

polls, projections and piffle

February 2010

Should the upcoming election affect your investment advice?
It's really all a matter of opinion, explains **Graham Bentley**.



Win or lose, we go shopping after the election. Imelda Marcos – 1986

We will have a new government by 3 June at the latest. Press comment suggests senior Labour figures are discounting the idea of a General Election in March or April, with expectations now increasingly focused on a 6 May poll, if only because this is the date already fixed for local elections. That means a March Budget before the Easter break, with campaigning to begin in earnest when MPs return from their holiday.

The press loves speculation, and there is nothing better than an extended election campaign to exercise the invention of journalists. The financial pages have caught on, giving advice on tax planning and investment decisions, implying they should be somewhat different in the run-up to an election. Where investment speculation is concerned, this involves formulating economic assumptions across various election outcomes. Forecasting is of course utter folly – as behavioural finance guru James Montier has suggested, “...the three blind mice have more credibility than any macro-forecaster at seeing what is coming”. However, this election does have a potential outcome that warrants consideration; an outcome that many readers may have had no experience of.

indecisive outcome?

At the next election the number of seats contested will be increasing from 646 to 650 as a result of boundary reforms. That means an absolute majority would require one party to win 321 seats

(ie excluding eight seats occupied by Sinn Fein, the Speaker and his deputies, none of whom vote). The way the polls are going, election forecasts suggest it is very possible that no party will have an overall majority at the 2010 General Election. This position, known as a hung-parliament, is where the party with most seats tries to form the government, but hasn't amassed the 321 seats, implying an inability to win votes to pass laws without the support of members of other parties.

A hung parliament means uncertainty – no party has a mandate to follow through on its election manifesto and there is a paralysis of decision making. The last time this occurred was in February 1974, where Labour formed the government in the midst of a global recession, having won the most seats, 301 out of the 635 available, but hence no overall majority. The lack of a mandate meant little business could be done, resulting in another general election only eight months later. In that period the FTSE All-Share Index fell by 48%*. The previous hung parliament saw Ramsey MacDonald's Labour party take the reins with only 288 seats, just four months before the 1929 Wall Street Crash. The Government was subsequently forced to cope with global depression, and the pressure of keeping to the economic orthodoxy required by international financiers and other governments became too much; the Government disintegrated under the strain. This has familiar echoes in 2010. Today, the world appears to be clawing its way out of a recession. However, the UK economy seems to be some way behind the pace. Between April and December 2009, the UK's budget

deficit was £120 billion compared with £64 billion a year earlier. Net debt climbed to £870 billion, or 61.7 percent of GDP in December, the highest since records began in 1974. The Bank of England committed to buying £200 billion of gilts as part of its 'quantitative easing' programme to boost the overall economy, but this has recently ended – just as the next government is forced to issue more gilts to fund the deficit. According to the IMF, the deficit will peak in 2011 at 13.2 percent of GDP, the most among G20 nations. A minority or coalition government would hit investor confidence and could cause ratings agencies to downgrade the UK's Triple-A status. If you believe it is unlikely the UK could be downgraded, then consider the fact that the Credit Default Swap markets are pricing in a lower default risk for Chile than the UK. A downgrading of the UK's credit rating would make it much more expensive for the government to borrow money, so they would have to offer higher yields on Gilts. Higher yields mean lower prices.

As for UK Equities, smaller companies trounced larger cap stocks during 2009, the Hoare Govett Smaller Companies Index rising by 57%, while the FTSE 100 was up 22%**. Fund manager Sarasin expects a resurgence of larger higher quality companies' fortunes; “...yields are now more attractive and sustainable; on pure valuation grounds many larger companies simply make investment sense whilst they are also better placed to cope with any further economic turbulence or monetary tightening.” Many of the better quality UK companies derive a significant amount of their earnings from overseas markets.

Sterling has fallen more than 29% against the euro since September 2007. It is quite possible for elements of the FTSE All-Share to perform very much better than the underlying UK economic fundamentals suggest, particularly as weaker sterling makes their overseas earnings more valuable.

problematic projections

Despite the evidence the polls proclaim, it is by no means certain there will be an indecisive election outcome; there is a contrarian view. Most election forecasts in the UK use poll data to determine how each party's share of the vote might change since the last election, and then apply that 'swing' to each constituency in the country to see who will win it this time around. The problem with forecasting like this is that it doesn't take account of the source of the vote – if the Conservatives get more voters, it matters whether they previously voted Liberal Democrat, or Labour, or just didn't vote last time.


An ICM poll for The Guardian in September 2009 discovered that people who voted Liberal Democrat in 2005 and decided to vote differently now were much more likely to vote for the Conservatives than they were to not vote at all. On the other hand people who voted for the Scottish National Party were much more likely to stay home than they were to vote for the Conservatives. In a marginal constituency where the Conservatives and Labour are the two largest parties, if there are lots of Lib Dem voters there who decide to vote differently it will benefit the Tories much more than it would if the third party in that seat was the SNP. Political spread-betting companies are especially conscious of this effect, but it rarely gets into the models used to predict the results. According to Resolver Systems, a UK software company who have modelled the data, when this analysis is done the forecast is for the Conservatives to win by a landslide with well over 400 seats. One can imagine that a Conservative Government with a very

strong mandate might generate a different outlook for the economy than that under a minority government of either persuasion (or Liberal Democrat, to be even-handed). These two extremes of outcome potentially offer very different economic landscapes.

How can you plan for these? Preparing for one outcome is in effect betting on it happening. Investment decisions should be made on the basis of what people are doing, not what they say they are doing. Portfolio planning should not be based on short-term probabilities, particularly where politics is concerned. It is easy to be a market pundit, but harder to actually act on that conviction. Most pundits do not have to bear the responsibility for their advice; financial advisers do. Re-evaluate the position (if you must) after the election. And if you don't like the result, at least the shops will still be open... ●●

*FTSE All-Share Index, 28 February 1974 to 10 October 1974 –48.24%.

**Financial Express Analytics, one year to 31 December 2009.



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