Fixed Income Focus.

UK election – Dazzled by uncertainty

Election fever has gripped the British chattering classes, dominating news bulletins and blogs across the country. But looking at financial markets you'd have thought absolutely nothing was going on. Like a rabbit caught in the headlights, it's as if the glaring uncertainty of it all has dazzled market participants into inaction. The question is whether we're about to get run over by a truck.

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Fixed Income Focus represents the viewpoint of the Active Fixed Income team at LGIM.

When it comes to uncertain events such as elections, two things generally impact markets: the probability-weighted impact of the election result and some risk premium for uncertainty. In terms of the first, last year's Scottish referendum was a good example of how a sudden shift in outcome probabilities can influence markets. For most of the campaign, it looked like the push for Scottish independence had very little chance of success, but as the 18 September voting day drew closer, the gap suddenly narrowed with a YouGov poll on 6 September actually signalling a lead for the independence campaign. This was not good news for businesses that could be thrust into the uncertain fiscal and regulatory environment of an independent Scotland. **Figure 1** shows the impact on the credit spreads of one such company – Scottish Widows – whose bonds lurched wider immediately following the YouGov opinion poll only to fully recover once the final outcome was known.

This was an example of a vote with a reasonably clear implication. The trouble with the 7 May UK general election is that even if you told me today what the result was going to be, I'm not confident that I could tell you the market reaction. Traditionally a Conservative party win is seen as better for businesses, but then there is the unwelcome uncertainty of a potential referendum on European Union membership, particularly if the UKIP agenda remains influential. A Labour victory would make an EU referendum less likely, but markets don't like the higher spending and larger deficits that are implied by such an outcome, particularly if the Scottish National Party forms part of the government with their easy spending policies. Then there's the added complication of the process of forming a coalition (or some form of informal agreement across parties). This could take quite a while, meaning that the true result of the election might not be known for weeks after the actual polling date.

This takes us on to the second impact described earlier – risk premium for the uncertainty of an election outcome. I'd have thought that UK corporate bonds would have underperformed their international peers in the run up to the election as investors reduce a little risk into such an uncertain event. But this has not been the case. If anything, UK corporate bonds have actually outperformed this year, thanks to a very strong January, and have shown little sign of giving

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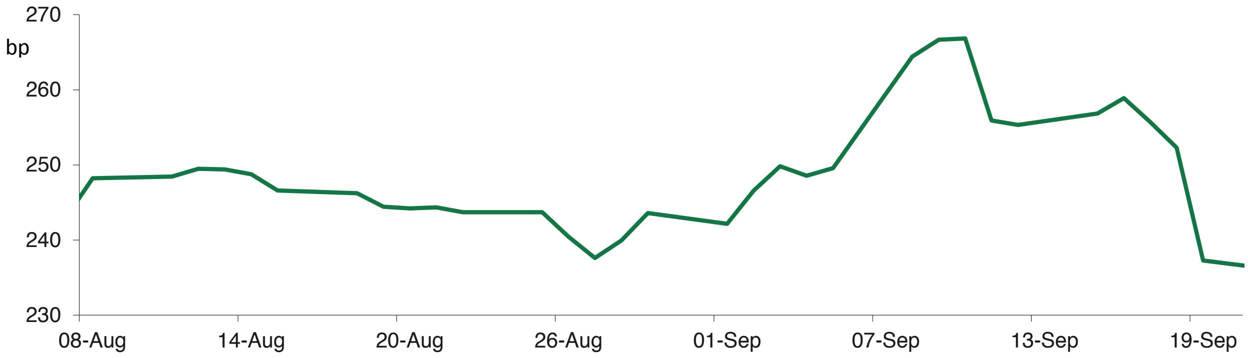
Figure 1: Credit spread of Scottish Widows during Scottish referendum (5.5% 2023)



Source: iBoxx, Markit, BarCap, LGIM

up these gains. Assuming that we don't suffer any last-minute jitters, the only conclusions that can be drawn is that market participants are comfortable that whatever the outcome of the election, the impact on the UK economy and UK businesses will be very small.

My view is a little more nuanced. I see the election result itself as relatively unimportant given the similar fiscal policies of the two main parties, and given that polling suggests that an EU membership referendum would likely result in the UK staying in. But I worry about the longer-term outlook for the UK under both parties: an economy that is over-reliant on financial services and a strong housing market, and runs a large current account deficit requiring constant capital inflows to balance the books looks vulnerable to me. Both parties are promising to close the deficit, but their track records are mixed, and we come from a pretty poor starting point.

So I think there should be more risk premium priced into UK markets today, not because the election could result in a particularly bad outcome for the UK, but because whoever is elected faces a difficult challenge in the months and years ahead.

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