Outlook for Investments – Elections and the Next Phase of the Cycle

5 March 2024

The final months of 2023 demonstrated the speed and strength of possible recovery in depressed asset prices as inflation and interest rate expectations turn. Uncertainty has returned year-to-date, but we remain cautiously optimistic that investors able to look past short-term sentiment will be rewarded with attractive returns.

In this article, we highlight the impact of possible political disruption in the year ahead and consider the debt conundrum facing most developed market policymakers.

2024 – an election year

Almost every year, it would be possible to make the case that major political upheaval had the potential to disrupt markets. For the most part, in our experience, the electoral cycle has less of an impact on financial markets than media coverage might have us believe.

However, the political cycle is unusually active in 2024. Almost half of the global population in over 60 countries are due to head to the polls this calendar year. Whilst not all of these elections will be democratically free processes, the results still have the potential to be meaningful. Vladimir Putin's re-election campaign, for example, is virtually certain to be 'successful', but the breakdown of the vote may – internally at least – be viewed as a measure of support for the ongoing war in Ukraine.

Domestically, polls indicate that the UK appears likely to see a new government after 14 years of Conservative rule. Whilst we anticipate a relatively limited shift in macroeconomic or business-oriented policy regardless of the outcome of the election, a level of uncertainty is no doubt present. We remain hopeful that stimulating UK growth will be a priority for any new government – with sentiment around UK-listed companies poor and valuation gaps wide, there is already much negativity priced into markets.

In a global context, perhaps the most important political event will come with the US election in November. With Donald Trump seeking a second term, having been unseated in 2020, there is likely to be a huge amount of noise throughout the year. We are still too early to be able to assess the policy environment under each Party's chosen candidate, but we will continue to monitor developments as they evolve and communicate to clients accordingly.

A policymaker's dilemma – government debt

One of the key issues facing incumbent and incoming governments is how to deal with bloated government debt burdens. At a high level, developed economies face a challenge in this area not seen since the World Wars:

- The International Monetary Fund (IMF) reports global government debt reaching a staggering USD 230 trillion in 2022, equivalent to roughly 90% of global GDP. This represents a significant increase from pre-pandemic levels, highlighting the impact of economic stimulus measures.
- The US national debt currently stands at around USD 34.27 trillion, translating to a debt-to-GDP ratio exceeding 110%.
- The UK's debt-to-GDP ratio sits at roughly 100%, reflecting the impact of the pandemic and ongoing economic challenges.
- Japan: holding the dubious title of highest debt-to-GDP ratio among major economies, Japan's stands at an eye-watering 214.27%. This raises concerns about long-term fiscal sustainability.

The implications of high debt levels can be severe, even for countries and economies considered to be fiscally robust. Higher interest payments divert resources from other areas of spending and the sustainability of such a debt burden can quickly be called into question. An erosion of investor confidence can rapidly increase borrowing costs, leading to a debt spiral that can impact all areas of a country's economy.

One way to ease a government debt burden is to allow systematically higher levels of inflation to persist for long enough to cut real-terms leverage. We have argued since the pandemic that this would be a tempting path for policymakers, with inflation viewed as the most politically palatable option to address ballooning balance sheets. Thus far, inflation has indeed remained elevated, and we perceive the likelihood of continued acceptance of above-target levels to be relatively high. When and how this translates to changes in monetary policy remains to be seen.

The process by which debt is eroded through inflation is considered below:

- As prices rise, the purchasing power of each unit of currency owed by the government decreases, offering a 'hidden tax' that reduces the real burden of its debt over time.
- While the value of fixed-rate debt shrinks, costs associated with inflation-linked obligations rise for governments. These include welfare payments, indexed public sector salaries or costs, and certain types of government bonds. These increased costs can partially offset the benefit of reduced debt value, especially if inflation remains high for an extended period.

Unchecked inflation can also erode public trust and investor confidence. If citizens and investors perceive the government as unable to control inflation, it can lead to:

- Higher borrowing costs: investors may demand higher interest rates to compensate for the inflation risk, increasing the long-term debt burden.
- Reduced tax revenue: as inflation shrinks household purchasing power, tax revenue might decrease, making it harder for governments to meet their obligations.

Ultimately, a balance must be struck between fiscal responsibility and the cautious use of inflation to reduce the immediate concerns faced.

Conclusions and investment implications

Whilst political uncertainty is nothing new, the environment for policymakers undoubtedly remains challenging. Fortunately, developed economies have thus far been more resilient than many anticipated, raising hopes for a relatively smoother transition to 'normal' rates than had been feared. Corporate earnings have been robust for the most part, particularly for companies with the ability to pass through cost pressures to the end consumer.

Global equity markets have shown a mixed picture, with the majority of recent strength coming from a recovery in US Large Cap. Other bright spots have included a strengthening Japanese equity market, although for international investors the impact of this has been partially offset by a much weaker Yen. We continue to see value in unloved areas of the market, including UK equities, but the catalyst for the reignition of domestic institutional or global interest required for re-rating remains unclear.

We believe that this environment calls for a pragmatic approach to asset allocation and fund selection. In some markets, particularly the US, the composition of the index is making it increasingly challenging for active managers to perform. We are concerned about the implications of the growth in passive investment for market efficiency, but ultimately feel that there is probably a place for some pure index exposure in many client portfolios.

Elsewhere, prudent selection of experienced managers remains key in delivering long-term value. Fixed Income, Smaller Companies and Emerging Markets are examples of areas that we feel will benefit from careful active management over time. We remain hopeful that continued macroeconomic improvement through 2024 will set the scene for a wider recovery in asset prices.

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