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CIO Outlook - Q3 2024

Elections and Interest Rates

From Dr Dan Appleby, CIO (Listed Investments)

A lot can happen in a quarter. Only three months ago, inflation and interest rates were dominating headlines in the UK. And while these key macroeconomic data are still important for markets, something I'll touch on at the end of this post, we now know the General Election will be held on 4th July. So for the coming quarter, politics will likely shape market narrative.

There are many instances of politics moving markets – quite considerably at times – as we have experienced in the past. For example, UK small caps rallied over 2% the day after the Conservatives secured a significant majority government in December 2019. Hence, a review of what's to come in the UK political world and our stock markets is pertinent for this quarterly outlook given the election is only days away as I write.

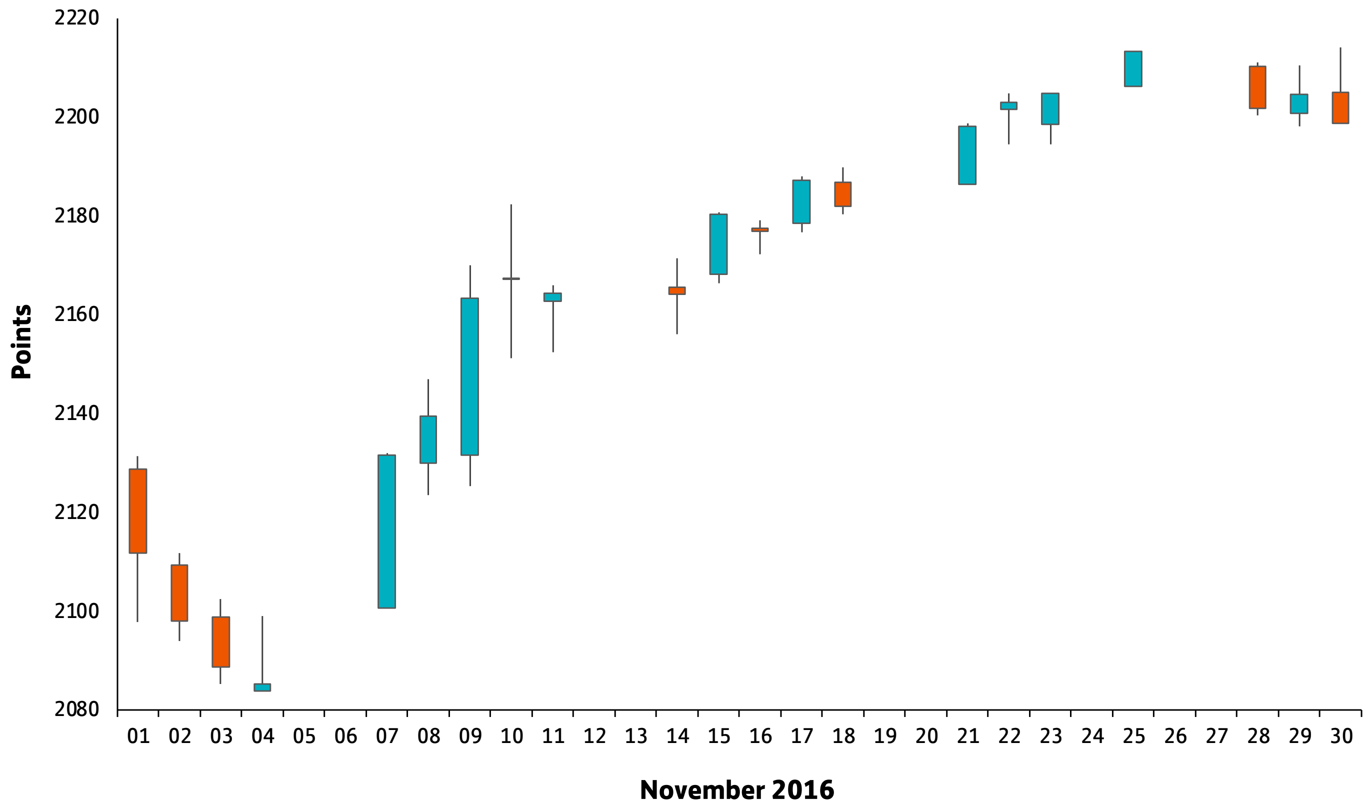
Yet we still cannot forget about interest rates. If anything, I view the future path of the Bank of England's base rate as more influential for markets longer term. At least after we find out who will reside in Number 10 for the next five years.

Elections and Stock Market Volatility

Before we address the UK's general election, a quick recap of a tumultuous presidential election in the States comes to mind. Back in 2016, not many people expected Trump to win the presidency. Indeed, polls had Hilary Clinton winning the Electoral College by a comfortable margin.

In the below chart, we can see how the US stock market responded to various political headlines approaching the vote on 8th November.

Figure 1: The S&P 500 through the month of November 2016 during the election when Trump became president.



Source: Bloomberg, Blackfinch Asset Management

Early in the month, the market fell around 2%. Headlines at the time were as follows:

- Clinton Win Could Send S&P 500 Back Toward 2150
- Trump Victory Could Lead to 5-10% Drop in European Stocks
- Clinton Victory Would Spark Relief Rally in Stocks
- Trump Victory Could Trigger 3-5% S&P 500 Selloff

Sources are derived from a variety of banks and analysts. But it is clear which way the narrative was headed; Trump would be bad for stocks, and a Clinton win would reverse the early November fall. We now know Trump did win the election, and the chart above shows the market rallied anyway. However, the chart masks what was a significant fall in the S&P 500 after the market closed on the 8th, as the election result started to become clear. For this, we need to look at the S&P 500 futures contract, which continues to trade once the spot market closes at 9:30 PM UK time. In the early morning of the 9th, Trump's election win was declared.

The S&P 500, as measured by its futures contract, fell by more than 5% from the previous close to its low that night. At the time, the volatility triggered the Chicago Mercantile Exchange to halt trading. This volatility was shared across world markets, with a headline at the time stating, "S&P 500 futures 'limit down' in global rout'.

Clearly, stock markets were not keen on President Trump – that is, for a few hours after the shock victory was announced. As soon as the market opened on the 9th, stocks rallied significantly. Suddenly, Trump was viewed as business-friendly. A slew of stimulus to come, from corporate tax cuts to deregulation, helped stocks hit all-time highs.

What can we take from this experience? First, that stock markets can be fickle over short periods, and news headlines can turn on a dime to match intraday market pricing.

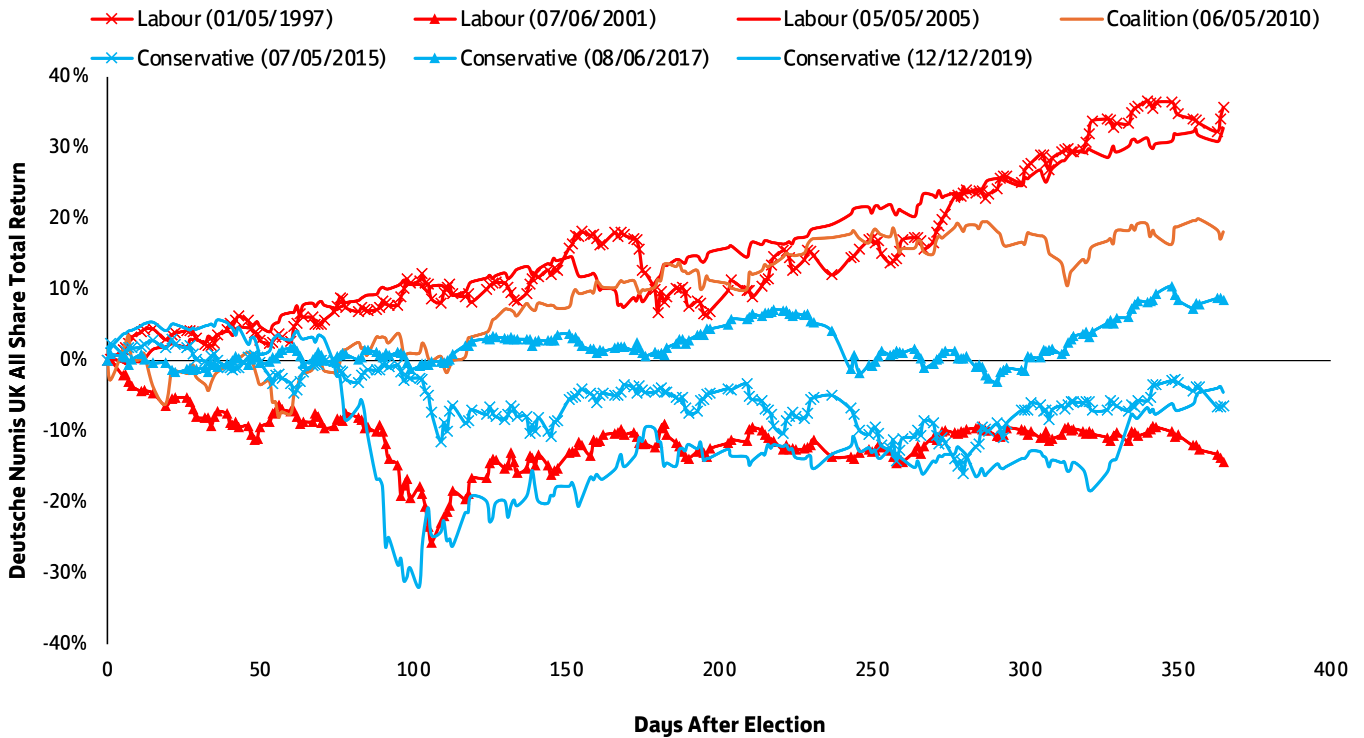
Perhaps we will see similar short-term swings as the UK election unfolds, just not to the extremes of the 2016 presidential election. But as we saw from the US stock market, any volatility likely won't matter over the long term.

Past UK General Elections and their Impacts on the UK Stock Market

Now to turn attention to the past seven UK General Elections and how they impacted the stock market. These elections were split evenly into three Labour wins, three wins for the Conservatives, and one coalition government.

Does the incoming political party matter when it comes to stock market returns? To help answer this, I used the Deutsche Numis UK All Share index as a measure of the UK stock market, and calculated the return over the following 12 months, starting from the day the election victory was declared. Figure 2 shows the results.

Figure 2: The performance of the Deutsche Numis UK All Share Index for the following 12 months after the previous seven elections. The date in brackets marks the start of the performance period as the day the election winner was announced.



Source: Deutsche Numis, Blackfinch Asset Management

Before discussing the chart, broad-brush analysis might consider a right-leaning Conservative government as more favourable for markets. As above, when the Republican-led Trump won the US presidency in 2016, the stock market eventually acknowledged his pro-business agenda and rallied accordingly. On the other hand, a left-leaning Labour government may instead focus on welfare and social initiatives at the expense of business.

It is a near-certainty that the next UK government will be run by Labour, at least according to the polls. Therefore, it provides some comfort for investors that the two highest-returning 12-month periods following an election came under a Labour government – specifically from May 1997 and May 2005. Conversely, a potentially market-friendly Conservative government resulted in two negative returning periods, from May 2015 and December 2019.

As such, it appears that broad-brush political analysis isn't sufficient to explain market reactions.

Expanding on 1997 as an example, given it shows as the highest 12-month return, Labour, under Tony Blair, won by a landslide, in turn bringing a sense of political stability. In addition, Blair's 'New Labour' and centrist approach to politics came with expectations of pro-business policies. One key element of this was granting the Bank of England (BoE) independence to set interest rates without political interference from government. Other pro-business policies included maintaining fiscal discipline by committing to the previous Conservative government's spending plans, and cutting corporate tax rates.

These policies sound familiar, and not just from the US election back in 2016. Keir Starmer is attempting to 'woo business', according to headlines, as he commits to keeping corporation tax where it is, while Labour's manifesto promises business certainty.

Alongside Labour's victory in 1997, the late 1990s saw generally strong global economic growth, low inflation, and rapid technological advancements stemming from the rise of the internet. This positive backdrop was also supportive for stock market performance.

Now to an example of underperformance. Earlier I alluded to the positive market reaction to the Conservative win in December 2019. We can see in the chart that the first 50 days or so post this election saw the market outperform all other examples provided. However, the UK stock market then crashed over 30%, because three months after the election, the pandemic unfolded.

I think it's a fair assumption that the market would have crashed regardless of the incumbent government. In a similar way, the market response after Labour's victory in June 2001 was marked by significant underperformance. This was amid the bursting of the dotcom bubble, so again I attribute this to market forces beyond the control of the sitting political party.

Although this was a useful exercise, I cannot conclude either way as to which party is better for stock markets. There are enough clues to suggest a party elected on pro-business policies will help (Labour in 1997 and Trump in 2016). However, the underlying economic backdrop should prevail over any political influence over longer periods.

And with that, we should review the now-independent BoE's interest rate expectations.

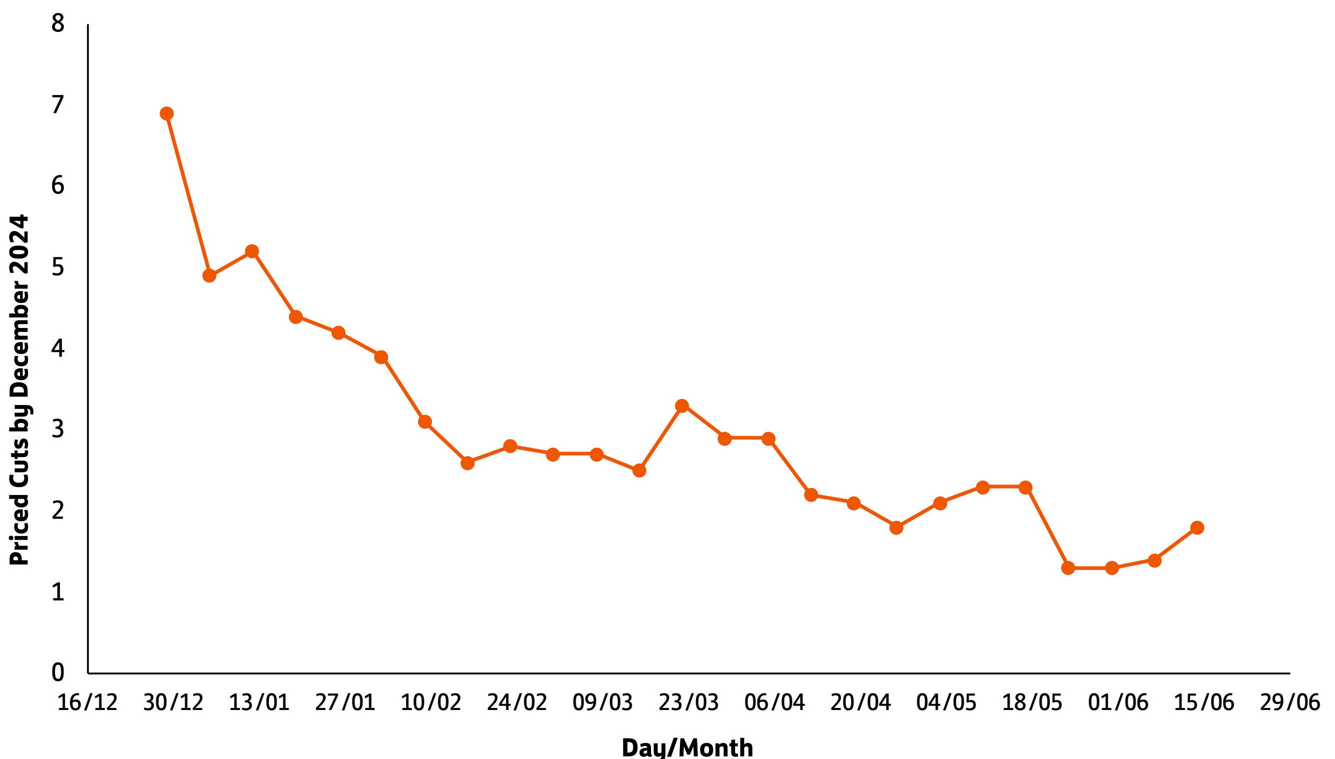
Interest Rate Expectations for the Bank of England

Markets got excited at the turn of the year on the prospect of central bank interest rate cuts. Indeed, it now looks like the bear market in UK smaller companies ended on 27th October, after what had been an over two-year collapse in share prices. Since this low, the Alternative Investment Market (AIM) is up over 15%.

Why the excitement? Predominantly falling inflation, and subsequently central banks signalling they want to start cutting interest rates. Very simply, falling interest rates reduce the opportunity cost of holding riskier equities over cash, and companies would be subject to lower cost of capital should rates fall.

We can see that market pricing suggested the BoE would cut rates seven times by December 2024 at the start of the year (Figure 3, below). However, a series of stickier core inflation prints led by services, and more cautious central bank communication throughout the first half of the year, has resulted in market pricing reducing expectations to now only two cuts by December.

Figure 3: Derivatives market pricing of expectations for Bank of England base rate cuts by December 2024.



Source: Bloomberg, Blackfinch Asset Management

Notwithstanding the reduced expectations for interest rate cuts above, there are still two being priced by markets before the year ends. And, at the BoE's June meeting, it left the door open to begin cutting rates as early as August.

The UK stock market has already performed well on the prospect of rate cuts, even after the number of expected cuts fell in the first half of the year. Hence, when rates do begin to fall, I expect the market to continue its upward climb from what has been a long and painful bear market.

So, whoever gets into Number 10 may end up taking credit for a market rally that perhaps the central bankers have had more influence over. Such is politics.

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