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Market View

What impact does inflation have on incumbents?

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At a glance

- US election: after an assassination attempt on Trump and Biden's withdrawal, Kamala Harris has become the Democratic nominee, set to face Trump in November.

- Impact of inflation on elections: high inflation and rising interest rates have historically led to electoral losses for incumbents, contributing to recent political shifts in the UK, France, India, and Mexico.
- Global political shifts: voter dissatisfaction due to economic pressures has led to significant changes in governments worldwide, with increased support for fringe parties and challenges for incumbents in maintaining power.

A week is a long time in politics. Labour Prime Minister Harold Wilson is thought to have said this in the 1960s, a phrase that appears more prescient than ever.

State of affairs in US

It was never going to be a straightforward election year in the US. After an assassination attempt on Donald Trump on 13th July, polls show Trump leading in several crucial swing states. One week later, President Joe Biden announced he would withdraw from the race after concerns surrounding his age and fitness. Subsequently, he has endorsed his vice president Kamala Harris, who made her debut as the presidential candidate this week. She secured enough delegate support to become the Democratic nominee and will face Trump in November.

Taking a wider view, most of the world has or will head to polls this year. As such, we thought it worth taking a closer look at how inflation impacts incumbents from an economic, social and political perspective.

How is inflation impacting elections?

We have covered inflation, high interest rates and their global impact in the weekly Briefs for some time. This recent period of inflation is particularly notable. We have not experienced such high inflation in the developed world since the 1980s when double digit interest rates led to recessions, high unemployment, and widespread strikes. The UK, in particular, faced labour unrest during this time, namely the miners' strike of 1984-1985.¹ Meanwhile, the US dealt with the air traffic controllers' strike in 1981,² and France saw strikes across various sectors, including transportation, education and public services.³

Inflation then and now

There are crucial differences between these two inflationary periods. In the 1980s, inflation led to higher unemployment rates, which eventually helped curb inflation. Today, post-pandemic labour trends show more resilience. Labour shortages and high demand for services upon re-opening have resulted in higher wages, contributing to sustained inflation.

Despite higher wages, incumbent presidents and prime ministers are not receiving recognition for this. Even as real incomes have begun to pick up, consumers are not happy paying £1.50 for a loaf of bread when it used to cost £1. That said, whilst food and non-alcoholic beverage prices rose by 1.5% in the year to June, they are down from 1.7% in May. The June rate is the lowest since October 2021, and compares with 19.2% in March 2023, the highest annual rate in over 45 years.⁴ Although the rate at which food prices are rising is slowing, food prices aren't likely to fall materially.

Does inflation make it harder for incumbents to be re-elected?

The rising cost of living erodes consumers' purchasing power, while rising interest rates increases borrowing costs for businesses and consumers. Public finances face pressure, leading to potential budget deficits. All this leads to inequality, public dissatisfaction, and labour unrest. More often than not, there are electoral consequences, with increased likelihood of incumbent politicians losing their seats.

UK and French elections

We have witnessed this discontent in the UK and France. In the UK, Keir Starmer's Labour Party delivered a decisive election victory earlier this month, leaving incumbent Prime Minister Rishi Sunak and his Conservatives suffering their worst-ever defeat. Several factors contributed to the Conservatives' losing power after 14 years, such as austerity, cuts to public services and Brexit, which remains divisive. But some argue it was Liz Truss's disastrous mini budget that spelled the end of the Conservatives, a budget that included large, unfunded tax cuts and increased public borrowing that spurred a sharp sell-off in UK government bonds and sent yields spiking. This quickly filtered through to the mortgage market, sending mortgage rates up significantly while the pound fell to the lowest level against the US dollar in decades.

Meanwhile, the European Parliamentary elections in June showed surging support for right-leaning parties in both France and Germany. This led French President, Emmanuel Macron, to call a snap election to try to discredit Marine Le Pen's populist National Rally as a serious party of government. It was a big gamble for Macron. After Le Pen's party secured approximately 34% of the vote in the first round of the French parliamentary election, comfortably ahead of Macron's incumbent party, the second round of elections showed strong support for the left-wing block New Popular Front and Macron's party. All three parties have less than 100 seats and therefore no majority, so France now faces a hung parliament. The centre ground seems to have been eroded as the electorate show their dismay by supporting the extremes of politics.

In India, Prime Minister, Narendra Modi, lost his outright majority for the first time in a decade, and will now focus on forming a coalition government which will make passing important reforms more challenging. In Mexico, Claudia Sheinbaum's landslide victory sent the peso and Mexican equities falling as markets feared more extreme policies.

We have witnessed changes in governments globally after high inflation topped the list of electoral concerns. In the UK, while the Labour Party's manifesto was about change, real change will prove difficult given the limited fiscal headroom. Meanwhile, France will have to deal with a hung parliament and the very real possibility of little getting done. We have seen large swaths of the population voting for fringe parties on both the left and right, and there is no question inflation has played a role in voter's minds when they cast their ballots. In the US, Republicans have blamed President Biden for inflation, even though there are a host of other reasons why inflation is so high.

Historically we have seen desires for political change when real incomes are squeezed. This time is no different. Government debt levels and fiscal policies will remain a focus for incoming parties, and we believe political events will continue to impact markets for some time. However, focusing on companies that can continue to compound earnings regardless of who is in power should be a cornerstone of investing in this climate.

[1] BBC, <https://www.bbc.co.uk/news/uk-england-68244762>

[2] UTA, <https://libraries.uta.edu/news-events/blog/1981-patco-strike>

[3] Cairn, https://www.cairn-int.info/article-E_ES_020_0031--striking-and-secularism-in-france-in.htm

[4] Office for National Statistics

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