Political Risk Emerging at Home

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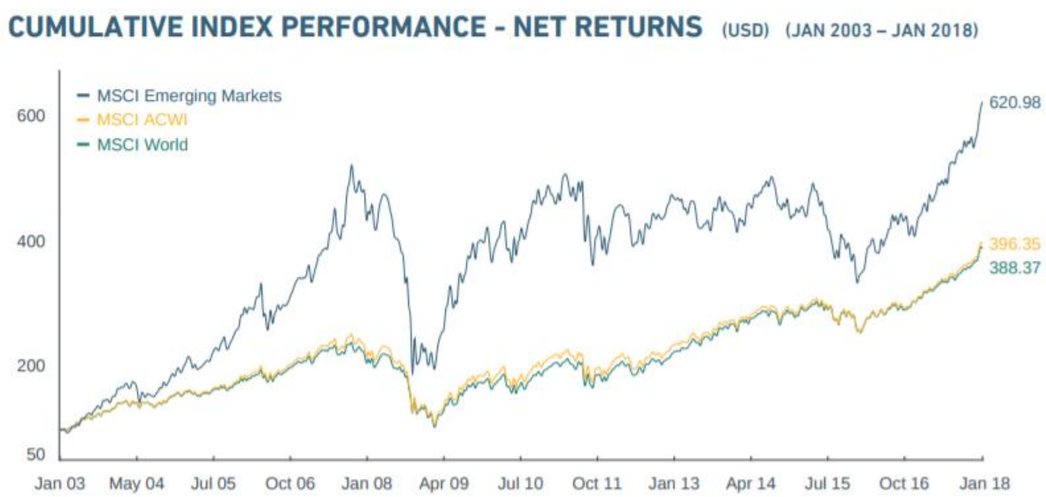
During the past year, emerging markets have performed particularly well compared to the global market performance as a whole. The MSCI emerging markets index posted an annual performance of 37.28% in 2017, compared to 22.40% for the MSCI world index. Due to the overall strong results on virtually all financial markets, this took place somewhat out of the spotlight. The graph below shows that over the past 15 years, emerging markets have clearly outperformed the global aggregate, but also have experienced some big downturns in the process. While the US stock market, for example, has ended the past 8 years with positive returns, emerging markets have only managed to do so 50% of the time. The risk-return trade-off when investing in these markets is thus illustrated here. There are several risks that are often cited as impacting investments in emerging markets specifically or more severely, such as unstable currencies, weaker corporate governance structures or a lack of liquidity as these securities are generally less widely traded compared to the ones issued in developed economies. One of the main risks that is almost always strongly highlighted is the potential for political instability in these regions. Weaker democratic structures or authoritarian regimes make the market particularly prone to government interventions. Extreme tax increases or even nationalizations and major instability can result in a situation of civil war, with all the wealth destruction that follows. However, there is also potential to quickly overturn a situation for the better, so risk has to be defined as a symmetric concept here, that allows for down- and upsides.



The recent case of South Africa has been a good example of this possibility. In December, the ruling ANC chose Cyril Ramaphosa as the new leader of the party, over Nkosazana Dlamini-Zuma, which meant that political power in the country changed hands radically. This ultimately led to the resignation of Jacob Zuma as president earlier this month, after a few years that were marked by multiple corruption allegations and repeated requests for his resignation. By August 2017, his presidency had survived eight motions of no-confidence. These struggles, along with Zuma's decision to dismiss Finance Minister Pravin Gordhan, led to a downgrade of South Africa's credit rating in April 2017 to the junk status, with an exacerbated fall in the rand and a decline in the value of the region's banking shares and government bonds as a consequence. Ramaphosa, who also has a history in the private sector in South Africa, is welcomed by the markets as being more business-friendly. The graph below shows that since December of last year, South African stocks have strongly increased in valuation compared to global stocks in general, even crossing the 1.00 mark. Next to that, the government's rand debt has also delivered strong returns in the recent period. Shortly after the announcement of the country's new budget, it had a total year to date return of 13.9% for 2018. This new budget is one of the first tangible indications of the change in policy that should follow the change in leadership. According to Citigroup Inc., this should probably be enough to avoid a downgrade of the country's credit rating to the junk status by Moody's, the only big rating agency that had not done so yet. The currency markets are no exception on this optimism, with the rand rallying more than 20% since November 2017, and expected the strengthen another 6% to 11% against the dollar according to Standard Chartered Plc.

The current political situation in the developed world shows somewhat of a contrast with the story above. In several of the recent examples, big political movements have been less welcomed by the financial markets. The Brexit vote, most notably, has triggered some very sharp negative reactions. The next day, the pound plummeted against all the other major currencies, with an 8% loss against the dollar, an 11% loss against the yen and a 5.8% loss against the euro. The equity market reaction in London was also very negative, the FTSE100 opened more than 8% lower on the day after the referendum, and ended up losing 3.2% for the day. The revenues of the companies in this index are mostly generated in foreign countries however, so the 7.2% drop in the FTSE 250, which depends more on the UK for revenues, might be more meaningful to point out here.

Next to that, another separatist movement that managed to get a democratic majority behind it is found in Catalonia. Although generally financial markets are not that worried that the movement will actually lead to a threat to the Spanish state, some results do show that an increase in the risk that it actually would happen is viewed as bad news. For example, on the 27th of October, the day of a vote for independence by the Catalan parliament, the Ibex 35 index closed down 1.5%, while the broader European equity market showed a positive performance.

The avoidance of an election victory for the nationalistic parties in countries such as France or the Netherlands, show that they have not managed to convince a majority of the population in all regions, but the fact remains that these political movements have gained substantial ground in recent times. Most recently, the Five Star Movement winning a majority of the votes in the Italian elections, was another clear example of the momentum Euroscepticism has gained.

That brings us to question whether it is fair to consider political instability as a factor that makes investing in emerging markets much riskier than investing in developed economies. Of course, the aforementioned cases are just a few examples in a much broader scope of markets to be considered, but the overall feeling one gets when browsing through political news these days is substantially different than it used to be. Next to the nationalistic movements in Europe, the world's largest economy, the U.S., is currently led by an administration that propagates an "America First" approach, meaning that it is no longer the strong supporter for globalisation and free trade as it used to be. The newly approved tariffs on solar panels and washing machines are some concrete measures taken in this regard, and recently Trump also announced a proposed tariff on steel and aluminium. He further added to the concerns tweeting "*trade wars are good, and easy to win.*"

On the other hand, the other major player in the global economy, China, has recently taken over the role of pushing for more open markets and economic globalization. In his speech in the world economic forum in Davos in the beginning of 2017, Chinese president Xi Jinping focused on this topic and made the following remarks, among others:

> *"Economic globalization has powered global growth and facilitated movement of goods and capital, advances in science, technology and civilization, and interactions among peoples. (…) It is true that economic globalization has created new problems, but this is no justification to write economic globalization off completely. Rather, we should adapt to and guide economic globalization, cushion its negative impact, and deliver its benefits to all countries and all nations."*

While most economists agree that globalization has a net positive effect on the different economies around the world, there seems to be a tendency to put stronger emphasis on the negative side-effects these days. It is definitely interesting to see this change in dynamics in the global, political and economic landscape, but in the long run, if the trend persists, it would fundamentally disadvantage the developed economies. As an investor in financial markets with a long-term horizon, this is definitely something to take into account when assessing the geographical allocation of assets in your portfolio and their corresponding risks.

Sources: MSCI, Bloomberg, BBC, CNBC, Financial Times, CNN, Investment Week, CBS news, World Economic Forum

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