

The *Market's* *Reaction* to the UK Election

It's about economics,
not politics

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Financial markets seem ambivalent about the UK's coming general election. Brooks Macdonald's Investment Strategist, **Matthew Cady**, discusses why economics, not politics, is currently the biggest influence.

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Despite the political shock waves of a general election called much earlier than expected, for Thursday 4th July, financial markets barely registered the news. Whether looking at sterling, the 10-year gilt yield or the FTSE 100 equity market, in all cases, the market reaction to the election news itself was muted at best.

Inflation indicators are more important

The currency, bond and equity market moves can arguably be attributed more to fundamental economic drivers. Chief among these was the news that April's UK inflation figures disappointed.

On the morning of the election announcement, the UK's inflation indicator, the Consumer Price Index (CPI), disappointed. Although the annual inflation rate fell close to the target of 2%, slowing to 2.3% in the year to April, driven by energy prices cooling off, beneath this headline rate, sticky services inflation remained much higher than expected at 5.9%.

As a result, the higher-than-expected inflation reading effectively ruled out the chances of a Bank of England interest rate cut in June. In doing so, the inflation data provided a slight boost to gilt yields and sterling while providing a marginal headwind for equities overall.

Three reasons for market ambivalence

Instead, the market's headline inaction to this week's political news is a testament to its rationality, not a sudden rush of political apathy. We see three economic factors are at play:

- 1. The market's understanding of political risks is evident:** For some time now, the opposition Labour Party has held a commanding lead over the governing Conservative Party in the polls. With such an established poll majority, the markets judge that Labour will not need to entertain any market-unfriendly radical economic policies to win extra votes. This risk has arguably hamstrung previous Labour Party manifestos coming into an election.
- 2. The market has had time to adjust to a change in leadership:** Given such a long-running lead in the polls before the election announcement, markets have had ample time to prepare for a possible Labour government's economic agenda for the first time in 14 years.
- 3. The Labour Party's commitment to financial stewardship of the economy.** Central to calming market concerns is the commitment by Shadow Chancellor Reeves made earlier this year to agree to maintain the importance of the main fiscal rule, a self-imposed rule where government debt as a percentage of Gross Domestic Product must be falling by the fifth year of the official forecast period.

Limited fiscal headroom provides reassurance

Considering the limited fiscal headroom of the UK, as observed by the Office for Budget Responsibility, this could ironically be seen as a positive. With limited room for manoeuvre, any incoming government's ability to move the aggregate fiscal dial and unsettle fixed income markets is restricted. Therefore, the market's reaction to the election outcome will likely to be minimal in the near term, whichever political party wins on 4th July.

Our asset allocation views

Equities: We continue to advocate a global equity balance between value and growth investment styles. As part of this so-called 'barbell balance', the UK equity value exposures that we seek, including resources and financials exposure at an index level, provide an important foil to our growth exposures in other asset classes and regions globally.

Bonds: With 'income' back in fixed income, bond yields can arguably play a more constructive role in asset allocation. Recognising inflation and interest rate uncertainty, in particular the timing of rate cuts and the eventual 'landing zone' for interest rates longer-term, we continue to prefer shorter-dated bonds to manage interest rate sensitivity.

Looking ahead: Ahead of the UK general election on Thursday 4th July, while political commentators will be scrutinising the main parties' manifestos, the cold reality is that neither party is going to want to spook financial markets, particularly the bond market. While the upcoming UK election will no doubt make great newspaper headlines, we do not expect it to drive a significant financial market impact in aggregate.

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