Market Bulletin

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What if May falls in June?

The market is currently assuming that the Conservatives will win a large majority and eventually deliver a relatively hard Brexit, but that the election will make it easier for them to agree to a transitional arrangement, prolonging single market access for two or three more years after March 2019. This assumption has driven the rally in the pound since the election was announced. Even if the Conservatives do win a large majority, it is not certain that this will lead to a transitional deal. The initial market reaction would likely be muted given this scenario is already mostly priced in. But it's worth considering what it would mean for markets if the election produces a surprise outcome that doesn't involve a larger Conservative majority.

A small Conservative majority

If the Conservatives win the election, but fail to meaningfully increase their majority, then markets would likely price a reduced probability of a transitional deal and a higher probability of a "no deal" outcome, as well as a more uncertain outlook. In this scenario, the gain in the pound since the election was announced would probably be reversed. The lower pound would probably support companies who get most of their sales from abroad, helping the FTSE 100. Mid- and small-cap equities might underperform though, as the potential for a "no deal" Brexit increased. Based on the same logic, UK corporate credit spreads could widen. The outlook for gilts would be hard to predict, given that they have been driven more by the outlook for global government bonds recently, than by UK specific factors. A similar outcome could play out, over time, even if the Conservatives win a large majority, but it later becomes clear that the newly elected MPs are willing to contemplate a "no deal" Brexit in 2019, rather than supporting a transitional deal.

A Labour majority

If Labour wins a majority, markets would have to digest Corbyn's plan for higher corporate tax, higher government spending and the nationalisation of various companies. Those companies that he wants to nationalise would most likely fall in value—perhaps quite sharply—due to uncertainty over the price shareholders would get from the government. Higher corporate tax would also clearly be negative for all equities after tax profits. Those companies who pay the highest percentage of their tax in the UK are most exposed to this risk. Government bond yields would likely rise, on the assumption that Labour's plans will lead to higher government borrowing. Markets would be concerned by Labour's Fiscal Credibility Rule focusing only on current expenditures; they would also be sceptical of the party's ability to raise as much tax as hoped from its proposed tax measures. Credit spreads would probably widen too.

AUTHOR

Michael J. Bell, CFA
Global Market Strategist

When it comes to Brexit, Labour's position is unclear, as its manifesto states that it will "have a strong emphasis on retaining the benefits of the Single Market" (soft Brexit), while also claiming that "Freedom of movement will end when we leave the European Union" (hard Brexit). It is the incompatibility between these two statements that is at the very heart of the Brexit debate. As such, the pound would probably be torn between a slightly higher probability of a soft Brexit and concerns over higher borrowing and a government perceived as less business-friendly. Under this uncertain outlook for sterling, the pound would probably fall, although that could later be reversed.

What happens to the pound would be key for equities. If the pound were flat, equities would be expected to fall, with domestic-focused companies underperforming more internationally exposed companies. A fall in the pound would exacerbate that relative performance, but could support internationally exposed companies and even cause them to rise in value, as we saw after the Brexit referendum. However, if sterling rallied sharply on hopes for a soft Brexit, large-cap equities with international exposure could come under pressure.

A coalition involving the Liberal Democrats

The Liberal Democrats have said they won't go into another coalition with either Labour or the Conservatives, but any coalition government that involved the Lib Dems would likely see sterling rally, at least initially, on the assumption that they would demand a softer Brexit in return for their support. A higher sterling could weigh on international earners and domestic stocks should outperform. Gilt yields would probably trade higher on expectations of a less dovish Bank of England.

Uncertainty to remain high whatever the outcome

Overall, even a large majority win by the Conservative Party would not dramatically reduce the uncertainty over the type of deal the UK will eventually get, although the market reaction on the day would likely be limited. While we have examined the most likely outcomes if the election delivers a surprise result, the market's reaction to unexpected outcomes could easily be unexpected too, given the large uncertainties involved. We therefore continue to think that this election is just one more reason– on top of the many that were already created by the Brexit vote–for investors to consider reducing the size of their active positions among the UK portion of their portfolios.

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