

An uncertain election result may lead to stagnant financial markets

Written by The Conversation

For the second time in the space of ten days, it appears that betting markets and pollsters have got it wrong. First, despite [odds showing a 90% likelihood](#) of “Remain” winning, the UK voted to “Leave” the European Union in its June 23 referendum.

Now, a mammoth federal election campaign has resulted in political stalemate in Australia, and the result will not be known [until Tuesday](#) at the earliest.

Clearly, the repercussions of a hung parliament are not as [wide-ranging as](#) [“Brexit”](#) and we are unlikely to see Canberra’s streets [flooded with protesters](#). However, when Australian markets open on Monday they will still be faced with a high degree of [political uncertainty](#). Investors do not tend to react favourably to such ambiguity.

Investors reduce risk under political uncertainty

Investors tend to respond in one of two ways. The [most-common situation](#) is for the political uncertainty to manifest in higher levels of market volatility and a flight to quality as investors try to reduce their exposure to risk.

This was what we witnessed post-Brexit: Australian stockmarkets and the dollar fell by more than 3%, while “safe” government bond [yields hit an all-time low](#).

An alternative is for markets to become locked in stasis – where investors sit on their hands, unsure as to whether they should buy or sell. Market liquidity falls and asset prices become resistant to change.

This is effectively what happened following the hung parliament of August 2010. In the aftermath of that election, stock prices remained within a tight trading range and the dollar hardly budged over the course of the following week.

When the result of the [2016 election](#) is finally known, it appears that the outcome will be either a minority Coalition government or a hung parliament. The Senate is likely to be more fractious than prior to the election.

Talk has already started about potential unrest among the conservative faction of the Liberal Party who supported former prime minister Tony Abbott. There is even discussion of an [election re-run](#) if the parliament proves ungovernable. Clearly, this uncertainty could linger for months.

Concerns for jobs and growth

The likelihood of a lengthy period of uncertainty is important. It means it will be [difficult to pass any economic or budgetary reforms](#). Without such reforms, it is unlikely the budget will return to surplus in the near future (if ever) and it becomes more likely that the AAA credit rating will be lost.

This creates multiple concerns for Australian financial markets, and the broader economy. A credit rating downgrade will likely [increase the cost of funding](#) for Australia's banks.

The [Big Four banks](#) will be particularly impacted given the significant role that offshore funding plays in their balance sheet management. This will mean higher interest rates for borrowers – which would not be beneficial for the housing market.

A prolonged period of uncertainty will make it difficult for firms to finalise investment decisions. At a time when the economy is still attempting to transition away from the boom in mining investment this will dent economic growth and employment. So much for “[jobs and growth](#)”.

Essentially, this is a recipe for a “[risk-off](#)” environment of declining stockmarkets and a depreciating Australian dollar. It is also likely that the market will price a [higher likelihood](#)

of a reduction in the RBA target rate at the July or August meeting. This will further aid a continued rally in relatively safe government bonds (bond prices rise as yields fall).

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If you consider the ongoing political uncertainty resulting from Brexit and the forthcoming US presidential elections in addition to the federal election, then months of nervous markets may lay ahead.

Lee Smales does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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