Smooth Starmer or Hard Labour?

Yona Chesner, Regional Head of Investment at Cartwright (North), comments on the impact the new government could have on the financial markets.

It's been almost two weeks since the historic election results came in. Labour holding its biggest majority in a generation at 412 seats, while the Torys have been demolished to just 121. Much has, and will continue to, be written about the types of policies that Labour will be pressing for, but I want to focus on the election's impact so far, and potential future impact on financial markets.

So, what should a UK DB Pension Scheme investor be thinking about following these results?

Markets' immediate reaction

Let's start with the immediate impact of the results. Recall that, on the results of some historic elections (Brexit, I'm looking at you), there were instant and significant impacts on financial markets. In particular, both currency markets and UK gilt yields.

However, in our case, neither of these markets appear to have reacted significantly. As I write this article, sterling stands at 1.30 vs. the US dollar and 1.19 vs. the Euro. Both are above where we stood in the days, even months, running up to the election, but only by 1-2% and neither reacted suddenly or significantly to the historic results. Gilt yields have similarly reacted positively but subtly with longer dated yields about 0.1% lower than running up to the election.

This fairly benign reaction to a huge change in parliamentary calculus can be seen as due to the widely anticipated nature of the results, but also potentially to the incoming government's fairly centrist messaging on fiscal policy. In many ways it looks like a case of 'out with the old, in with the old'.

Focusing on equity market's reaction is always tricky given the preponderance of foreign stocks within the FTSE, however the story here was similar. As I write this the FTSE 100 stands at 8,145, almost exactly where it was on the eve of election day.

Labour's challenge

A key question that remains to be answered is whether this huge Labour majority will embolden Keir Starmer to govern from the largely centrist position that he campaigned under, or will it strengthen the more left-wing parts of his party to demand a more significant change in approach? The answer to this question may have significant impacts on markets over the coming year or so. Early signs from the King's speech suggest a restrained agenda, particularly the "fiscal lock" proposal that would restrain the government's fiscal wiggle-room. More significant information on fiscal policy can be expected at the budget, presumed to be in October or November.

Labour inherits a difficult economic environment – very different from the one it inherited when it came to power in 1997. Government borrowing as a percentage of GDP is close to the highest it has been in two generations, while continuing to run both a high budget and current account deficit. At the same time, we have been in an extended period of zero or close to zero economic growth stretching back four years. And, following the inflationary spike of the past two years, combined with higher interest rates, household disposable income is the lowest it has been since the 60s.

Due at least in part to these factors, Labour campaigned on a very restrained agenda. Its promise to 'not raise taxes on working people', but also no suggestion (so far) of raising corporation tax and a promise not to raise VAT (except in its commitment on VAT for private school fees). While there is some room for increased taxes (anyone remember the 'investment income surcharge' of the 70s?), certainly Labour has boxed itself in, at least to some degree.

Pensions questions

On the pensions front, so far Labour's comments don't differ too significantly to what was the previous Tory governments agenda. However, coming at things from a different philosophical perspective may lead to some changes.

The inclusion of a new Pension Schemes Bill in the first King's Speech shows positive signs that the Government is keeping pensions issues high on the agenda. Key measures included were the requirement for schemes to offer decumulation solutions as well as the creation of DB superfunds. Somewhat surprisingly, there was no mention of a public sector consolidator as yet. Whether this was a permanent omission or merely awaiting finer detail before announcement remains to be seen.

Portfolio implications

From an investment perspective, our view is to put in place long-term strategies that are able to weather a broad range of economic circumstances. Once again, the two markets most likely to be impacted by UK-centric issues are UK bonds: government and corporate as well as currency. Investors would be well advised to ensure that they have considered exposures to both of these areas and stress test them for a range of potential shocks. Hopefully the lessons of 2022's gilt crisis are well learned. And pension scheme investors, have well stress-tested any exposures to leveraged gilts as well as having clear plans in place to deal with any significant volatility should it arise.

With regards to equity markets, the fact that most investors have moved to far more globally diversified portfolios in recent years means that impacts on UK equity markets in particular are likely to have less effect on client portfolios. Watch out for the US election results in November for possibly a more significant impact. While that race is fairly strongly predicted to go Republican, there is plenty of time for a surprise to still be in the making. Equity investors with shrinking time-horizons may well want to consider a structured approach to their holdings that brings with it the benefit of limiting downside while capturing the upside required.

For trustees of smaller UK DB pension schemes in particular, reassessing your end-game planning is advisable. For those on the cusp of transfer to insurance there is unlikely to be any rationale to change course. However, for those a little further off, it is worth bearing in mind that the landscape of options may well be changing in the coming two to three years.

Labour are also more committed to greener energy than the last government, which will come with the need to attract private sector investment. This may well mean they have their eye on pension scheme assets but could also come with potential opportunities. However, while the UK green commitment ramps up, it is quite possible that a Republican victory in the US would lead to a ramp down on the other side of the Atlantic. Having a considered approach to ESG, and transition investing in particular, can help ensure that investors are optimally positioned to benefit from opportunities as they arrive.

Key takeaways

In short, the market's fairly benign reaction to a change in government is comforting. While we will certainly see the new government change approach on a multitude of fronts, the centrist rhetoric we have seen so far means that more extreme outcomes are somewhat less likely.

Bear in mind that, across the globe, we still have many elections to come this year. In particular, the aforementioned US election in November will be one to watch.

Schemes should always ensure that their strategy is tailored to their specific objectives and risk tolerances and not be tempted by portfolios that have been designed for 'generic' investors. Those with significant equity holdings should consider their time horizons and objectives.

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