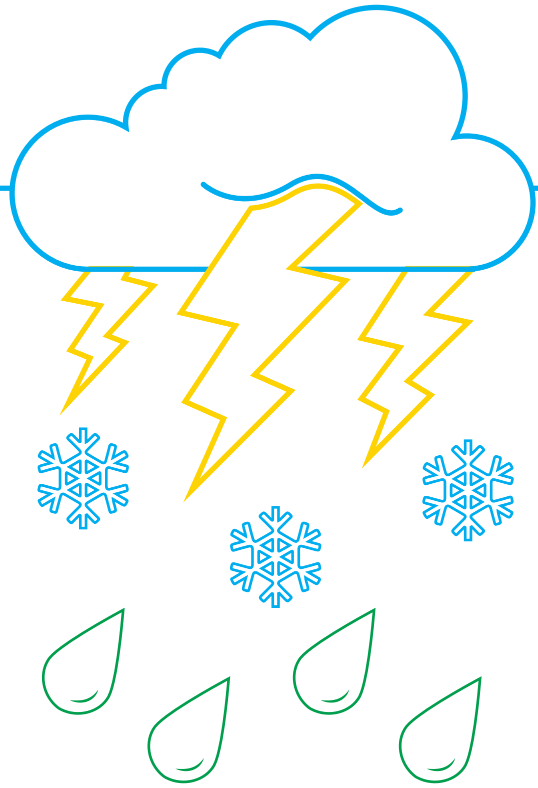
MACRO **MATTERS**

Going to extremes

With 2017 now upon us, it is clear that a new political paradigm has emerged. The prominence of Brexit, Trump, Le Pen, Corbyn, Alternative for Deutschland and many others is not the result of idiosyncratic national political issues; they reflect a systemic political shift.



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"My friend, the panda will never fulfil his destiny, nor you yours until you let go of the illusion of control." From Master Oogway in the movie Kung Fu Panda.

I used the days between Christmas and New Year to clear my desk, inbox and head. In doing so, I came across an excellent paper called "Going to Extremes: politics after Financial Crises 1870-2014"[1]. It conducts a study of the political fall-out from systemic financial crises over the past 145 years and has valuable insights for today's new political paradigm.

A SHIFT TO EXTREMES

The paper's main finding is that policy uncertainty rises strongly after financial crises as government majorities shrink and polarisation rises. Following a crisis, voters seem to be particularly attracted to the political rhetoric of the extreme right, which often attributes blame to minorities or foreigners. On average, extreme right-wing parties have increased their vote share by 30% after a financial crisis. However, the authors do not observe similar political dynamics in 'normal' recessions or after severe macroeconomic shocks that are not financial in nature. They believe this is because normal recessions are viewed as "excusable", while financial crashes are not. Moreover, financial crashes can entail bailouts, which are typically unpopular with the main electorate.

1. Funke, Schularick and Trebesch (2015)

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This push to fringe politics can take a while as governing becomes more difficult after financial crises, irrespective of which parties are in power. Following World War II in particular, crises have been associated with greater political fragmentation. This, in turn, is associated with a higher probability of government crises and changes in leadership. Street protests also typically increase in the aftermath of financial crises, with riots, strikes and demonstrations seen as an additional political constraint on governing. All this supports the phenomenon that economies usually only recover very slowly after a financial crisis due to dysfunctional politics.

INCOME INEQUALITY AND GLOBALISATION

There is clearly a deep feeling of anger and disappointment with the establishment in large groups of society. Besides the fragmentation in politics, the fall-out from the financial crisis and the bank bailouts researched by Funke, Schularick and Trebesch, there are several other factors at play. For instance, rising income inequality in developed nations is a key driver, even as global income inequality has actually decreased (the World Bank reports that the number of extremely poor people has fallen 35% since 1990).

Globalisation is seen as depriving the middle classes in developed markets of opportunities and jobs. The resulting anger can be converted into votes. During his campaign, president-elect Trump used foreign trade as his lightning rod in his defence of the beleaguered American middle class. While every economist worth his salt can explain the broader benefits of globalisation, individuals feel threatened and worse off as specific jobs and opportunities move abroad. Increasing immigration and terrorism have exacerbated this trend. According to BCA research, 72% of the foreign-born workers in the US have at least a high school diploma, which puts them into direct competition with equally educated native born workers.

WHAT DOES THIS MEAN FOR MARKETS AND PORTFOLIOS?

The cyclical backdrop becomes more challenging in 2017, with the US economy approaching the latter stages of its economic cycle. During this period, equity Sharpe ratios typically become less stable and predictable, while the world starts to pay more attention to systemic issues. On top of this, the new political paradigm of opportunism and isolationism appears to be here to stay. We believe we are likely to get less fiscal austerity and global trade (with possible trade wars), alongside more protectionism, political risk, inflation and uncertainty.

We would argue that this backdrop is broadly neutral for bonds despite the upward pressure on inflation due to increased protectionism, tariffs and taxes. Indeed, we don't believe that we're at the start of a sustained bear market for bonds as high global debt levels make growth vulnerable to higher rates, and we see increased uncertainty and recession risk. This seems to be textbook 'late cycle' dynamics, which should provide strong demand for bonds and other safe haven assets.

Growing populism is adding to the challenges for equities in the coming years, given that we are moving towards the end of the economic cycle and valuations are already high. In addition, rising barriers to trade and immigration are likely to raise labour costs, especially in regions that are already at full employment such as the US. This, in turn, could lower profit margins. Domestic companies in the US could benefit, while large multinational companies may suffer the most. Open economies, such as Korea and Taiwan, are dependent on world trade and could also face headwinds. Although commodity prices could suffer from weaker global trade, gold and especially oil have historically been the most efficient hedges against geopolitical risks.

THE ILLUSION OF CONTROL

As master Oogway teaches Shifu in Kung Fu Panda, the most important conclusion is that we need to let go of the illusion of control. The Trump and Brexit victories highlight that populism can pop up in any country, even in two of the world's most capitalist countries. The new commander-in-chief of the free world at present seems to rule his empire via tweets rather than via traditional policy statements, so who knows what could be said? If a trade war emerges, the precise execution of strikes and counter strikes will be key in gaining an idea of winners and losers in sectors and currencies for instance. It's time to expect the unexpected.

We don't believe there will be any major trends that last for quarters. Instead, we expect momentum in markets to be short-lived and mean reversion to occur regularly. Markets tend to overshoot on newly emerging political risk and correct in the days, weeks or months after the news hits markets. The recent market reaction on the Trump victory only lasted for a few hours. This means it becomes even more important to keep portfolios diversified, liquid, and flexible. Medium-term themes still matter but it is crucial to be nimble and actively trade around these themes as they get quickly get priced in (or out) by markets.

Over the long haul, the degree to which rising populism hurts or helps investors will depend on how far it proceeds. If it simply restores real wages, increases fiscal spending, allows interest rates to come off the zero bound and reduces inequality while restricting some of the trade and labour flows, then the impact on investor portfolios could be reasonably benign. In contrast, if the populist backlash begins to spiral out of control and morph into a trade war or even worse, then the outcome could be much uglier than most investors currently expect.

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