ECONOMIC ELECTION INSIGHTS Higgs' Certainty

by Ben Davies

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The current UK General Election polls indicate that another hung parliament is highly likely. It would be the third since 1974, the other being the current coalition that was elected in 2010. This introduces a very real example of 'regime uncertainty', quite literally speaking.

The polls show a Labour led coalition with the SNP. Can you imagine that? This type of poster probably is enough to scare those who are unsure where to cast their vote, away from Labour to UKIP or even Conservatives and Liberals. The thought of the SNP having a say in our UK parliament sends a shudder through most of us.

Vicious: The Conservative poster appears to distort Ed Miliband's features (left). It also shows him embracing Alec Salmond and Sinn Fein's Gerry Adams (right)

Regime uncertainty is a concept that was developed by Robert Higgs, an American economic historian and economist of the Austrian School. It describes a pervasive lack of confidence felt by investors when they cannot foresee the extent to which future government actions will alter their private property rights.

Higgs uses this concept to explain why the prolonged nature of both the Great Depression and the current Great Recession was, and is, so serious. He particularly focuses on investment and shows that investment spending is highly sensitive to risk, most notably uncertainty over future tax and regulatory policy.

"This uncertainty can arise from many sources, ranging from simple tax-rate increases to the imposition of new kinds of taxes to outright confiscation of private property. Threats can arise from various sorts of regulation, for instance, of securities markets, labour markets, and product markets. The security of private property rights rests not so much on the letter of the law as on the character of the government that enforces, or threatens, presumptive rights."

(Mises Institute)

Regime uncertainty pertains to more than the government's laws, regulations and administrative decisions. Two administrations may administer or enforce identical statutes and regulations quite differently. A business-hostile administration will provoke more apprehension among investors than a business-friendlier administration, even if the underlying "rules of the game" are identical on paper. This seems very relevant to the past decade, where politics have largely moved towards the centre. In other words, the policy 'bites' are the same, but the 'bark' is different.

The crisis of 2008 arrested this slide and the opportunity for polarisation arose once again – the proletariat versus the bourgeoisie. The old boundaries of left and right appear to be re-emerging. The outcome of this UK election will see a slide to one side or the other, depending on whether there is a majority or what type of coalition is formed.

Economic Election Risks

I think we would all agree that the main area of risks for economics revolves around:

- Fiscal Deficit

- Taxation Agenda

- Immigration and EU Referendum

Fiscal Deficit and Taxation Agenda

Whoever gets elected as the next government will have to address the fiscal deficit issue and try to eliminate the structural deficit. As I wrote last month, although the UK budget deficit rate of increase has fallen, it remains one of the largest in the world.

The Conservatives wish to achieve a budget surplus in totality over the course of the next parliament, whilst Labour wishes to achieve a current budget surplus, i.e. cyclical vs structural. The Institute of Financial Studies (IFS) claims that fiscal tightening – cutting public expenditure – is the best way to achieve these outcomes.

Fiscal Consolidation:

Conservatives: 4.3% of GDP

Labour: 3% of GDP

Liberals: 3% of GDP

Conservatives have created one of the most competitive tax regimes in the world, both for households and corporates. They will not seek to balance the books through the false economy of higher tax rates, but Labour will. We already know about their intention to 'right' the unfairness of income equality, having failed to comprehend why we have it. It's the credit system, not taxation, that is the root cause. Labour will reinstate the 50p income tax rate, raise corporate tax and instigate some type of mansion tax.

You may recall from last month that the UK relies heavily on the excesses of external capital and commentators are still not really 'eyes wide open' to the risks associated with such an over-reliance on foreign funding. A Labour taxation agenda against the rich could help capital inflow accelerate further. It is already beginning to slow from overseas, as wealthy foreign immigrants and investors stay away. What is more concerning is any business-hostile taxation by Labour could really impact our current account deficit, as we rely on significant overseas foreign direct investment (FDI), which rose significantly after Osborne's corporation tax cuts.

Immigration and EU Referendum

Cameron has promised that an in-out referendum on the UK's membership of the European Union (EU) will be held no later than 1st January 2018. Is Cameron playing realpolitik? I believe this is a case of the means justifying the ends. He is trying to diminish the UKIP threat, which 6 months ago seemed to be impacting the Conservatives' position more than Labour's, although both seem vulnerable to disenfranchised voters.

I suspect Cameron believes he can renegotiate with Brussels, as he has a good relationship with Merkel, who is a powerful ally in this regard. A big sticking point is on the free movement of labour between EU member states, which was set in stone in the Treaty of Rome. The British public clearly wants to reduce the number of migrants coming into the UK. The Treaty will not be changed in my opinion, but I do see there being a cap or quota system that many countries would like to be introduced within the EU anyway.

Brexit only becomes an issue that I am concerned about under the following coalition scenarios.

12 Government Permutations, Economic Policy and Market Risks

Conservative Majority
- Aggressive deficit reduction
- Spending cuts, no tax rises
- Business-friendly, FDI sought
- EU Referendum guaranteed by 2017, Brexit risk low, as its time for negotiation
- FTSE 100 breaks new highs, buy underperforming utilities
- Buy Sterling

Labour Majority
- Slower deficit reduction
- Tax Hikes, Bank Levy increase, Mansion Tax
- Interventionist risks to business, FDI falls
- EU Referendum
- Sell homebuilders, sell banks, sell energy utilities
- Sell Sterling
- UK Bonds rally on economic risks and QE
- BoE does not tighten on slower deficit reduction

Liberal Majority
- 326 seats needed, let's not discuss!

Conservative-Lib Dem Coalition
- Similar to Conservative Majority
- EU Referendum still possible, but not fait accompli

Conservative-UKIP Coalition
- Similar to Conservative Majority
- EU referendum accelerated into 2016, Brexit risk high

Labour-Lib Dem Coalition
- Similar to Labour
- Personal tax allowance raised, but CGT and Dividends Taxes raised

Labour-SNP Coalition
- SNP and Sturgeon against deficit reduction
- SNP would bargain for Devolution Referendum and Trident cut
- Risks to UK government credibility
- Sterling and UK govt bonds fall

Labour Rainbow Coalition (liberals/SNP/Greens and Plaid Cymru)

Labour Minority

Conservative Minority

Conservative - Labour coalition (Would only happen in war emergency – call for another election)

No overall control = Multi-party coalition or fresh elections

I have taken the liberty of including a Deutsche bank probability table on economic outcomes, as they fit neatly with a general consensus. They have added into the other categories Scottish succession and a 'stability' or rather 'instability' column.

ECONOMIC ELECTION RISKS

	Harsh austerity	Corporate/income/wealth tax hikes	EU referendum	Scottish succession	Political sclerosis or instability
Lab minority	Medium	Medium	Low	Medium	High
Lab - Liberal	Medium	High	Medium	Medium	Medium
Lab - SNP	Medium	High	Medium	High	Medium
Lab majority	Medium	High	Medium	Medium	Low
Cons minority	Medium	Low	Medium	Low	High
Cons - UKIP	High	Low	High	Medium	Medium
Cons majority	High	Low	High	Low	Low
Cons - Liberal	High	Low	High	Low	Medium
Lab rainbow	Medium	High	Low	Medium	High
National government	Medium	Medium	Medium	Low	High

Source: Deutsche Bank, Jan 2015

Minority Governments and Weak Coalitions

Policy is hamstrung and political stalemate is likely to result in an extension of regime uncertainty and volatile markets at lower prices than we currently have in all assets in the UK.

The UK's external borrowing is funding the budget deficit. Under these governments, if austerity is not undertaken (which is likely) and the budget is slashed, the burden on our external borrowing position will continue to rise.

Domestic Private Sector Financial Balance + Public Sector Balance + Current Account Balance = 0

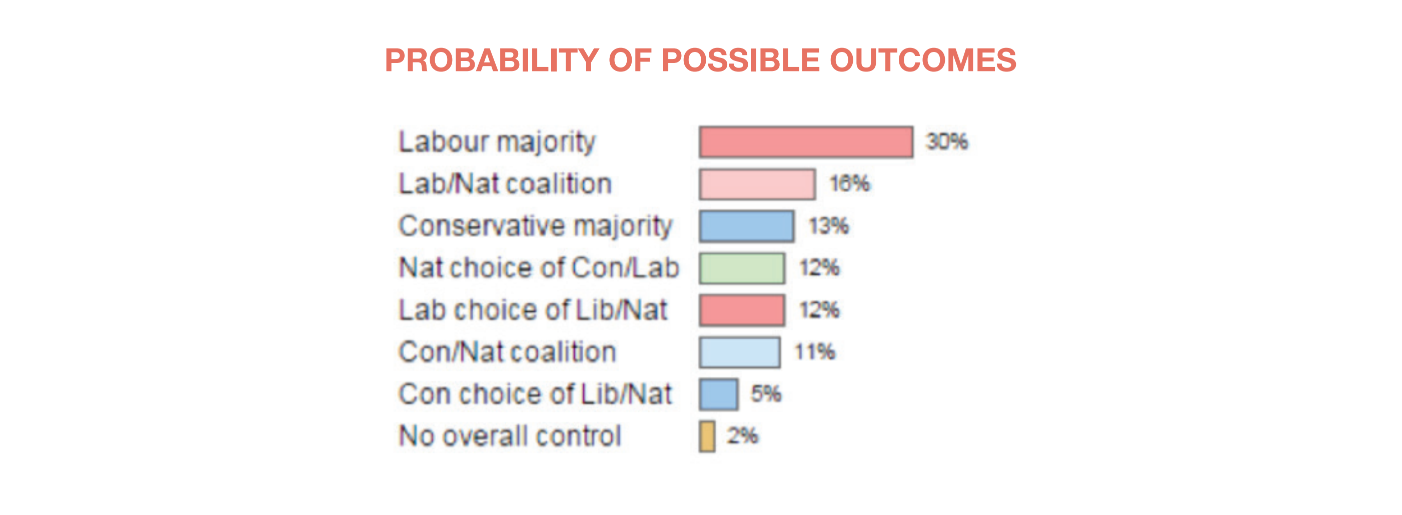
Or put another way:

Budget deficit = Savings + Trade Deficit - Investment

Remember the Current account deficit = Capital account surplus

A reduction in the budget deficit thus reveals a fall in the current account deficit, but if we have a weak coalition, as seems likely, then much-needed austerity measures will be less likely to occur. However, with indebted private sector domestic and non-financial firms no longer able to borrow much more and zero growth in UK tax receipts, then who do we look for to borrow from? More QE from BoE is the likely solution.

Election Probabilities and Expected Outcomes



Source: www.electoralcalculus.co.uk

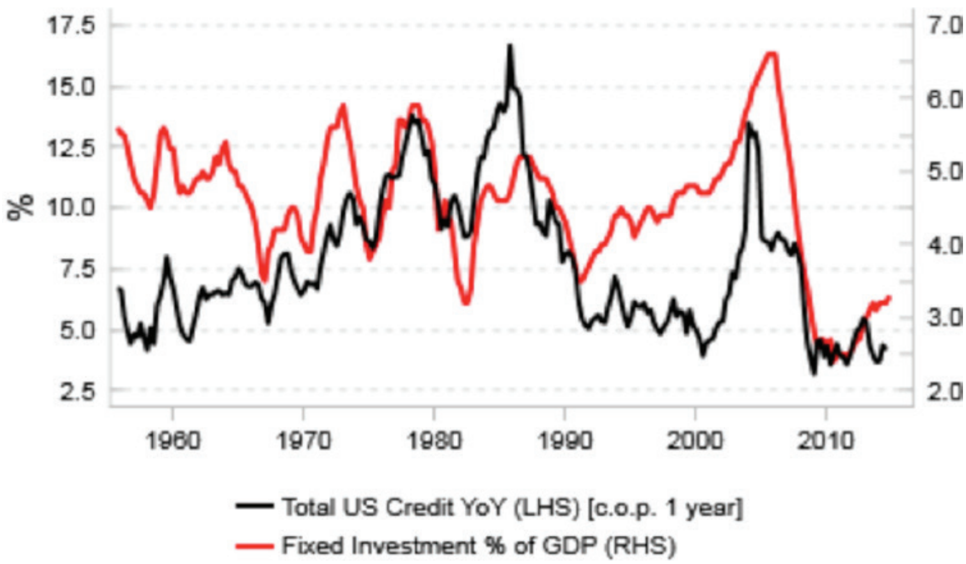
I would finish off by saying uncertainty seems a bit of a red herring to us. Just because we experience existential feelings of uncertainty doesn't mean there will be bad outcomes. Far from it, our worst fears are not usually realised and there is a bounce-back effect or release of pent-up 'animal spirits' and / or positive market behaviour.

Arguably, when all appears to be highly stable and the status quo seems certain, that is when we should be most concerned; although the temporal nature of a negative regime change is what economists and market participants continually seek solutions for. Minsky's by now famous Financial Instability Hypothesis has provided such a quantitative and qualitative model, although it was the Austrian economists under Mises who had already articulated in their Business Cycle Model that stability breeds instability.

At the stock specific level, our biggest concern as investors is observing a margin of safety that buys us time to see if a company or sector is in danger of obsolescence from innovation or political regime shift. We believe our methodology of purchasing companies with solid balance sheets and solid cash-flow metrics gives us that margin.

In stark terms, regime uncertainty refers to the mere fact investors are no longer confident that they can continue to operate within a capitalist system, and it is this which stymies growth. Although I would actually contend we have been experiencing a socialist form of capitalism – where political and corporate interests have actually become corruptly entwined, most notably in the US. It is also clear monetary and fiscal policy work hand in hand and fiscal government dominance over monetary policy has interfered in the market process. We have no more markets, only engineered markets but we learn to adapt. Our resounding hope is that Perez's productive capital deployment begins to take hold, despite the overhang of financial capital, and that as private fixed investment begins to trend faster than credit growth, then we may see a golden age of sustainable growth.

US FIXED INVESTMENT AND TOTAL CREDIT YoY



Maybe there is a glimmer of hope here, as fixed investment appears to be rising.

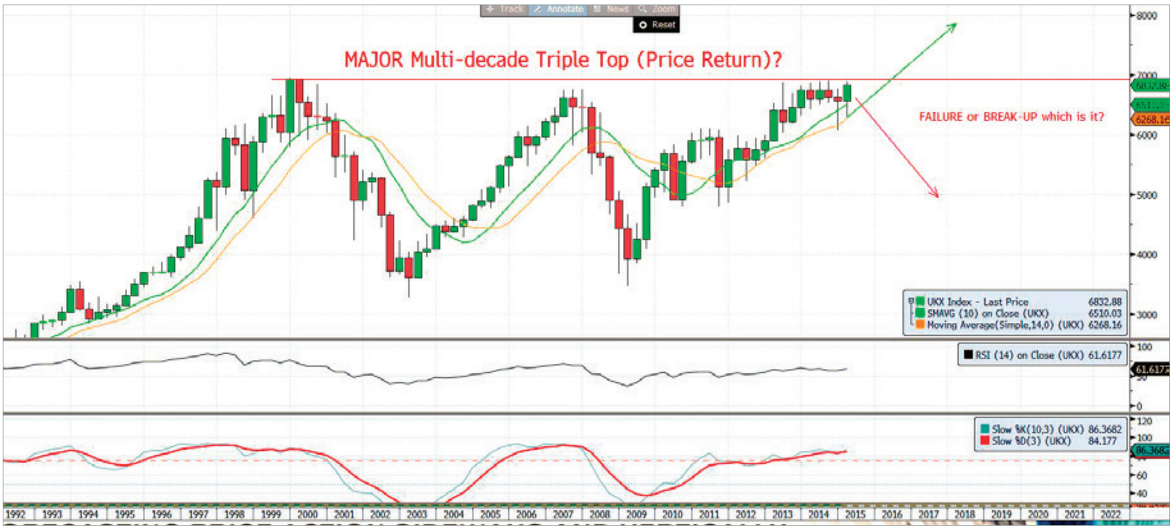
Whatever the outcome of these elections and future economic certainties, I certainly hope you enjoyed the debate thus far.

WHAT HAPPENED? Market & Sector Analysis

The polls have had the Labour party over the last year as the lead contender for a majority, however as the months run down Labour and Miliband have lost substantial ground to the Conservatives. Notwithstanding this we believe the markets have priced in a high probability of a Labour led coalition government. Markets are discounting mechanisms and it would appear they trade well in the face of a business and market unfriendly potential government.

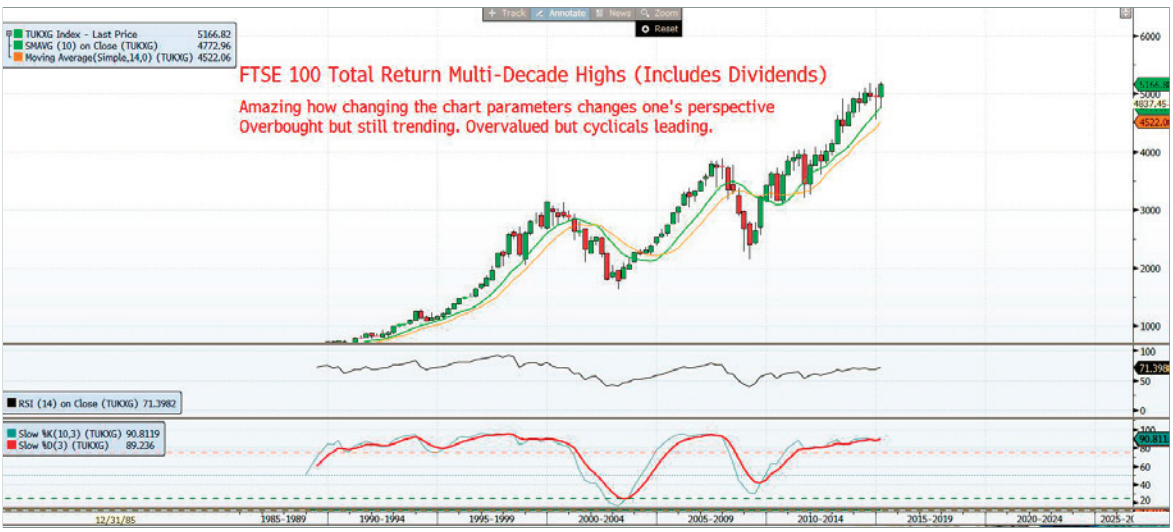
Here are two interesting charts. One of the FTSE 100 Price returns (no dividend inclusion). It shows we are on the cusp of creating a major triple top over many decades. If we fail here then the retracement could be substantial. If we break higher it is a significant acceptance of value over time and buying agents will send prices much, much higher at least to 9,000 to 10,000.

FTSE 100 (PRICE RETURNS) MAJOR MULTI-DECADE TRIPLE TOP?



This next chart shows the FTSE 100 with dividends included and compounded. Amazing how it changes our perspective. We are at multi-decade highs, overbought but trending with no signal of impending failure apparent.

FTSE 100 TOTAL RETURNS AT RECORD HIGHS

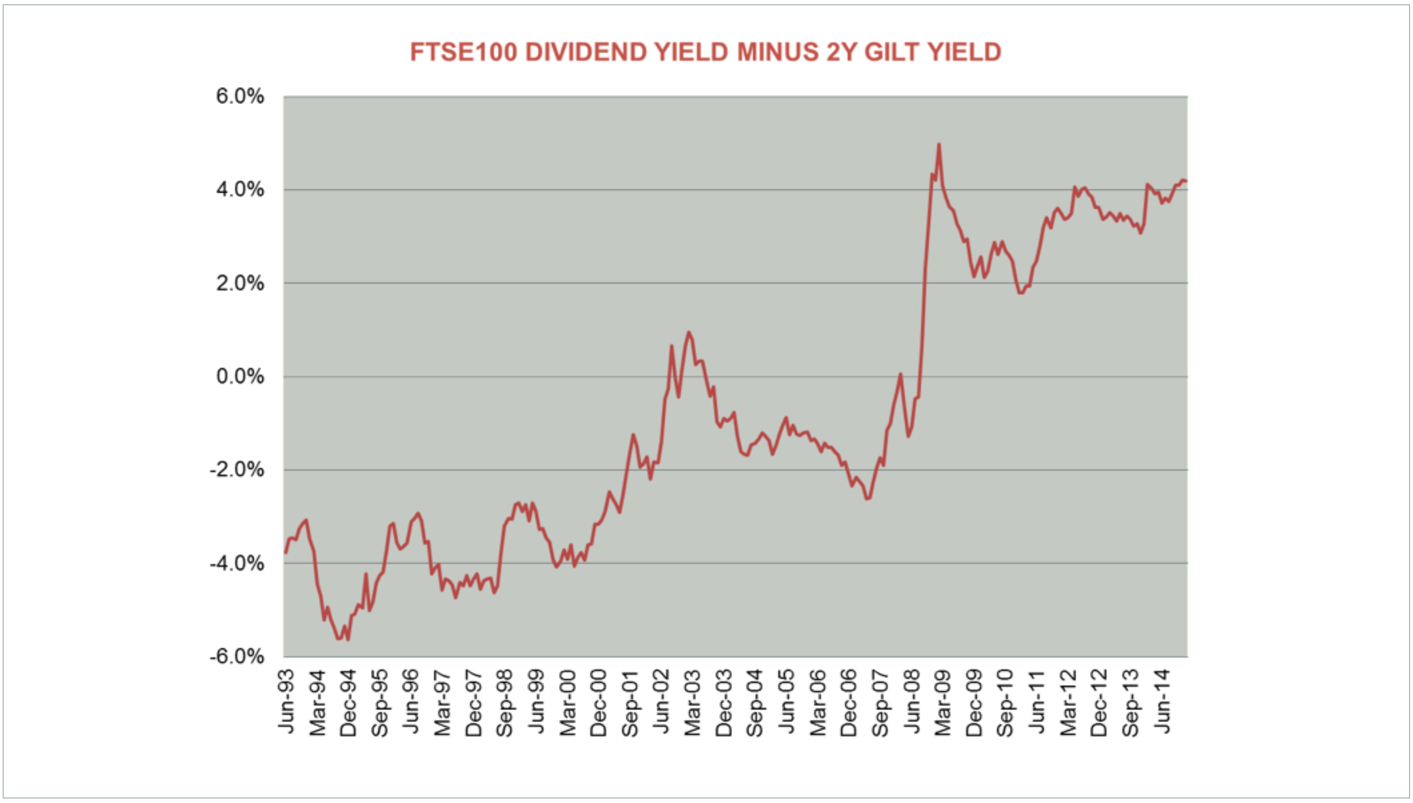


UK Market Valuations

If we look at valuations and the current P/E, it is at the high end of the range but the estimated forward P/E is 15.6, so analysts expect earnings to remain strong. We haven't shown here but EPS misses have been increasing. So we don't see earnings rising to meet price which would reduce the price multiple.

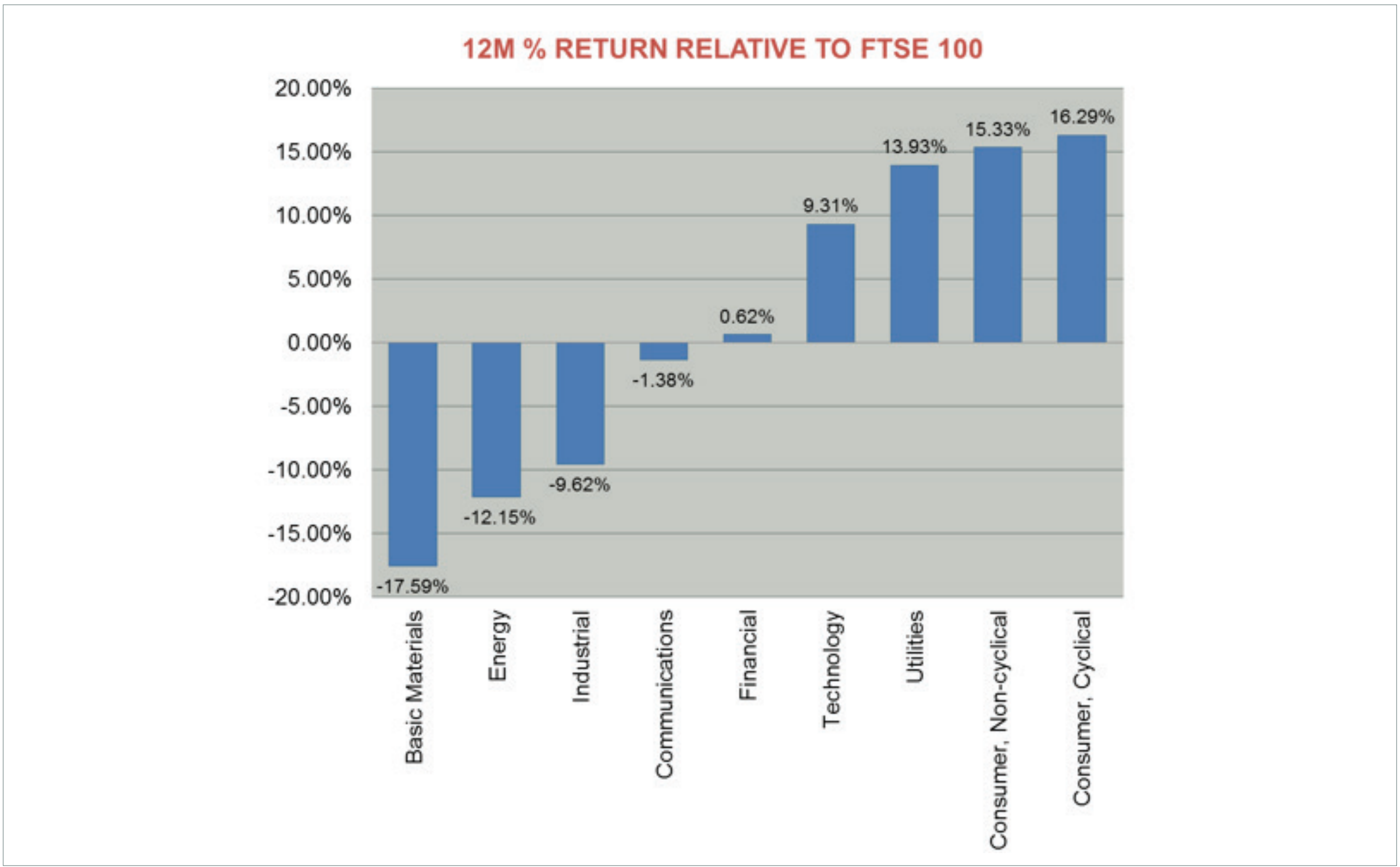
UK INDICES	PRICE/EARNINGS RATIO	PRICE/BOOK RATIO	DIVIDEND YIELD (%)
FTSE 100 INDEX	21.26	1.92	4.53%
FTSE 250 INDEX	17.83	2.27	3.41%

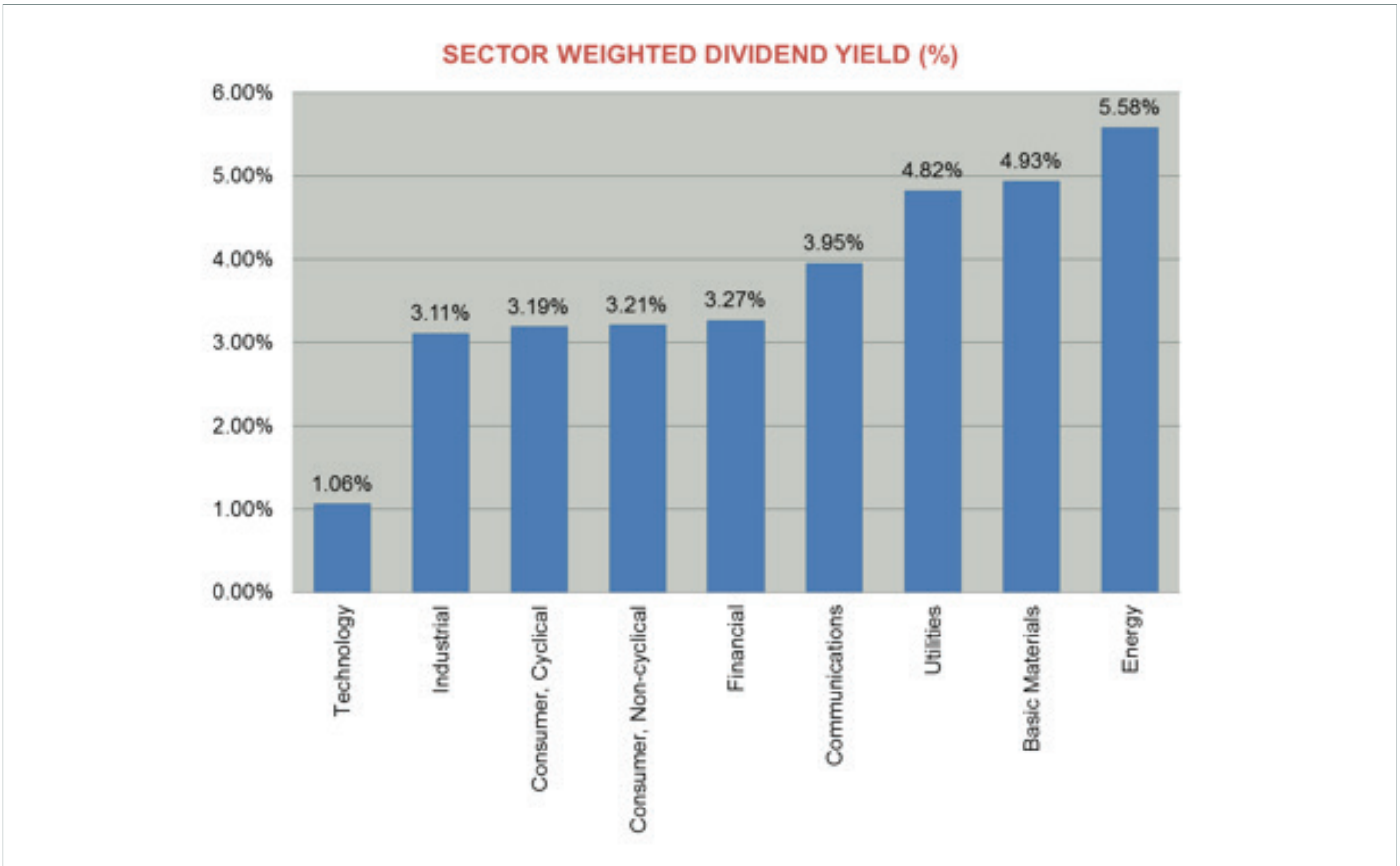
Our main risen to believe markets could break higher is the equity markets offer too much yield relative to government and corporate rates. This alone can drive markets to higher and higher valuations. The market has been very resilient on any sell-off. Each dip has got shallower. We await a trend signal and confirmation of a break up or down.



Sector Returns

The Consumer cyclical sector is leading over the last 12 months a positive for now. It has broadly benefited from lower oil prices as airline stocks have rallied, and homebuilders have performed well, buoyed by the recent Stamp Duty announcement and lower bond yields.





Sector Returns

Smaller capitalised companies are rich relative to big capitalised stocks but in a ZIRP environment where liquidity drives yields lower, risk premia gets compressed. So we can see small caps trade tighter to big caps in the same way junk bonds trade tighter to government bond yields.