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Financial markets remain political

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Given all the political uncertainties in the world right now, it is easy to become pessimistic – perhaps too easy. In fact, the fundamentals suggest the market decline in October should be categorized as a classic autumn correction, not a recession-induced bear market. But geopolitical developments, above all the US-China conflict over trade but also other unresolved issues, can be expected to keep global financial market volatility (on both sides) higher than normal.

On 4 October, US Vice-President Pence made it clear that America's conflict with China was not just about bringing down the US trade deficit. It is much more a case of rivalry with China over technological, economic, military and therefore geopolitical supremacy, as we highlighted back in our April market commentary. Meanwhile, Jair Bolsonaro's victory in the Brazilian presidential election was further confirmation that politicians who prioritize national interests over globalization are enjoying increasing electoral success. A growing proportion of the world's population is propelling politicians of this kind to power, which is neither good nor bad when taken solely from the perspective of economic and financial market development. However, because this phenomenon represents a sharp change to the status quo, it is driving up volatility.

Dominant, nationally-oriented politicians have come to power not just in Russia and China (which started the trend towards prioritizing national interests), but also in Brazil, the Philippines, Poland, Hungary, Italy and the US. In other words, nationally-oriented politicians hold the reins of power in countries that together make up more than 50% of the global economy. The established traditional parties, which have (perhaps over-zealously) supported ever greater globalization, are being voted out by electorates who are more concerned by the disadvantages of globalization and the accompanying trend of migration than the corresponding advantages. Although the economic policies preferred by nationally-oriented heads of government – such as tax cuts for companies and individuals alike, prioritization of local jobs and industries, and higher government spending – do initially help to stimulate the economy, they are also likely to drive up inflation.

An important question here is whether investment is being channelled into areas that improve productivity. If so, the rise in inflation would prove only a temporary phenomenon, as would the rise in bond yields and the general level of interest rates. An additional insight in this area is provided by Harvard Professor Dani Rodrik, who has postulated that the global economy currently faces not a dilemma but a "trilemma". Specifically, he argues that in a globalized world a country can either a) be far advanced in the process of global integration, b) retain its traditional democratic institutions, or c) remain a sovereign nation – but can hardly do all three simultaneously. According to this theory, if a country's economy is fully integrated into the phenomenon of globalization, it will increasingly cede the powers of its own democratic institutions to a supranational authority, e.g. in Brussels. It appears that such a step is unpopular in Italy and other countries. Welcome to a structurally-driven rise in political, economic – and hence also to technical volatility on the markets.

> "Risks can be spread through the use of multiple asset classes and focus modules. With volatility on the rise, such an approach continues to make sense."
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> Gérard Piasko, Chief Investment Officer

Although the October correction may have been an early expression of this rise in structural-policy volatility, it may also have been a cyclical phenomenon, coming in the late phase of the current global economic cycle. It was triggered by a combination of rising US bond yields and evidence of weaker economic growth outside of the US. A tight US labour market pushed yields on US Treasuries above the 3.2% level, while the trade conflict together with Italian and Brexit uncertainties led to weaker European economic growth – which in turn prompted cyclical companies to adopt a more cautious outlook. In view of the trade dispute, it is hardly surprising that corporate managers try lower the expectations of analysts, perhaps also with a view to being able to surprise on the positive side at a later stage.

Financial markets will remain fairly political. In our view, many political problems are likely to remain unresolved. The confrontation between the Italian government and the EU Commission, which rejected Italy's proposed budget deficit of 2.4% of GDP, could drag on for quite a while, for example. While the EU could ultimately impose a fine of perhaps 0.25% of GDP on Italy, the budget decision can really only be made by the Italian government. An important question going forward is whether the Italian government will be influenced in its decision by market forces. On the one hand, it is committed to delivering on its promises to the electorate, namely to lower taxes and introduce a minimum income for the less affluent sections of the population. On the other hand, Italy will hardly be able to finance its debt mountain of more than 130% of GDP if the fixed-income market demand yields of 4-5% on Italian government bonds. ECB President Draghi has already indicated that no central bank assistance would be forthcoming in such a scenario. The still unresolved Brexit problem is another major item on the long agenda of urgent political issues.
And last but not least, we have the trade conflict, which is about so much more than just import tariffs. An escalation of this dispute, which is set to see 25% tariffs being imposed on Chinese imports into the US from 1 January 2019, could have a greater effect on export-oriented countries and cyclical financial markets than defensively positioned countries or those whose economy predominantly revolves around the domestic market. The reassertion of control by the Democrats in the House of Representatives could possibly make US President Trump to pursue a less radical policy – and equities have historically performed better when there has been a division of power between the executive and legislative branches than when both have been dominated by a single party.

In summary, we appear to be confronted with "political" markets at the moment. Given the long list of political issues in the spotlight, this is likely to be true for 2019 as well as for the remainder of the current year. There is no clear recipe for such a situation, but ensuring balanced diversification across various asset classes and focus modules – i.e. avoiding concentrations in particular segments or countries – will reduce the risks. When volatility is on the rise, such an approach only makes sense.

Gérard Piasko

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