

Life after BoJo



As Prime Minister Boris Johnson gets ready to leave office, what is the outlook for the UK economy and financial assets?

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Chronicle of a predicted fall

On July 7, Boris Johnson announced in a televised address his resignation as Prime Minister, following a series of scandals and controversies that led to the departure of many members of his government. BoJo's resignation as leader of the Conservative Party (and therefore as Prime Minister) is all the more spectacular given that, since the 2019 elections, he has had a very comfortable majority of eighty MPs in the House of Commons. Furthermore, the international context - including the Russian invasion of Ukraine - should have played in his favor. However rather than his policies, it is the man who has been rejected, largely because of the lack of integrity he is accused of.

Boris Johnson will leave 10 Downing Street once the Conservative party has appointed a successor. As a result, a leadership election must now be held. This process may take between six to eight weeks and is expected to unfold over the summer. Unfortunately, until this process is completed, political uncertainty will remain high. Potential candidates, in order of likelihood to replace Johnson, include former chancellor Rishi Sunak, former trade minister Penny Mordaunt, defence minister Ben Wallace, former chancellor of the exchequer and former health minister Sajid Javid and former foreign minister Liz Truss. The image below represents the odds at the British bookmakers (source: The Daily Mail).



Consequences for growth as well as for fiscal and monetary policies

The Prime Minister's departure coincides with a very complicated economic climate for the United Kingdom. The domestic economy has been affected by both the Covid crisis and Brexit. It is now facing a context of stagflation with an inflation rate (9.1% in May) at its highest in 40 years and a high risk of a "technical" recession in the second half of the year (two consecutive quarters of GDP contraction).

Boris Johnson's successor will therefore have a lot to do. They will, of course, have an important influence on the international policy agenda (especially Brexit) and the economic agenda (especially fiscal measures).

Although it is still unclear who will become Prime Minister, an improvement in relations between the European Union and the United Kingdom seems likely. Systematic opposition to EU proposals had become the hallmark of Boris Johnson. The new prime minister - however eurosceptic he or she may be - will almost certainly be less dogmatic than Johnson about convergence with EU rules. In particular, many

observers are hoping for more compromise on the Northern Ireland issue, which would ease tensions with the EU. On this last point, the degree of flexibility varies according to the candidates. The hard Brexit line represented by Liz Truss will offer less compromise, while Rishi Sunak or Sajid Javid will probably be more open to negotiation.

The arrival at 10 Downing Street of a more traditional member of the Conservative party than the quasi-populist Boris Johnson also suggests an economic stance much more in line with that of the party. First, the economic situation has changed dramatically between BoJo's election in 2019 and today. Indeed, with the threat of stagflation, the successor to the current Prime Minister will have much less flexibility than Boris Johnson had four years ago and will have to deal with the Treasury, the Bank of England and the economic lobbies. In addition, the new government should be more willing to accept the idea of a recession to help curb inflation. This course of action is easier to pursue with a newcomer, who will be able to blame the current poor economic situation on the outgoing government.

Changes in fiscal policy are certainly in order. But the different candidates have different approaches to this issue as well. Some candidates are in favour of providing additional assistance to households to cope with the rising cost of living. This could include a reduction in fuel taxes and VAT. Other candidates favour an early income tax cut, while some want to scrap the corporate tax increase (from 19 per cent to 25 per cent) scheduled for next year. The new chancellor, Nadhim Zahawi (who replaced Rishi Sunak, the apostle of fiscal discipline), has already stated his determination to do more to cut taxes. It is the extent of the cuts, their realization and their effects that remain to be determined. Among the candidates, Rishi Sunak and Sajid Javid favour fiscal discipline, while Liz Truss favours the line taken by Nadhim Zahawi, which is to increase the budget.

It should be noted that this possible loosening of fiscal policy could increase pressure on the Bank of England to continue monetary tightening.

Finally some positive signals for the pound?

The end of Boris Johnson's tenure as Prime Minister could potentially act as a catalyst and trigger a revaluation of the British pound against the euro and even the dollar.

There are several factors that could work in favor of the pound after Johnson's resignation. First, an easing of tensions between the EU and the U.K. is likely to improve the appeal of the pound.

Another potential catalyst for the pound is the change in economic policy mentioned above (fiscal support but also a greater conviction in the fight against inflationary pressures), suggesting that the Bank of England will continue to raise rates, which is conducive to an appreciation of the pound.

Finally, BoJo's resignation increases the Conservatives' chances of re-election in the 2025 general election. The new Prime Minister will almost certainly have a grace period with the possibility of attributing much of the current difficulties to BoJo's leadership. An early general election in the second half of next year may even be possible if the economic situation is not too unfavourable. Historically, the pound has performed better under a Conservative government than under Labour.

These various elements could favor a rebound in the pound after the substantial devaluation it has suffered against the dollar and the euro over the past 3 years. It seems that the long wait and the strong speculation around Boris Johnson's resignation have contributed to the devaluation of the pound and, in this sense, his departure had already been anticipated by the markets. The arrival of a new Prime Minister should therefore help to restore stability in the medium term.

Of course, there are other factors that could work against the GBP. Pronounced stagflation or a new Prime Minister who does not reassure the financial markets could prolong the pound's bear market.

Hot and cold weather for UK stocks

During Boris Johnson's tenure (July 2019 to present), UK equities (performance reported in dollars) have underperformed most other developed countries. The collapse of the pound explains some of the underperformance of UK equities reported in dollar terms. On a P/E multiple basis, the FTSE 100 index is now among the most attractive in the world: the UK market is paying 10 times expected 12-month earnings, a 10% discount to the European market and 40% to the US market. On a historical basis (median P/E over the last 20 years), the FTSE 100 index is trading at a 20% discount. With the arrival of a new Prime Minister, should we expect a return to favour for British stocks?

Poor Investment: UK Stocks were laggards in dollar terms during Boris Johnson's Tenure



Source: Bloomberg

Improved relations with the EU and more visibility on economic, monetary and fiscal policy are positive for the sterling, and they are also likely to improve investor sentiment.

However, it is important to keep in mind that the UK equity market is divided into two main categories: first, domestic stocks, which tend to perform well when the fundamentals of the domestic economy (growth, employment, purchasing power) are in good shape. These are mostly defensive growth companies, but also financials. Logically, these stocks have a positive correlation with the British pound. On the other hand, export-oriented companies generally benefit from the weakness of the British currency. International stocks make up the largest portion of the index (75% of market capitalization). This segment includes pharmaceutical stocks (Astra Zeneca, GlaxoSmithKline, etc.), consumer stocks (Unilever, British Tobacco, etc.) and also value stocks with a high sensitivity to commodities (Shell Plc, BP, BHP, Glencore, etc.).

In a scenario of a strengthening pound, export-oriented stocks could therefore be negatively impacted. However, it is the performance of commodities that will have the greatest impact on the above-mentioned value stocks. The appreciation of the pound, on the other hand, could benefit the domestic segments, especially in the case of fiscal support for households. As mentioned earlier, fiscal easing would imply a tight monetary policy that could benefit banks.

The fact that domestic stocks are a minority in the index suggests, however, that the expected changes allowing for a stronger pound will not necessarily benefit the equity markets as a whole.

Conclusion

The impact of policy on financial markets is too often overestimated, especially for developed economies. But in the case of the U.K., the BoJo years have undeniably had a significant impact on the economy and the behavior of the pound. Investor sentiment toward UK assets may be on the upswing with the arrival of a new Prime Minister. Whoever is elected, the economic and political outlook is likely to be viewed more favorably by the market than in recent months, which could eventually benefit the Pound.

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