State of Play

Resignation may signal change

14 July 2022

After several of his senior cabinet members called for him to step down, Prime Minister Boris Johnson eventually bowed to pressure and resigned as leader of the Conservative Party and UK Prime Minister. With the election of a new leader over the next few weeks, are investors factoring in a change in UK economic strategy? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Should politics matter to investors?

Arguably, for the most part, investing is about how to build an appropriate portfolio and in the decisions that follow, assessing which asset classes, sectors or even which individual companies appear attractive with encouraging prospects. Rarely would an investor think about the political environment except when there is great uncertainty. However, economic progress, wherever in the world you may be focused on, relies on two fundamental pillars in my humble opinion, monetary policy and fiscal policy. So, what are these and how do they work?

Monetary policy

For the most part, central banks over the years have taken on much of the responsibility for monetary policy. This role involves maintaining the money supply, setting interest rates, bank reserve requirements, and the purchase and sale of government securities and foreign exchange to ensure financial stability and, importantly, liquidity.[1] When the financial crisis developed in 2008 central

banks played a key role by slashing interest rates and starting quantitative easing (QE).[2] Central banks created or 'printed' new money and used this to buy debt from retail and commercial banks, so bank balance sheets were repaired, and in the long-term were able to begin lending to individuals and businesses again.[2] Although it took many years for economies to recover, what followed was the longest 'bull' market in history.[2]

What is the key role of central banks?

It is explained by the International Monetary Fund (IMF)[1] as the following:

'Central banks play a crucial role in ensuring economic and financial stability. They conduct monetary policy to achieve low and stable inflation. In the wake of the global financial crisis, central banks have expanded their toolkits to deal with risks to financial stability and to manage volatile exchange rates. In response to the COVID-19 pandemic, central banks used an array of conventional and unconventional tools to ease monetary policy, support liquidity in key financial markets and maintain the flow of credit. Central banks need clear policy frameworks to achieve their objectives. Operational processes tailored to each country's circumstances enhance the effectiveness of the central banks' policies.'

Investors looking for better returns embraced more investment risk because cash and bonds offered very low investment returns which motivated more investors to buy shares.[2] Also, in a very low interest rate environment start up and growth businesses thrived as they were able to access borrowing more easily and at very low borrowing costs.[2] I would argue that such a loose financial environment shifted the emphasis from government policy to central banks. As we approach normalisation of monetary policy, where interest rates will rise closer to their historic average and QE is reversed through quantitative tightening (when money created previously is allowed to mature and not replaced), the shift in responsibility to tackle rising prices and stimulate economic activity will move back to government policy.

Fiscal policy

Fiscal policy is essentially the policies put in place by central governments on how much we are taxed and then how they spend this tax revenue on public services. Depending on the stage in the economic cycle, this often influences the key decisions that are made as treasury departments attempt to calculate whether to curb spending and tighten the national purse strings or whether to loosen them.[1] Fiscal policy that increases demand through an increase in government spending is typically known as 'loose' or expansionary. By contrast, fiscal policy is often considered 'tight' or contractionary if it lowers spending to try and cool demand.

After the financial crisis, many governments working in partnership with central banks increased the size of their national debt to try and stimulate their respective economies. Government debt in developed economies rose

dramatically according to the IMF who said: 'Debt increases are particularly striking in advanced economies, where public debt rose from around 70% of GDP [Gross Domestic Product], in 2007, to 124% of GDP, in 2020.' The global pandemic emerged just as many governments and central banks had begun a programme of normalising financial policy.[3] To protect liquidity, jobs and to enable individuals to stay at home during lockdowns and restrictions, governments extended their borrowing still further.[3] We are now at a stage where the path for UK government policy is uncertain, and the route forward will be defined by the new Prime Minister.

What happens next?

The Conservative Party needs to elect a new leader over the coming weeks, who will, by virtue of holding the position, become our new Prime Minister. The party will follow a well-defined process summarised in their latest rules documen[4]:

'The leader of the Party must be a sitting MP. Conservative Party leadership elections consist of two stages:

- Stage 1 – Conservative MPs choose two candidates to put forward to stage two.
- Stage 2 – Party members are balloted. The candidate with the most votes wins.

A leadership contest will occur if a sitting leader resigns or if they lose a vote of no confidence of MPs.'

The committee of backbench MPs, called the 1922 Committee, oversee the leadership election. At the time of writing the UK Government are about to conduct the second ballot and further ballots until the final two candidates are chosen.[5] These two will debate at hustings over the summer recess and then Conservative Party members will vote with the announcement of their new leader expected on 5 September when MPs return from the summer recess starting on 21 July.[5]

Why does a change in leader matter to investors?

Some investors who dislike or try to avoid politics, may conclude that they have limited interest in who might be the new Conservative Party leader and UK Prime Minister. However, given the current economic uncertainties with sustained high inflation, slowing economic growth and rising interest rates, whoever is elected will face a very challenging workload. Central banks have committed to bringing inflation back down to the target of 2% over time, regardless of the potential economic shocks this may induce.[6] They need to cool the economy to bring down price rises without tipping it into a recession. Whilst this task may seem challenging, it is crucial, therefore any decisions on fiscal policy to help achieve the long-term goals of stable prices and gradual stable economic growth and prosperity will be essential.

Depending on the views and opinions of the newly elected Prime Minister, they may choose to take a pro-active stance on helping people struggling with the

cost-of-living crisis by introducing tax cuts and financial support, even if this may feed into price rises remaining higher for longer.

Why is this important to investors? If a change in fiscal policy leads to greater pressure on monetary policy managed by the Bank of England, it may seek to tackle rising prices by increasing interest rates further in the future which would affect every asset class (not unlike what we have witnessed so far this year). Higher expected rates lead to higher bond yields and further repricing of shares. Higher borrowing costs and pressure on margins lowers future expected earnings and profits, bringing down share valuations with it. If they seek a similar path of austerity used by David Cameron's Government back in 2010, then higher taxes, lower government spending and financial fiscal tightening, may lead to a likely economic slowdown or recession. Investors will watch on with great interest over the next few weeks to assess what to expect when the 77th Prime Minister is elected.[7]

Market update

Apart from China, most stock markets have grinded higher this last week or so, recovering from a difficult June.[8] However, at the time of writing, investment markets remain incredibly nervous, especially following the new inflation data from the US as rising prices remain persistently high.[9] Bonds have also seen yields tail off within the last couple of weeks, as market participants reassess the economic slowdown and the potential change of reaction from central banks, not so much this year, but certainly next year and beyond.[8] Most bond indices have seen a small recovery in values as yields have fallen back from recent highs, apart from UK and Euro high yield.[8] Later this month is the next crucial Federal Reserve meeting where they are expected to increase the base rate yet again by a minimum of 0.5%, but more likely 0.75%, with some market commentators even talking about a possible 1% rise. This is set to be quickly followed in the first week of August by the next Monetary Policy Committee meeting at the Bank of England to agree the next rate rise.

They are under increasing pressure to be more aggressive with the next rate rise, as UK inflation has yet to peak and UK pound sterling has seen a significant fall in value versus the dollar, down over 13% in the last year.[9] Future inflation pressure will not be eased with the latest assessment from Cornwall Insight predicting a 64% increase in the UK energy cap in October, taking average household bills to a whopping £3,244 - over £2,000 higher than a year ago.[10] Whoever is elected over the next few weeks to be the new UK Prime Minister will face a tough balancing act to navigate the UK's return to lower inflation and more stable economic times.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

Note: Data as at 12 July 2022.

[1] International Monetary Fund (IMF), 24 February 2020 and 3 March 2022
[2] Forbes, 24 February 2022
[3] Financial Times, 10 July 2022
[4] UK Parliament, 13 July 2022
[5] BBC News, 13 July 2022
[6] Yahoo Finance, 16 June 2022
[7] UK Government, 11 July 2022
[8] FE Analytics, 11 July 2022
[9] Investing.com, 11 and 14 July 2022
[10] Cornwall Insight, 8 July 2022

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