulus plans – a programme that was set to add trillions to the national debt if carried out verbatim – suggests that bond investors are unconcerned with fiscal balances in all but the most intensely leveraged and broken nations.

Taxes: UK still attractive

Under the Conservative plan the rate of corporation tax would fall a further 2% to 17%. This may not stimulate business investment, given that the UK already has the lowest rate of corporation tax in the G7 (Canada is a distant second at 27%).

That said, a relatively low tax rate is likely to help stem firms' relocation after Brexit. The UK has a lower rate of corporation tax than all of the original 15 EU member states except Ireland (12.5%). But, arguably, it is now more important to remain competitive versus Ireland, our English-speaking neighbour, as the regulatory costs of doing business with the EU rise after Brexit.

UK economy: are we better off?

The distributional impact of austerity is concentrated in the lowest income decile. As it stands, the IFS estimate that the poorest 10% will suffer more than a 9% fall in annual net income (i.e. including benefits and transfers) worth £1,000 a year by the end of the next Parliament. Doubt has already been cast over consumer spending power. Our equity analysts have noted retailers becoming more pessimistic, and we would avoid UK-focused consumer goods and services that focus on lower-end discretionary spending.

Gauging the vigour of the UK economy is very difficult, with many conflicting data. Unemployment is at its lowest in 40 years and the number of job vacancies relative to applicants is at a record high. But according to economists' favoured measure of welfare – inflation-adjusted GDP per capita – the recovery has been much weaker than in the US, Canada, Germany and even Japan.

Pay growth since 2010 has been exceptionally weak, averaging just half the growth rate of the 10 years before the global financial crisis. The last time unemployment was this low, in 1975, inflation-adjusted ('real') pay was growing at 5%. In the last few months, average pay fell in real terms for the first time since 2014. Worse still, the ten year change in real pay has also turned negative for the first time since 1860! And that's not all – very large gains in executive pay mean that the change in the 'average' wage masks an even worse contraction for the majority of the population.

Has the bar been set too high?

It's been pleasing to see consensus estimates for growth in 2017 being revised up from overly pessimistic forecasts declared after the referendum. Nevertheless, what drives markets in the short term is not so much the level of growth as the level of growth *relative to expectations*. As a result, we now see more risk of a disappointment than a pleasant surprise.

In particular, we see a threat to household consumption. This is crucial, as it accounts for about 70% of the economy and has been the only component to make a consistently positive contribution to growth over the last three years. Our analysis suggests that real (inflation-adjusted) pay growth is unlikely to return to anything much above zero for the next six months or so.

As we discussed in our Brexit report last year, there is little evidence to suggest that immigration has placed downward pressure on the top 90% of incomes; dismal pay growth is more a result of poor productivity growth and high underemployment (workers working fewer hours than they would like). This has also held back real GDP per capita.

Our proxy measure of under-employment has not fallen as quickly as unemployment over the last year.

A relatively large number of people still want to work more hours and this excess supply places downward pressure on wages. Meanwhile, while there are tentative signs of improving productivity, meagre gains in productivity are a global phenomenon. Although there are many competing explanations, none would suggest a reversal in the short term.

Over the last two years, improving wage growth and the falling cost of fuel and energy have made the consumer more confident. Confidence alone raises consumption as households draw down on their savings and take out consumer loans. Consumer loans (not counting mortgage debt) rose by £25 billion (or 15%), and the proportion of disposable income saved has fallen to the lowest level since records began in 1980. We believe that this boost to consumption has run its course. We also note a strong negative correlation between confidence and household inflation expectations, which are in turn rather backward-looking and linked to actual inflation. As inflation increases throughout the year, household expectations will rise further, dragging down confidence,

which is already markedly below its peak.

If new question marks over the leadership of the UK erode consumer confidence further, household consumption would be even more likely to disappoint.

We don't expect other components of the economy to pick up household consumption's slack. Goods export orders are finally rising, but to a lesser degree than the depreciation in sterling would imply due to companies keeping 50% of the depreciation in higher profit margins. Indeed, imports outpaced exports in the first quarter of 2017 and so trade was a net drag on GDP growth. The Bank of England agents' survey points to improving business investment intentions in both manufacturing and services for the coming months, but intentions are still low for a non-recessionary period. Brexit-related uncertainty seems to be biting here.

Housing: plugging the gap

The Conservative manifesto offers some hope for a greater contribution from residential investment. It promises to fulfil the 2015 pledge to

build a million new homes by 2020, and an additional 500,000 units by 2022.

This leaves PM May committing to c.1.25 million dwellings over the next five years. If delivered, this policy could slow house price rises and reduce private rents, a remarkable move after decades of knowingly under-building. Low interest rates and the long legacy of a supply deficit should prevent any house price collapse. But it is difficult to see house prices continuing to rise as much as homeowners have come to expect, given the very stretched nature of valuations relative to incomes or rents.

The bottom line

Market reaction so far suggests that politics will take a back seat to economic fundamentals. While bringing greater uncertainty in the near term, PM May's loss could even translate into faster growth than might have been the case under a Conservative majority, if it results in a softer Brexit and/or less austerity. We will keep you updated as things develop.

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