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UK general election commentary

9 June 2017

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Global asset spread shields investors from the UK's hung parliament

UK voters woke up this morning to a hung parliament. Last night's exit polls gave the first indication of the scale of the upset but, as election night wore on, the political miscalculation of the prime minister, Theresa May, was starkly revealed. Immediately after May called this general election, debate centred on the scale of the likely Conservative landslide. She fought it on the issues of "strong and stable leadership" in the UK's Brexit negotiations, the need to strengthen national security in the wake of recent terrorist atrocities and thriftiness in the country's public finances. She lost ground on the issues of public spending, particularly among the young and the old. Amber Rudd disparagingly referred to Jeremy Corbyn's "magic money tree" but his commitment to increase funding for public services struck a chord with many voters. In refusing to engage in televised debates with opposition parties, May cast herself in a presidential light at the expense of building a rapport with voters. In the days to come there will no doubt be a full post-mortem in the press to determine the reasons for this political reversal.

May said at lunch time she would form a minority government with Ulster Unionist support. If this deal falls apart, Labour may try to take power backed by a "progressive alliance" in the Commons. What seems certain is that the political wrangling is likely to continue for some time. It is an old adage that "markets dislike uncertainty". Investors are likely to experience some increase in market volatility in the days to come.

Your portfolio

Market reaction has been swift. The pound fell more than 1% against the dollar and the euro last night on the announcement of the exit polls. It fell further this morning after the result was confirmed. Sterling, however, remained significantly above its recent lows against both the dollar and the euro.

As the Brexit vote showed, a weaker pound is a double-edged sword because it improves the competitiveness of UK companies in export markets and increases the sterling value of their overseas earnings. The UK equity market overall rose modestly this morning although more domestically-orientated small and medium-sized companies fell. It is possible that the fall in the pound since Brexit may more than compensate for any potential European Union trade tariffs as long as the government continues to favour no deal over a bad deal.

Sterling investors will benefit today from both the rise in the value of their investments in large cap UK equity funds and the increase in the sterling value of their investments in foreign-exchange denominated investments such as overseas equity funds.

UK gilt yields did not move significantly this morning. The fall in the pound increases inflationary pressure and the likely squeeze on UK disposable incomes from higher import prices. If the domestic economy proves resilient, the Bank of England may tighten monetary policy earlier than expected in response to rising inflation. I remain concerned about the outlook for longer-dated UK government bonds.

On a note of caution, political developments ultimately matter to investors because of their potential impact on the economy. Today's sanguine response to the unexpected news of a hung parliament may reflect the conviction that a minority Conservative government is the most likely outcome. I believe this would have a limited impact on the outcome of the Brexit negotiations and thus on the economy. Investors have been heartened by the continued strength of the UK economy since the Brexit vote. The impact on both the pound and domestically-orientated UK equities might, however, be more severe in the event that a Labour-led coalition becomes a realistic possibility because this would significantly impact both Brexit and the domestic policy agenda.

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Brexit

Brexit was explicitly included in the Conservative manifesto and the Conservative majority in terms of both votes and seats is in effect a second electoral endorsement of the EU referendum result by UK voters. This should deter potential opposition in both houses of parliament whoever leads the negotiations for the UK.

Outlook

The election result ushers in a period of domestic uncertainty and potentially increased volatility in sterling-denominated assets but the impact on global markets is likely to be relatively modest. The pace of global economic growth remains steady overall and is improving in Europe excluding the UK and in some emerging markets. The Federal Reserve is gradually tightening monetary conditions but central bank policy in aggregate remains supportive. In an environment of gently rising inflation, equity funds should provide some protection for investors in real terms.

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