A Bird's Eye View
Sparrows Newsletter

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Political Risks

The world is awash with political uncertainty: Brexit, Trump, the rise of populism in Europe, the National People's Congress in China, North Korea, and now a snap election in the UK. Yet financial markets are unruffled. Why is this the case, and what might it mean for your investments?

The expected Trump effect didn't materialise in the US. Market participants are instead betting that an expansionary fiscal policy and pro-business legislation under a Trump presidency will prove supportive to the economy and reflationary. Equity markets have rallied on the back of these expectations and it may be the case that they are now fully priced in, but employment remains below pre-crisis peaks, and inflation is on the rise. President Donald Trump remains a wild card; his tweets hint at potentially massive changes to US policy on China, in addition to calling out companies and Wall Street executives. With a move into the deep unknown, it is unclear why the Volatility Index remains at historical low.

A possible explanation of US euphoria is that Trump presages a rebalancing of world order, in diplomatic, military and economic terms. His election may be more negatively felt by countries that depend heavily on exports to the US (China, Japan, Germany/EU, Mexico), or on US military protection (Europe, Japan).

The fundamental message sent by US voters mirrors that of voters in the United Kingdom and throughout Europe: the status quo has become unacceptable.

There is evidence that Europe is more fragile under the surface than has previously been recognized. New episodes of European theatre emerge every now and then. Last year, such episodes included the Spanish re-election and the Italian constitutional referendum. This year will see contested European elections in France and Germany and a revival of Grexit.

The European Commission is bracing for troubled times ahead with a more protectionist trade stance from the US, two years of critical negotiation with the UK on its withdrawal from the bloc, an aggressive Vladimir Putin to its east and south, and a continuous flow of migrants from the war-ravaged Middle East. As a backdrop to all of this, Europe's governments are still struggling with the effects of the debt crisis nearly seven years after Greece's first bailout.

The markets were unprepared for the results of the UK's European Union Referendum (Brexit), and the majority vote (52-48) to leave the European Union stimulated a bout of global risk aversion across markets and risk asset classes. The UK finds itself very much in uncharted waters: although the rules for leaving the Union are spelled out in Article 50 of the Treaty of Lisbon, the drafting is vague and such exit is unprecedented. A long, complex negotiation lies ahead. It is much too early to be definitive around any lasting implications; however here is what we do know.

By voting to leave, the UK has effectively "poked the bear" and consequently is unlikely to experience a smooth negotiation. Fearing that other member countries might follow suit, EU officials have little incentive to make exit attractive. While the vote clearly affects the UK, investors are also concerned about the potential knock-on effect across Europe and beyond. Marine Le Pen, French presidential hopeful and leader of the far-right National Front party, has already rallied around a "Frexit." With a number of meaningful elections across Europe in 2017, the growing populist momentum is a real concern. As a result, interest rates across the Eurozone have ticked up this year.

This increased uncertainty may have a tangible near-term impact on both EU and UK growth. Estimates of magnitude vary, but there is near unanimity that the hit to gross domestic product (GDP) will be material. UK growth had already slowed during the Referendum cycle, and the combination of the Leave vote and the associated lengthy negotiation timetable could significantly dampen appetite for foreign direct investments. Sterling's post-referendum drop made history, dipping 10 percent at the low point; this will drive inflationary pressure. Both Northern Ireland and Scotland voted overwhelmingly to remain within the EU; Brexit is a catalyst for them to rekindle their independence movements, further exacerbating the general sense of uncertainty.

Is this a Lehman Brothers moment? No. Does it present a short-term risk? No. Brexit does not represent a global systemic risk, and it is important to note that many of the post-global financial crisis regulatory changes have prepared the global banking system to withstand periods of stress.

Central banks have been consistent in their message: they have multiple options and are willing to use all available tools to provide liquidity as needed. This is particularly important in the UK where the banking sector faces tremendous stress (equities in the sector have fallen by 30 percent). So far, we have not seen any monetary policy changes; however, the Bank of England may ease policy if the economic consequences of Brexit begin to impair growth significantly. Successive policies involving low or negative rates and quantitative easing have produced diminishing effects.

The recent ECB Financial Stability Review report warned of the growing risk of global market corrections, citing growing political uncertainty in Euro area and continued fragilities in emerging markets that could reignite global risk aversion.

In a world where economic growth is elusive and fragile, and where investor confidence is vulnerable to shocks, we expect the rise of populist politics to remain a key risk driver globally. While these are geopolitical issues, the danger is that they translate into economic policies that may harm macroeconomic fundamentals and, ultimately, capital markets.

Investors should recognize, once again, that global risk asset markets correlate very strongly during times of market stress — at exactly the time that investors are most reliant on the diversification benefits of a globally diversified risk asset portfolio. This is predictable, and heightens the utility of a "risk control" portfolio of high-quality fixed income — even at these low yields. This risk control portfolio continues to offer true and robust diversification benefits during times of market stress: opportunities for investors still exist during volatile times, but it's important to ensure proper portfolio diversification.

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