

# UK Election 2017:

## Hung Parliament may weigh on UK assets

### How did markets react to the outcome of the UK election?

Despite the unexpected outcome, which resulted in a hung parliament, market reaction was relatively muted as investors expect potentially looser fiscal policy may fuel economic growth: sterling fell less than 2% versus the US dollar and the euro, while government bond yields dropped slightly. UK equities rose. The result extends the period of political uncertainty in the UK, particularly in light of the impending Brexit negotiations due to start on 19 June. This may continue to weigh on UK assets.

### What do our portfolio managers say?

#### **Michael Browne, Portfolio Manager, Martin Currie:**

*"The message from the electorate is they wish to see more spending on government services. This means the vote is a clear call for increased fiscal spending and the markets are going to have to work out how the new Chancellor (whenever he or she is announced) will pursue this. That faster spending may well be needed, as business uncertainty caused by both this election and the upcoming Brexit negotiations is already slowing Gross Domestic Product growth. In the short term, key factors will be business and consumer confidence, alongside the possibility of yet another election. The UK economy had been performing better than its low post-Brexit expectations, on the back of a strong consumer, but still well below the previous five years. Consumer spending has been softening recently under pressure from rising inflation. Inflation is peaking and any removal of the public sector wage cap would significantly lift optimism.*

*"The election result will not be supportive for business confidence, companies were already cautious, but will feel the outlook for a soft Brexit is higher. However, no one will invest in this outcome, until a final deal on Brexit is reached. International investors, already deterred by Brexit, have another reason for avoiding UK assets for the time being.*

*"With Europe powering ahead, the UK could become a quiet backwater, of less relevance to international investors, and will remain that way, until another election is called and the results are in. That has been our view for a while and will continue."*

#### **Andrew Belshaw, Head of Investments London, Western Asset:**

*"Will this lead to a softer Brexit which could include remaining inside the customs union? It may well, and the relatively muted reaction of sterling to the result may reflect that. This may not necessarily be the case as the Democratic Unionist Party is pro-Brexit and the government will be beholden to its more Eurosceptic wing to pass legislation. Given the size of the anti-austerity vote, further fiscal laxity cannot be ruled out, which should cause risk premiums to rise on gilts and other UK assets."*

#### **Jack McIntyre, Portfolio Manager, Brandywine Global:**

*"Markets are indeed averse to ambiguity, so we therefore anticipate a short-term sell-off in the pound sterling, as well as falling gilt yields. While our long-term thesis suggests better economic growth will give the Bank of England cover to tighten and eventually lift gilt yields, we do expect the central bank to maintain its current degree of accommodation at the upcoming 15 June meeting, and generally in the near term."*

#### **David Nadel, Portfolio Manager, Royce & Associates:**

*"As the negotiations over coalition forming play out, equities are likely to be volatile, especially if a short-lived minority government is followed by yet another snap general election. The wild card remains Brexit negotiations — we remain somewhat skeptical about the ease with which a graceful and positive exit can be achieved and suspect instead that the process could be iterative and, at times, painful. Yet another reason in our view to favour sustainability and quality in UK small-caps. While this was not the result Tories were anticipating when Prime Minister Theresa May called for elections, we see it as a short-term challenge that could create several positive long-term opportunities for quality-centric small-cap investors such as ourselves."*

#### **David Maywald, Portfolio Manager, RARE Infrastructure:**

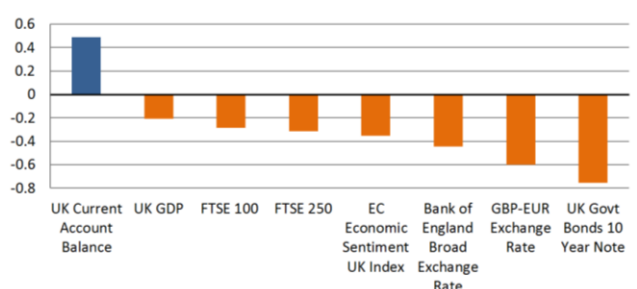
*"This election outcome is likely to be somewhat negative for UK infrastructure assets, with slightly higher regulatory uncertainty and a greater focus on consumer bills for water and energy. More political discussion has been provided on re-nationalisation, with widespread under-appreciation of the benefits that have flowed from private ownership, including higher quality, significant investment and much higher efficiency compared to public ownership."*

### What does this mean for UK assets?

Given the widespread rejection of austerity, further fiscal laxity cannot be ruled out, potentially leading to an increase in the UK budget deficit. Analysis by Legg Mason reveals that historically, rising budget deficits have been negative for UK assets broadly.

**The chart shows** how a rising budget deficit is negatively correlated to economic growth, domestic equities, sterling, bonds and economic sentiment.

Chart 1: UK Budget leading correlations



Source: Bloomberg as of 07.06.2017

### What could investors do?

Given the political uncertainty in Britain, a global and active approach could help UK investors mitigate risks and profit from the ongoing global reflationary story. According to the [Legg Mason 2017 Global Investment Survey](#), UK investors are still domestically focussed in their portfolio allocations with 24% of respondents saying domestic stocks offer the best opportunities over the next 12 months. Learn more about where [Western Asset](#) and [Brandywine Global](#) find attractive fixed income opportunities

around the world. If you are interested in unconstrained fixed income investment, read the weekly [Mid-Week Bond Update: Emerging Markets: sugar highs](#). For more information about the benefits of infrastructure investing, please read [RARE Insights: Understanding Infrastructure](#). If you are interested in global smaller capitalisation stocks, see [Are Small Cap Earnings in Trouble? by Royce & Associates' co-Chief Investment Officer, Francis Gannon](#).

**Further reading:**  
[The Reports of U.K. Economic Demise Appear to Have Been Greatly Exaggerated](#)  
*Brandywine Global, Around the Curve, 07 June 2017*

[Market & Strategy Update](#)  
*Western Asset, Ken Leech, CIO, 04 June 2017*

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