Oh! Jeremy Corbyn

What a Corbyn-led government could mean for investors
Foreword

Whether you're chanting it from a tent in Glastonbury or howling it at Radio 4 in despair, the name Jeremy Corbyn tends to incite some rather impassioned reactions. Our job is to try to work out what a Corbyn-led government might mean for the UK economy and its financial markets. That's not an easy one in this case given the difficulty of reconciling the 2017 Labour manifesto with the radicalism claimed by many of Jeremy Corbyn's acolytes. I've tried very hard to suppress any political bias, and I hope you can too. Any analysis that doesn't isn't worth the paper it's written on.

Let's get one thing out of the way: we're not in the business of forecasting elections, especially when even the timing of the next one is hotly debated. The polls suggest that the Conservatives would be out of No. 10 if they called an election today. So for the purpose of this note, we assume that Corbyn becomes Prime Minister tomorrow.

Some believe that Corbyn's bold new policies will usher in a more equal society, while others worry that his agenda will bankrupt the nation and drive businesses from these shores in droves. After extensive analysis, we feel both are likely to be wrong. But there are a few risks. Not least, a Corbyn-led government would polarise people, and people (unfortunately) influence investments.

We start by looking at what the markets have done since Labour started soaring up the polls in May. We then look for any pertinent historic precedents of a Western leader with a Corbyn-like agenda. Next we go through 2017's Labour manifesto in some detail and ask what that might do to the economy if we were to take it at face value. But given that it's not nearly as radical as many of Jeremy Corbyn's supporters believe it to be, we then ask if we can take it at face value at all.

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What a Corbyn-led government could mean for investors

Part 1: What do markets like less, Brexit or the hard left?
The FTSE All Share markedly underperformed global equities in 2017, particularly since the early summer, when Mr Corbyn started to eat into the Conservatives’ polling lead (figure 1). Its underperformance has been far more severe than its recent relationship with some economic fundamentals would imply. Over the past 20 years the index has had a very tight relationship with moves in sterling, the price of oil and leading economic indicators in Asia.

Indeed, a simple model based on these variables can explain almost all of the FTSE’s relative performance since 2008 (figure 2). So the timing suggests the recent deviation from this relationship could be explained by a ‘Corbyn factor’. Of course, it could also be due to the overtly poor start to Brexit negotiations. But if investors were penalising the FTSE for that, why has the pound stayed steady (figure 3)? Similarly, FTSE 350 stocks most exposed to domestic revenue streams did not suffer relative to those who do major business overseas, at odds with past periods of Brexit-related turbulence (figure 4).

It’s possible that international investors may cheer a Labour government because the majority of Labour MPs are nominally anti-Brexit. But the Labour leadership is more ambivalent. Corbyn’s equivocation is a matter of ongoing division within his party. He has made no secret of his hostility toward the EU over the past 30 years and advocates regularly for local and national protectionism.

How UK stock markets and sterling have reacted to the changing political landscape

Figure 1: UK political polls and relative stock market performance

Conservative Party lead in polls (left)  
UK equities relative to world equities (right)

Source: ukpollingreport.co.uk, Datastream and Rathbones.

Figure 2: FTSE has underperformed by more than simple fundamentals

FTSE relative to global equities, year-on-year change  
Simple econometric model (2 stage)

Source: Datastream and Rathbones.

Figure 3: Sterling has not reacted

Conservative Party lead in polls (left)  
Trade-weighted £ exchange rate index (right)

Source: ukpollingreport.co.uk, Datastream and Rathbones.

Figure 4: Companies most exposed to the UK have not suffered more

Conservative Party lead in polls (left)  
FTSE 350 most exposed to UK earnings relative to least exposed (right)

Source: ukpollingreport.co.uk, Datastream and Rathbones.
Perhaps the most damning evidence is that Labour’s economic advisory council, set up during the first days of Corbyn’s leadership and filled with highly regarded, mainstream economists such as Simon Wren-Lewis and David Blanchflower, disbanded because its members could not support a party which tacitly endorsed Brexit. Moreover, Labour’s manifesto confirmed that ‘freedom of movement will end when [they] leave the European Union’. As the EU insist that membership of the Single Market Programme is inseparable from the freedom of movement, Labour is also advocating de facto for a ‘harder’ form of Brexit.

Deal or no deal?
That said, Labour also states that no deal whatsoever is the worst possible outcome: this suggests the party might concede ground on immigration before walking away from the negotiating table. It may even hold another referendum. Yet the only way to do that without offending the Labour supporters who voted ‘leave’ is to first spend a long time at the negotiating table. In short, a victory for Corbyn is unlikely to mean more clarity on Brexit.

This could be why the pound barely budged as Labour soared up the polls. But it could also be that investors netted off a positive lift on the Brexit front with a negative impact from the potential for capital flight if Corbyn enacted a hard-left agenda.

Certainly sectors most directly in the firing line of nationalisation have suffered more than others. UK utilities have underperformed global utilities by an enormous 24% since the Conservatives’ polling lead peaked in April 2017 – three times the underperformance of the broader UK market.

**Part 2: A hard-left precedent**

While none of the examples of a left-leaning government replacing a right-leaning one over the past 30 years have had a meaningful impact on equity or bond markets, they have all been centrist, not hard left. There is no good UK precedent.

The first government of Harold Wilson was hamstrung by an ultimately doomed effort to avoid devaluation. Wilson imposed wage freezes and reined in public spending, hardly a radical departure from his Conservative predecessors. Although he certainly favoured state-direction of industrial investment, he had little taste for nationalisation (he renationalised the steel industry only to placate Labour’s left wing after he watched Hugh Gaitskell, his predecessor as Labour leader, effectively end his own career by trying to remove industrial nationalisation from the party’s constitution).

James Callaghan took over from Wilson (second term) by defeating the hard left’s Michael Foot and Tony Benn in a leadership contest; and his left-wing tendencies were reined in by the Lib-Lab pact. It hardly needs to be said that there’s no precedent in Blair or Brown:

Labour’s manifesto confirmed that ‘freedom of movement will end when [they] leave the European Union’.

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**Figure 5: Conservative and Labour government borrowing**

Annual government net borrowing as a percentage of GDP during Blair’s premiership averaged less than any other prime minister’s term since Wilson’s first.

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Source: OBR and Rathbones.

For the markets, Mitterrand’s campaign slogan of ‘La force tranquille’ certainly didn’t ring true. Just five weeks after the election, the French stock market had fallen 35% relative to global equities. Government bond
If, even after a period of failure, a Corbyn government were to jettison its most left-wing reforms and start to court private enterprises just a little, markets could recover very quickly and indeed still enjoy considerable success.

left-wing agenda. Perhaps investors were more concerned about political disarray than anything else. Yield spreads over bunds fell almost in a straight line, eventually reaching zero by the time Mitterrand handed the reins to Jacques Chirac in 1995 (figure 6).

A 'radical' change
The French index was erratic though, with further significant falls until a particularly strong recovery in 1983. That final and lasting recovery coincided with Mitterrand’s *tournant de la rigueur*. Nationalised firms were costing the government an exorbitant amount of money amid a protracted global economic downturn. Unlike Corbyn, Mitterrand was interested in nationalising only ailing, unprofitable companies and, unsurprisingly, they remained unprofitable. In fact, they were haemorrhaging money. Only now the government was on the hook for fresh funds and, in short, it couldn’t fund both jobs and productive investment. Democracy got in the way.

The denouement came in March. Mitterrand approved rigorous austerity measures, slashing state expenditures, increasing taxes on workers and consumers by 40 billion francs, while reducing charges on businesses. The former communists were silenced and a new centrist economic consensus prevailed within Mitterrand’s government, driven by his finance minister Jacques Delors.

This case study raises interesting questions about how a Corbyn–led government would fare. Markets could run riot initially, but higher rates and yields widened by 2% relative to their German equivalents almost overnight (figure 6). At the time the franc was pegged to Germany’s Deutsche Mark under the European Monetary System (EMS), a precursor to the euro. However, the finance ministry was forced into successive devaluations to stem pressure on its foreign exchange reserves from capital outflows.

Yet higher yields and a cheaper currency actually did a good job of stemming the leak, with money pouring in from 1982 onward. Overseas investors did not divest their direct holdings (the red line in figure 7) and there were only two quarters in which French firms shifted operations abroad, but still only at a rather modest rate (the dashed red line). Domestic portfolio investment (defined as equity and debt ownership less than 10% of market cap) took flight during only one quarter (dashed blue line). Sure, the government imposed some capital controls, but these were limited by the rules of the EMS. Overseas portfolio investment actually flew into the economy from late 1982 on (the blue line) as foreigners bought the debt of the newly nationalised corporations.

The stock market recovered from its post-election slump, and recouped its relative underperformance within eight months once Mitterrand shored up support in the National Assembly elections, even as he enacted his very
a weaker exchange rate should limit capital flight. And if, even after a period of folly, a Corbyn government jettisons its most left-wing reforms and courts private enterprises just a little, markets could recover very quickly. Of course, this requires Corbyn to allow centrist colleagues to join in the debate. He currently refuses to permit anything of the sort; his army of activists have demonised the terms ‘centrist’ and ‘Blairite’ while threatening MPs and councillors found wanting of hard-left credentials with deselection.

Let’s hope Corbyn doesn’t recall Mitterrand’s supposed last words to his aides: “In economics, there are two solutions. Either you are a Leninist, or you won’t change anything.”

Part 3: Assessing Labour’s manifesto
While Mitterrand’s 110 Propositions provide the best precedent for what a hard-left government might look like, the latest Labour manifesto is nowhere near as radical. Although later we consider whether it can be taken at face value, it’s the only costed and all-inclusive policy document available for an objective analysis of what a Labour government would mean for the economy.

Council tax would be redesigned to reflect current land values so poorer homeowners don’t pay disproportionately more tax on their homes, but this is small fry and there are no sizeable taxes on wealth, property or inheritance. There are populist nods to workers such as extra bank holidays and a freeze on the state retirement age, but no revolution on workers’ rights. The higher minimum wage is quite radical, but then the Conservatives have committed to a very large increase too. Of course there are the nationalisations of the water companies, the National Grid and the Royal Mail, which are likely to prove costly. But they are not really a major affront to free market economics because these industries are natural monopolies (you can’t choose your water provider).

Minimum wages: Who would benefit?
Both Labour and the Conservatives have committed to large and rapid increases in minimum wages, and both propose reaching a minimum wage in 2020 higher than that in most comparable countries (figure 8). Labour promises an increase in the National Living Wage (NLW) to £10 per hour by 2020, more than the £8.75 promised by the Conservative government (which would still be a record high relative to average earnings). The Conservative plan already equates to a three-fold increase in the NLW between 2015 and 2020, while Labour propose a five-fold increase. Labour’s increase would put the UK on a par with France. That might make you gasp, but growth in business investment was no lower in France than in the UK over the 10 years to 2016.

Someone, somewhere along the chain must pay for higher minimum wages. Either domestic firms make less profit, cut jobs or other benefits or pass on the increased labour cost to households in the form of higher prices.


Figure 8: Minimum wages relative to median earnings
Both Labour and the Conservatives have proposed large increases in the minimum wage, which is set to be higher than in many other countries by 2020.
firing squad. Of course, that’s in aggregate and firms that lack pricing power — who are more wage-takers than setters — will inevitably suffer, as will their employees. This is all before accounting for likely spill-over effects on the wages of workers earning a little above the NLW. Previous increases in the UK have been found to affect up to the 30th percentile of earners. These extra costs would also come on top of increases in the cost of providing pensions to employees due to the Conservatives’ auto-enrolment policy, as the minimum employer contribution increases from 1% of earnings to 3% by 2019.

So what would Labour’s plan for the NLW do to inflation? Let’s guestimate that it adds £17.5 billion, or 1%, to household disposable income in 2020 after accounting for spill-over effects and income taxes. That’s an upper-end guestimate because it assumes that firms don’t lower wages and bonuses elsewhere or decrease employment. An increase in the income of low-to-mid income households is likely to generate inflation due to their higher-than-average marginal propensity to consume, but 1% of disposable income is not enough firepower to induce a wincingly high rate of inflation.

A 1970s-style episode of stagflation is also unlikely. That death spiral of high inflation and high unemployment was in part caused by the succession of inflation-indexed annual wage increases achieved by many (unionised) workers. Crucially Labour are not proposing to index the NLW. After the NLW reaches £10, any negative effect on growth or employment will quickly produce subsequent deflationary pressures.

We must also remember that the relationship between wages and prices is historically very weak — close to zero between 2001 and 2016, even when we account for lags. This is in no small part due to the success of central banks in targeting inflation. So higher NLW may lead to higher interest rates, in absolute terms as well as relative to inflation, which brings us to the rub for index-linked bond investors. Any uplift from which brings us to the rub for index-terms as well as relative to inflation, lead to higher interest rates, in absolute account for lags. This is in no small part is historically very weak — close to zero relationship between wages and prices subsequent deflationary pressures.

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Spending and taxes: Only fix the roof when the sun’s shining
Labour promises to more or less maintain borrowing for everyday expenditure at current levels, so its plans for a very large increase in state spending would have to be funded by a very large increase in taxation. The IFS has questioned whether Labour’s tax measures would raise anything like the £49 billion required, particularly over the longer term.

For example, there is the usual overly optimistic reliance on tax avoidance measures, though this isn’t a new risk because the Conservatives used similarly fanciful estimates in the Autumn Budget. Moreover, Labour’s estimate that changes to income tax would raise £7 billion makes no concession for behavioural response – for example, people giving more to charity or setting up tax-free trusts for their heirs. The IFS calculate that even a moderate ‘response’ would leave Labour £4.5 billion short. And the dynamic impact of higher taxes on economic growth could lower tax receipts further if it changes corporate attitudes to hiring and spending.

Any shortfall of receipts is more likely to be made up by higher taxes than more debt thanks to Shadow Chancellor John McDonnell’s own version of a ‘fiscal rule’ – taxes must cover current spending within five years. This part is not too dissimilar to former Chancellor George Osborne’s rule, which he regularly failed to meet with no penalty whatsoever from bond investors – we should take a peculiar solace from this. McDonnell’s innovation is a knockout when interest rates are near zero and monetary policy can not be called upon to stimulate the economy during a recession. This could be summed up idiomatically by, ‘only fix the roof when the sun’s shining’, and reflects the lessons of the vast body of evidence gathered since the financial crisis.

Corporate and financial taxes: More reasons to relocate?
The academic literature tells us that economic growth is far more sensitive to changes in corporation tax than it is to taxes on personal income, consumption or property. Labour plans to increase the corporate rate to 26% in 2020 from 19% today, and we believe it is highly likely that this would have an adverse effect on wages and investment. Still let’s not get carried away. A paper by HM Treasury modelled the long-run impact of the eight percentage point reduction in the corporate tax rate between 2010 and 2015, the biggest percentage point cut in any single parliament since the 1980s. Their modelling work suggests that GDP would be just 0.6% to 0.8% higher after 20 years. While it could have a bigger impact in the short term and the model probably underestimates the effect on foreign direct investment, it still tells us that Labour’s corporate tax hike may be less harmful to long-term growth than some fear.

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In an international and historical context, Labour’s plan for taxation would not make the economy’s tax burden particularly onerous compared to other developed nations. Across the entire economy the UK would still place only half way up a table of the 35 most developed countries when ranked by tax receipts as a percentage of national income. The 26% tax rate is still 4% below the 30% tax rate in effect from 1999-2008, when the economy and business investment grew strongly. It would still mean the UK offered the third-lowest rate of taxation among the world’s seven largest developed economies (the G7).

That said, Brexit already threatens to decrease after-tax profits as regulatory and compliance costs of doing business in Europe rise, and our concern is that this could provide a further nudge to international companies considering relocation. Sure, the UK has a corporate tax rate lower than all of the original 15 EU member states except Ireland (figure 9), where it is just 12.5%. But it is now more important than ever to remain competitive versus Ireland.

Labour also expects to raise £5.6 billion by introducing a 0.5% stamp duty on derivative and bond transactions, claiming that such a tax will ensure a fairer distribution of financial system profits and eliminate ‘destabilising’ speculative high-frequency trading. While it isn’t exactly logical that equities are subject to stamp duty but not derivatives and bonds, and it could provide a useful source of government income, we see this proposed tax as an indirect and ultimately misguided attempt to fulfil those two aims. First, it’s a tax on transactions, not profits, and anyone with a pension will suffer a higher cost of investment. Second, the majority of derivative transactions are for risk-management purposes, not speculation, and the academic evidence would suggest that preventing short-selling via derivatives would likely raise not lower volatility. It clearly gives finance houses another excuse to leave the UK too.

The infrastructure card
Labour’s plans for increased infrastructure spending could have a large positive economic impact. The party’s manifesto sets out a significant package of £250 billion in investment over 10 years, as well as plans to set up a National Investment Bank financing a further £250 billion of private sector investments in public infrastructure. This equates to a 50% increase in government capital spending. Initially, the programme would require extra borrowing, but Labour believes that it too could lower the national debt relative to the size of the economy and even commit to another ‘fiscal rule’ that mandates them to do so over the course of the next parliament.

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As such, most evidence-based estimates suggest that every pound of public investment generates more than a pound of economic output. More economic output raises GDP relative to debt, with the potential for higher output to generate more tax receipts and lower future borrowing requirements.

**Nationalisation: Populism over profits?**

The haziest part of the manifesto is the uncosted commitment to renationalising utility, mail and rail companies. A back of the envelope calculation based on current market capitalisations suggests that this would cost more than £100 billion. That would render any early reduction in national debt all but impossible and could well cause Labour to break its own fiscal rule. Although the government would be acquiring cash-generating assets to offset the new liabilities – and one must bear this in mind when thinking about the impact on public finances – the ability of the civil service to manage them productively is a serious concern (until recently, most government departments couldn’t even measure their productivity!).

McDonnell has claimed that Labour’s nationalisations would be costless over the long term. Theoretically, this is possible if the purchase is made via an equity-for-debt swap, and current market capitalisations suggest that this would cost more than £100 billion. That would render any early reduction in national debt all but impossible and could well cause Labour to break its own fiscal rule. Although the government would be acquiring cash-generating assets to offset the new liabilities – and one must bear this in mind when thinking about the impact on public finances – the ability of the civil service to manage them productively is a serious concern (until recently, most government departments couldn’t even measure their productivity!).

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The consultancy Oxford Economics estimates that the UK national debt as a percentage of GDP will increase by around six points to 95% by 2020 (including nationalisations), still well within the better half of a ranking of developed countries. (Of course, this does not assume a collapse in the capital account!) A recent, well-received academic paper estimates that the maximum sustainable debt for the UK, the point at which the government debt position does not just become a drag on growth but becomes unstable, is 126% of GDP.

The consultancy Oxford Economics’ dynamic modelling work suggests that Labour’s manifesto pledges would push up 10-year gilt yields by 0.75% at most. Even if the tax shortfalls discussed above are made up with higher borrowing, it is difficult to envisage the total debt ratio approaching anything like that of France or Japan, whose debt bond investors are unconcerned with fiscal balances in all but the most intensely leveraged and broken nations.

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Part 4: Corbyn’s left-hand man

No doubt many of you will have been muttering throughout this article: “But how do we know Labour will stick to its manifesto?” Especially when we consider that its relative mundanity belies the radical rethink that Corbyn’s supporters believe he will bring about.

Most strikingly, most of the heavy cuts to working-age benefits proposed by successive Conservative Budgets are kept in place. The IFS estimates that the poorest 10% would still suffer a 7.5% fall in annual net income (including benefits and transfers) by the end of the next Parliament (figure 10). While only the top 5% of earners would experience higher personal income tax rates, higher corporation tax could impact the income of all households if hiring and spending plans fall in response.

So either Corbyn’s ‘people’s champion’ persona is just for show, or he has deliberately chosen to omit a key policy plank from a costed manifesto (presumably because he hasn’t figured out how to fund it while simultaneously delivering free university education, the great vote-winner for the middle classes).

Furthermore — and maybe more importantly, given how Mitterrand’s government was saved by a centrist finance minister — many business leaders fear the influence of the Shadow Chancellor. John McDonnell is a self-declared Marxist, who 11 years ago stated that Lenin and Trotsky were the “most significant” influences on his thought.

Admittedly, that was in a vote-gathering interview with the Trotskyist Alliance for Workers’ Liberty, but it’s not so hard to believe given the ruthless way Labour MPs or councillors who have dissented openly from the Corbyn worldview have been sidelined and silenced. While the majority of Labour MPs are to the right of Corbyn and McDonnell, only a minority are speaking out.

More subversively, McDonnell has also referenced Antonio Gramsci, a Sardinian neo-Marxist who advocated “a long march through the institutions”, by which he meant ingratiating oneself with the established order and mounting insurrection from within.

Unfortunately for analysts, judging just how deep McDonnell’s Marxism really runs and how exactly he intends to turn the teachings of Das Kapital into policy is extremely difficult. We tracked down a copy of his 2007 pamphlet, Another world is possible: a manifesto for 21st century socialism, in the British Library, expecting to find a cache of scandalous quotes. They’re difficult to find. It is a rather bland, to find a cache of scandalous quotes. That wooliness appears to have thickened as ‘Another world is possible’ has been adopted as a slogan of Corbyn’s leadership. When used by Momentum, the hard-left faction of activists responsible for entrenching Corbyn’s power and attracting so much support during the election, it is forcefully anti-capitalist; when used more widely it can mean something much softer, something that appeals to the centrist voters who usually swing elections – an easing of austerity and a redress of policies that have widened the inequality of wealth and stopped social mobility in its tracks.

So it’s really anyone’s guess. Is the Labour manifesto a Trojan horse that will usher in widespread nationalisation, the state-directed allocation of capital and the undoing of economic liberalism? In that case international businesses couldn’t be blamed for exiting in droves and the UK’s cost of capital will rise considerably. Or is it more of a half-baked attempt at progressivism from a couple of political throwbacks hoping to ride the current wave of populism into No. 10? In which case, it probably won’t be as bad as some investors think. And, through the party’s infrastructure-based economic stimulus, there’s even the chance that it could turn out for the better.

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**Figure 10: Distributional impact of personal tax and benefits measures**

The IFS estimates that the poorest 10% would still suffer a 7.5% fall in annual net income by the end of the next Parliament.

Source: Institute for Fiscal Studies.
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