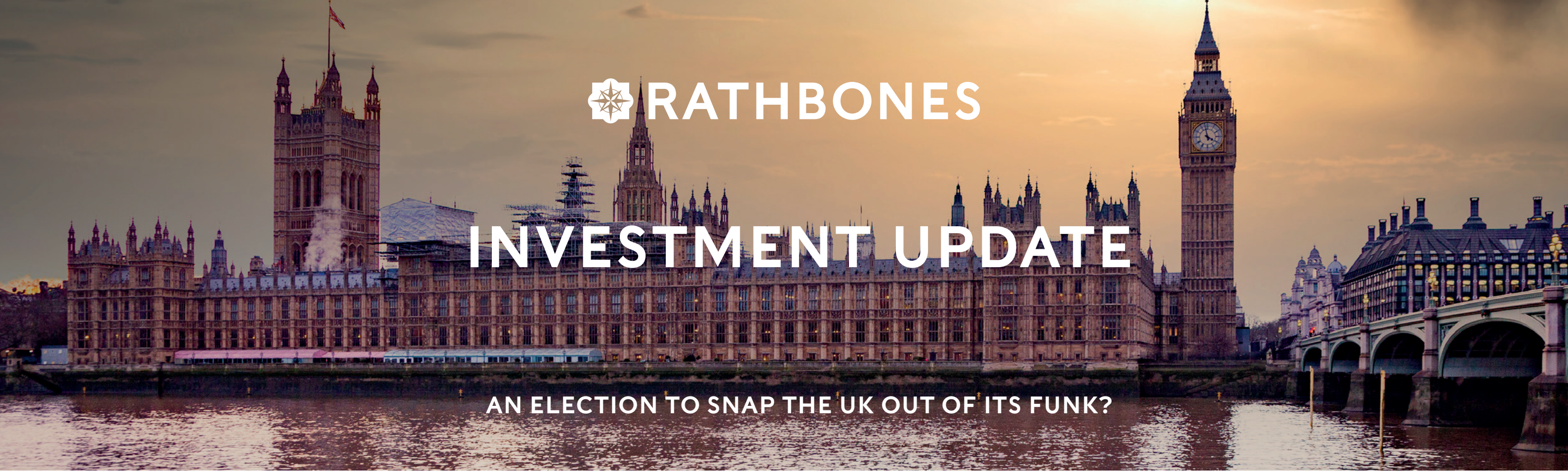


RATHBONES

INVESTMENT UPDATE

AN ELECTION TO SNAP THE UK OUT OF ITS FUNK?

The government has called a snap election with just six weeks' notice and has raced into campaign mode, yet all signs point to a Labour victory. We offer four reasons why investors need not fear the result.

With Prime Minister Rishi Sunak having announced a general election for Thursday 4 July, the Conservative Party has a mountain to climb to avoid a heavy defeat. Labour has a large lead in the polls (around 20 percentage points) that has been sustained for more than a year and a half. The polls can of course be wrong, or shift – but usually only by so much. It would take a historic swing in such a short time to make a big difference to the outcome.

It isn't just the headline polls suggesting that the Conservatives face an uphill battle either. The public rate Labour better than the Conservatives on all three of the issues they care most about: the economy, the NHS and now even immigration. Sunak is personally unpopular too, in contrast to the start of his premiership. His net approval rating is now close to that of predecessor Liz Truss at the end of her ill-fated time in Number 10, and far behind that of Labour leader Keir Starmer. Hundreds of Conservative councillors lost their seats in the local elections of early May, while several recent by-elections produced swings to Labour of well above 20pp.

In other words, the chance of a change in the political landscape, after 14 years of Conservative rule, is high. Bookmakers are offering odds as long as 33/1 on a Conservative majority after the election. It's natural to worry about how possible regime change in Westminster may affect our investments, but we see four reasons for comfort.

1. No dramatic short-term change in fiscal policy on the cards

Shadow Chancellor Rachel Reeves has taken a leaf out of the Blair/Brown 1997 playbook in mirroring a lot of existing economic policy. She has pledged not to raise the most significant taxes – income tax, national insurance, capital gains tax and corporation tax. And she has committed to follow a set of fiscal rules virtually identical to the current ones (as well as showing her commitment to those rules by ditching previous pledges which don't comply with them – more on this later).

This cautious strategy means that the election is not likely to alter the short-term path of the economy much, or to upset the UK government-bond market. Labour's clearest points of difference on fiscal policy are arguably its plan to charge VAT on private school fees and to stop 'carried interest' (a share of profits earned by general partners of private equity, venture capital, and hedge funds) being considered 'capital' and therefore attracting the lower capital gains tax rates rather than the higher income tax rates. While significant for those affected, they won't move the needle for the economy. We'd expect GDP to continue its recovery from the shallow recession of last year.

Admittedly, *whichever* party wins the next election will eventually have to confront the so-called 'fiscal fiction' which underlies current spending plans. This is the assumption that there will be significant spending restraint in key departments (figure 1), which are likely to prove politically impossible. Areas including local government, justice and the Home Office theoretically face very large cuts to spending per person.

Something will have to give, regardless of who is in power. Given both main parties' pledges not to raise key taxes, the path of least resistance would be to change the fiscal rules which these plans are designed to meet. Current tax pledges may of course come under pressure in time too. (We wouldn't be surprised to see Reeves eventually revisit capital gains tax in particular – she has mentioned several times that she is reading *Follow the Money* by Paul Johnson, the head of the Institute for Fiscal Studies, which advocates reform here.)

But the implausibility of current spending plans isn't a Labour-specific issue, and neither would an eventual change to those plans or to the fiscal rules necessarily be a bad thing. It's worth remembering that the rules change remarkably often – there have been nine alternative versions since 1997.

The current set (and its predecessors) are far from perfect in any case, arguably encouraging politicians to cut worthwhile investments in projects with long-term pay offs, exemplified by the experience of the Cameron/Osborne austerity years. Think-tanks like the Resolution Foundation have published proposals for alternatives which would maintain discipline while allowing more space for the productive investment the UK needs.

The value of investments and the income generated by them can go down as well as up.

2. Labour has dropped the radicalism of Corbyn era

The last general election in 2019 offered voters two radically different economic visions: Boris Johnson's pledge to 'Get Brexit Done' against Jeremy Corbyn's socialist agenda. But the Labour Party has transformed since then, leaving most of the Corbyn policy platform behind, emphasising (in the words of Reeves) "partnership with business" and courting the City. There are some key differences between the two parties' economic policy platforms today, but these are much smaller than they were in 2019.

Gone is Labour's commitment to nationalisation as an end in itself. The party does plan to renationalise virtually all passenger rail services within five years, as existing contracts with private operators expire. Yet things have been moving in this direction by stealth anyway. The current government has already taken over several major rail franchises, including Southeastern, LNER, ScotRail and TransPennine, under its 'operator of last resort' regime. (Waiting for existing franchises to expire also minimises penalties from breaking contracts.) Labour also plans to establish a publicly owned company to invest in green energy, such as floating offshore wind. But these moves are well short of wholesale nationalisation.

What about the rest of Labour's agenda? One key point of difference with the Conservatives is Labour deputy leader Angela Rayner's proposed 'new deal' for working people. This would restrict (but not, as initially suggested, ban outright) 'zero hours' contracts, scrap qualifying periods for basic employment rights like sick pay and parental leave, and remove some restrictions on unions imposed since 2010. Again, though, these proposals are not radical. They would not change the fact that the UK has a very flexible labour market by international standards.

Another key difference is Labour's greater commitment to industrial policy and support for public investment. This focus reflects what has already become the norm in other major economies, so once again this is by no means radical. Since the pandemic, the US, EU and others including Japan and South Korea have launched some of the biggest industrial policy projects in decades (figure 2). Shadow Chancellor Reeves is on record as an admirer of the Biden administration's policy, which has earmarked trillions of dollars for investment in green energy, strategic sectors like semiconductors, and infrastructure.

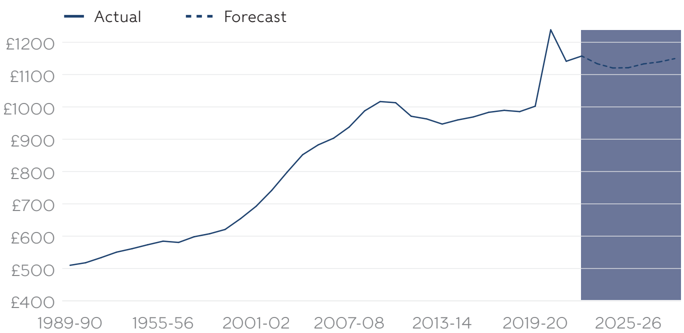
How much difference these policies might make will depend on two things: how they're implemented and how much money is behind them. On the first point, Reeves has talked extensively about the need for a "modern industrial policy" which matches the reality of what our competitors are doing – one which targets areas where the UK has a competitive advantage and works with the private sector rather than simply picking winners.

Though we know little of the detail so far, those are sensible goals. However, on the second point, Labour has ditched its pledge to commit £28 billion a year to green investment under its Green Prosperity Plan, sacrificing the spending on the altar of the fiscal rules. Overall, it's possible that we'll see some positive change given the lack of any meaningful industrial strategy at present. But equally it looks highly unlikely that we'll get a true equivalent of the US Inflation Reduction Act and CHIPS Act, or the EU's NextGenEU agenda. Far less fiscal firepower is likely to be committed here in the UK.

3. New government may have political capital for much-needed reform

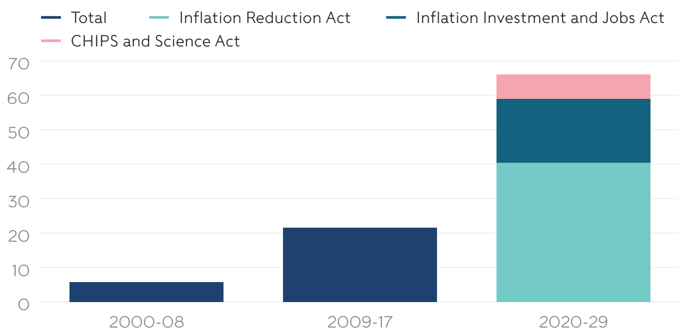
Reflecting the long-running poor performance of the UK economy, there are a few key areas which *both* main parties have identified as ripe for change, but where the current government has failed to muster the political capital to pass any significant reform. A new government with a fresh mandate could make a positive difference.

Figure 1: Total managed government expenditure forecast to fall sharply (£ billions, adjusted for inflation)



Source: OBR, Rathbones

Figure 2: US government spending on climate change has ramped up ($ billions, annual average)



Source: The Economist, Credit Suisse

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The context behind all of this is the weakness of productivity growth in the UK since the global financial crisis in particular, which in turn is linked to the long-term dearth of investment. (figure 3). Many of the specific problems policymakers worry most about – from regional inequality to the state of the health service – are ultimately connected to insufficient investment.

An important barrier to investment that both parties have identified is the UK's unusual planning system. Our system is discretion-based, whereas virtually every other advanced economy relies more on zoning and rules. The discretion-based system is slow and unpredictable, which discourages development and makes building much-needed infrastructure harder. Infrastructure projects here face much high costs than in most other advanced economies, in part because of planning-related delays and legal challenges. London's CrossRail, for example, cost 10 times as much per mile as Madrid's metro system. The spiralling costs of HS2 are notorious, and the project has been the defendant in 45 separate legal cases since 2018.

The current government has earmarked planning as an area where reform is needed. But it hasn't managed to muster the political support to pass any substantive change. This would be an appealing area for a new government with a fresh mandate to address, particularly as it can be done without the need for large spending commitments. (To quote Reeves, "This Labour Party will put planning reform at the very centre of our economic and political argument.") There are likely to be legal changes to speed up infrastructure building, introducing a more standardised approach to what is and isn't allowed. More planners will be hired to reduce backlogs and delays too. So-called 'grey belt' land may also be targeted for development – things like car parks and wasteland which are currently part of the green belt.

Another problem area for investment is the financial system, and how investment flows from it to UK companies. Domestic pension funds' investment in UK equities has been in long-term decline. They own little of the market now, as they've shifted into bonds and overseas equities (figure 3). Chancellor Jeremy Hunt has proposed a package of measures to address this, his so-called Mansion House reforms, and Labour has endorsed an almost identical set of proposals. Under the next government, whether it's Labour or Conservative, we're likely to see a few changes. Smaller pension schemes will be encouraged to consolidate, and new vehicles will be created to encourage them to invest in smaller UK companies. There will probably be more disclosure requirements around investment in UK equities, and encouragement – although not explicit requirements – to invest in UK assets. At the margin, these changes should be positive for investment in the UK.

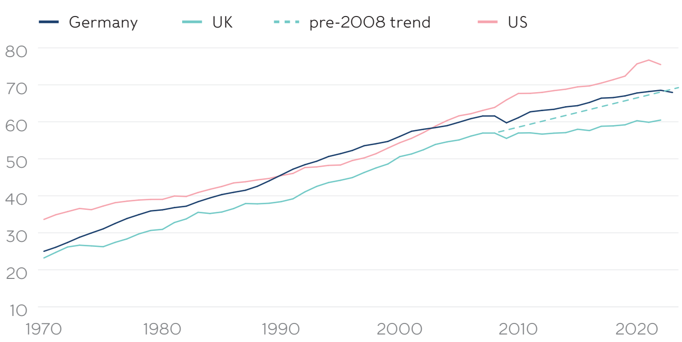
4. Investors have set the bar for success low

UK assets currently appear cheap compared to their underlying financials and growth prospects on a variety of different measures. As we noted in our investment update *The non-patriotic case for UK equities* earlier this year, international investors fell out of love with them in the unstable period which followed the 2016 Brexit vote. We've shown that it wasn't until then that the gap between the valuations of stocks in the UK and elsewhere (particularly the US) emerged (figure 5).

We've also demonstrated that the gap is much larger than can be explained by the relative profit growth and 'quality' characteristics of UK firms, or by the spread of industries that make up the UK market. Bank of America's widely followed survey of global fund managers clearly shows the deterioration in sentiment towards UK stocks in the second half of the 2010s, which has lingered since. The story is similar when we analyse the currency – sterling trades well below measures of its 'fair value' based on economic fundamentals.

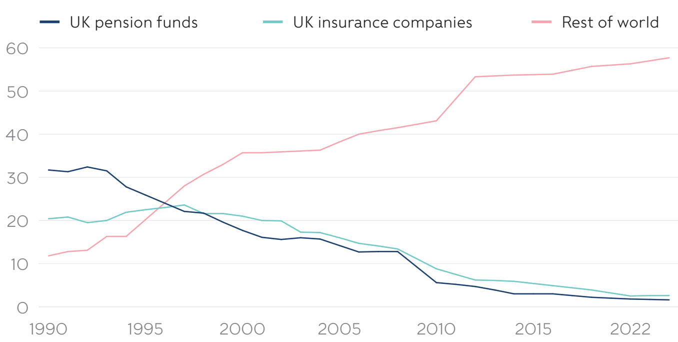
This offers cause for optimism. Some of the potential reasons for international investors' antipathy towards UK assets may be changing. If they disliked the years of domestic political

Figure 3: GDP per hour worked (*in dollars per hour, converted to constant 2015 prices)



Source: OECD, Rathbones

Figure 4: UK equity market ownership shares (%)



Source: ONS, Rathbones

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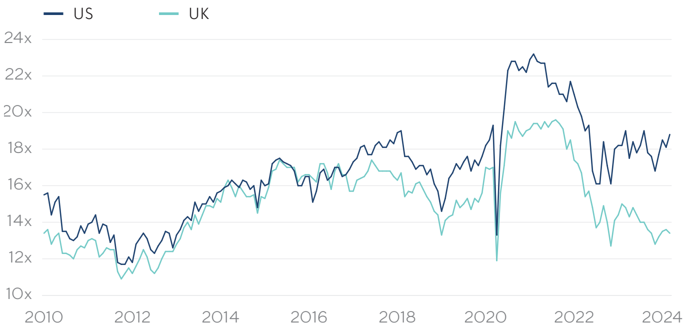
instability – characterised by a succession of prime ministers and a lack of policy space to address structural issues – they may change their minds if the election results in a new government with a reasonable majority. And if they disliked the pervasive uncertainty around the UK's relationship with the EU, there's some potential comfort there too. Labour favours a slightly more collaborative relationship with the EU, including more co-operation on security and trade, while accepting the fundamentals of the post-Brexit settlement. Stability alone might be an improvement on the political and economic turmoil that has existed since 2016. Investors have set the bar for success for the next administration low.

An end to uncertainty?

So while the snap election has quickened pulses and sent Westminster aflutter, it may actually bring greater certainty to the UK. By 5 July, an arguably lame duck government will be gone and the country will have another. Whether it's run by Labour or the Conservatives, the challenges, the policies and the mandate will be largely the same. Unless there's a hung Parliament that is. Then our uncertainty begins a new chapter...

Figure 5: Prices relative to earnings (PE ratios)*



Source: LSEG, Rathbones; *adjusted for sector composition

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ADDITIONAL INFORMATION

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