Economic Insight

Politics and markets will reconnect

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Executive Summary

- War in Ukraine and Syria, rising tensions over North Korea, high policy uncertainty related to Brexit and the Trump presidency, a super-election cycle in Europe … political risk is noticeably higher than it has been in decades. Meanwhile, financial markets are rushing from one high to the next.

- Why are markets jubilant despite widespread political gloom? We find that improving economic momentum indicators since mid-2016 largely swamp political worries, while the impact of monetary policy on the risk-return expectations is still dominant.

- The disconnect between political uncertainty and market performance is unlikely to last. Monetary stimulus will be withdrawn. The recovery will peak at one point. Assuming that the political risk level will remain high, markets will reconsider, although an immediate sharp reaction looks unlikely.

1. The great disconnect

Most indicators of both international and domestic political risk have been on an upward trend for several years. In addition to this undisputable trend, the world has recently witnessed a series of large, often negative and destabilizing political events: war in Ukraine, Syria and Yemen, the migration crisis, Brexit, the Turkish coup, the election of Donald Trump, and tensions with North Korea, to name the most unsettling.

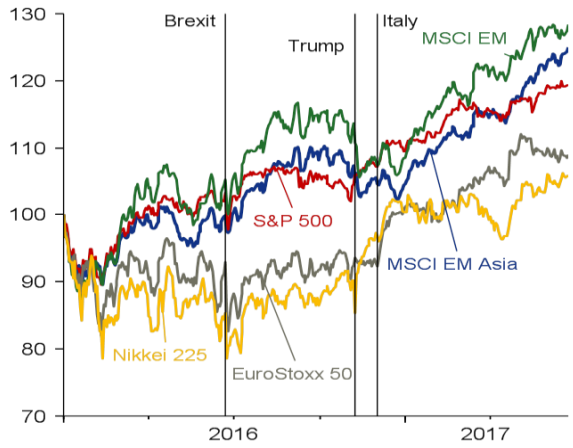
Many political analysts are warning that the world is now in a process of systemic political change, whereby both the political consensus underlying western democracies and the post-war global order are fraying. If this is so, the world will not return to the extraordinary political stability witnessed in the decades since the end of the Cold War.[1]

Historically, equity markets have recovered from political shocks, even large ones like the Iraq war and 9/11, within a few months. In recent times, however, we have measured political market downturns in hours, if they happened at all. Several stock indices around the world reached record highs in the first half of 2017.

[1] Katinka Barysch and Michael Heise, 'Big bang? Financial markets and systemic political risk', Allianz Research, July 2017.

Although there were some wobbles in bond and currency markets in response to political developments, it is not possible to say whether such moves priced in political risks 'correctly', since there is no benchmark for what the reaction should be. The overall impression is that there is a great disconnect between political risk and market performance.

Stock market indices (Jan 1, 2016=100)



Sources: Thomson Reuters Datastream, own calculations

What is political risk?

Definitions of political risk abound. For the purpose of this paper, political risk is defined as the likelihood that a political action or event alters investors profits or return expectations.

The distinction between political risk and political uncertainty is important. A risk can be relatively clearly described and a probability can be attached to it materializing. In today's dynamic and interconnected political context, it is often more correct to speak of political uncertainty, since the probability of an event cannot be predicted using a normal distribution and the consequences of any given political event are almost impossible to describe with accuracy.

2. Missing market signals

None of the traditional political risk indicators that investors look at – spreads, volatility, oil prices – has been flashing red in recent times. This may have less to do with political fundamentals than with changes in the policy and market environment.

Spreads

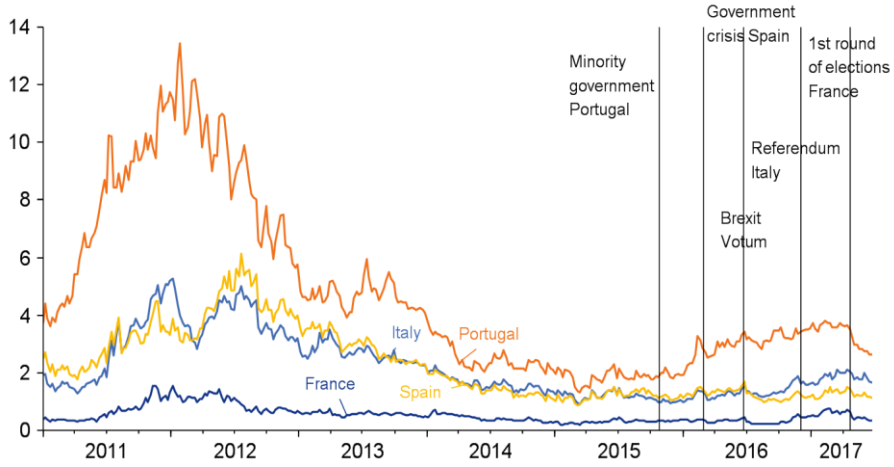
The successive measures of the European Central Bank[2] have had the undeclared, but probably not unintentional, effect of compressing yields, particularly

[2] Not just QE lowered spreads but also SMP and OMT. Gibran Watfe, 'The Impact of the ECB's Asset Purchase Programmes on Sovereign Bond Spreads in the Euro Area', Bruges European Economic Research Papers,35/2015.

in the eurozone periphery. Without QE, sovereign funding costs for Italy, for example, may well be 200-250 basis points higher, reflecting more accurately underlying risks.[3] And while French spreads rose and German ones went negative in the run-up to the French presidential election, this may also have been driven by a scarcity of German bunds as a result of the ECB's asset purchase program.

It is an open question whether monetary policy simply insulates markets from political risk or whether it reduces the level of political risk itself, for example by taking pressure off governments temporarily. We would argue that spread compression not only complicates the assessment of underlying political risk, it also allows governments room for complacency on reforms, which might store up economic and political risk for the future. (More on monetary policy below).

Spreads of 10-year government bonds of German Bunds



Source: Thomson Reuters Datastream

Volatility

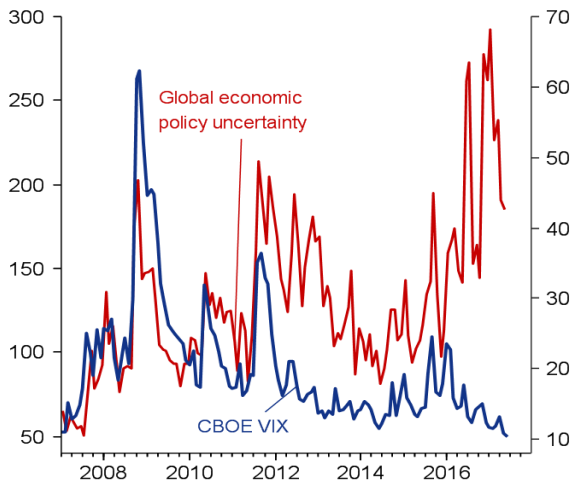
Volatility indices used to move roughly in line with political uncertainty, as measured by the global economic policy uncertainty index. Today, the relationship seems to be inverse. Despite heightened anxiety surrounding, inter alia, the Trump administration in the US and elections in key European countries, the VIX index, which measures expected stock-market volatility, has been extraordinarily low in 2017.

There might be several reasons for this: continued monetary stimulus coupled with forward guidance, a persistent savings glut[4], widespread consensus on the positive economic outlook, confusing political signals and trading strategies that bet on volatility falling further.[5] Some analysts expect that volatility will spike upwards once current trades on falling volatility are unwound. Even if there is no

[3] Tomasz Wieladek and Antonio Garcia Pascual, 'The European Central Bank's QE: A new hope', CEPR Discussion Papers, 2016.
[4] The global savings glut – excess of desired saving over desired investment – suppresses interest rates and props up asset prices, with investors' risk aversion further muted, as they embark on the search for yield in a low-rate environment. Hung Tran, 'Uncertain politics, resilient markets – A lasting disconnect?', IIF, Capital Markets Monitor, May 2nd 2017
[5] Robin Wigglesworth, 'The fearless market ignores perils ahead', Financial Times, April 18th 2017; Tanuj Dutt and Robert Samson, 'Mispricing of volatility in a post-QE world', Nikko AM, March 27th 2017; Lubos Pastor and Pietro Veronesi, 'Explaining the puzzle of high policy uncertainty and low market volatility', VoxEU, May 25th 2017.

sudden volatility burst, it seems highly unlikely that volatility will stay at its current record-low level.

Global economic policy uncertainty Index (lhs) & CBOE VIX (rhs)

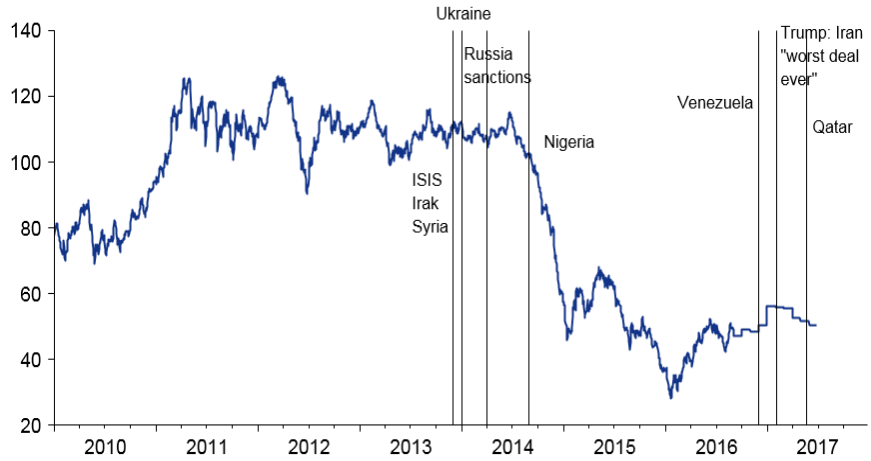


Source: Thomson Reuters Datastream

Oil prices

Although there is a widespread perception that oil prices act as a gauge for (geo-) political risk, the relationship is not well established. Nevertheless, it is notable that the oil price is hardly driven by political concerns today, although a significant number of major oil producers, including Russia, Iran, Syria and Venezuela, are affected by political turmoil, war and economic sanctions. The flexible supplies coming from the US shale oil sector, combined with changes in Saudi supply policy and doubts about OPEC discipline, seem to trump any political effects on oil prices. Only a darkening of global growth prospects or a very large shock in at least one of the top producing countries can likely change this dynamic.

Oil price (Brent, $/barrel)



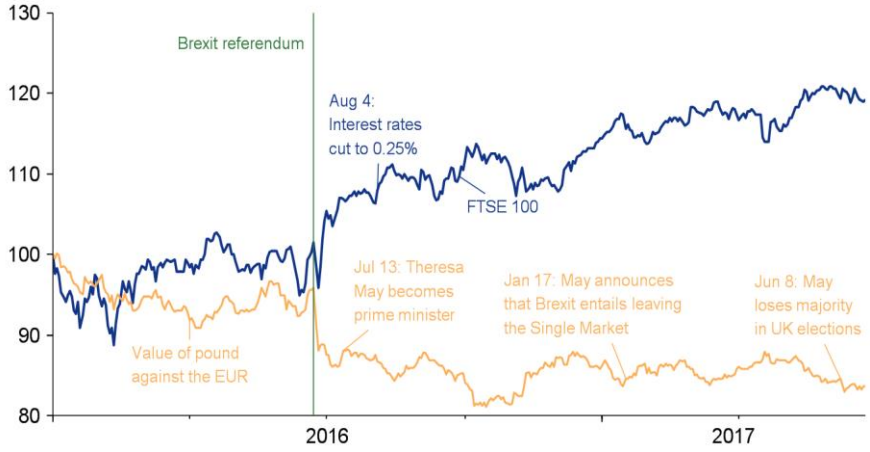
Sources: Thomson Reuters Datastream, Allianz Research

Exchange rates

Exchange rates have arguably become the main indicator of investors' sensitivity to political risk. Even if monetary policy has strongly influenced foreign exchange markets in recent years, currencies have reacted, at times forcefully, to political news in a way that other markets have not.

The threat of populist and eurosceptic election victories, for instance, weighed heavily on the euro in early 2017, while demand for the Swiss franc – seen as a hedge for European political risk – soared. Similarly the British pound – as 'Brex-ometer' – fell steeply following the Brexit referendum. It has traded at lower levels since, remaining highly sensitive to political news, while other UK-related asset classes have proved much more robust. Similarly, the Mexican peso turned into a 'Trumpometer' during the US presidential election campaign, while the Korean won has been affected more by tensions over North Korea's missile program than the Korean stock market.

FTSE 100 vs. Pound since the Brexit referendum (Index: Jan 1, 2016=100)



Sources: Thomson Reuters Datastream, Allianz Research

3. Economic momentum

Higher uncertainty is often associated with a broad-based decline in economic activity, and in particular private investment. Also, studies suggest that political uncertainty can have as big an impact on economic outcomes as actual political events.[6]

Despite various uncertainties, the global economy is in its best shape for ten years. Positive economic news seems to dominate over worrying political developments in investors' minds. Why is this the case? There are various reasons for this, in our view. These factors partly reinforce each other.

- None of the current political risks are **immediate or tangible enough to trigger a big confidence shock** in face of strong economic data.

[6] Some researchers find that political risk impacts economics more than actual negative political events. Dario Caldara & Matteo Iacoviello, 'Measuring Geopolitical Risk', Preliminary and incomplete draft, September 7th 2016.

- While ongoing wars and tragedies in the Middle East and parts of Africa may create a sense of gloom, the turmoil in geopolitics has had little impact on global economic prospects. Taken together, the **most unstable regions** in the world, make up less than **10% of the global economy**.
- The rise of **populist** forces worries many, but historically populist economic policies have often been **good for growth and markets**, at least in the short term.[7] This certainly seems to be the case in the US, where Donald Trump's promises of tax reform, deregulation and infrastructure spending have created a positive confidence shock, especially among investors and small businesses.
- The Brexit vote came as a shock to many. But **Brexit is a process** not an event, so the vote itself did not affect economic fundamentals. The Bank of England stepped in quickly to quieten nerves, while the swift government handover also helped to shore up confidence.
- For every political shock, there was one risk that **did not materialize**,[8] allowing investors to relax and focus on economic fundamentals.
- Market euphoria, in turn, **feeds economic confidence**, creating a virtuous circle to some extent.

Immediate political risks in Europe are receding after the Dutch, French and British elections returned mainstream governments, although Italy remains a concern for many investors. In the US, investors will continue recalibrating the balance between upside and downside risks associated with the Trump presidency. The assumption is, however, that there are few plausible political scenarios that could derail the current economic upswing. Those that could do so, such as a military confrontation with North Korea or a massive cyber attack on the US, are in the realm of tail risks that are too vague or far-fetched to affect economic confidence directly.

Looking into the future, if and when the global cyclical recovery peaks, economic fundamentals will no longer provide such solid support for rising markets. A sharp market correction looks unlikely, in our view, given that we do not detect a broad-based credit boom or major imbalances, while global capital flows appear moderate. Nevertheless, investors will have to adjust their expectations downwards. The real test for financial markets will come once other major central banks follow the Fed's lead and start normalizing monetary policy.

4. Monetary policy

Ultra-expansive monetary policies since the financial crisis have created ample liquidity and driven the search for yield. Risk perceptions have, to some extent, become anesthetized, and not only in the bond markets. Our assumption is that in this yield-hungry environment, political risk is also harder to price.

[7] Moritz Schularick, 'Populism and Financial Markets', Presentation for Allianz Global Investors, April 2017. The historical sample, however, has limited value for predictions, and populist economic policies can lead to bubbles and busts over the medium term.

[8] Among the things that did not happen in 2016-17 were populist victories in the Austrian and French presidential elections and the Dutch parliamentary elections, prolonged political turmoil in Italy after Matteo Renzi lost an important referendum and a flare-up of the refugee crisis as a result of growing Turkey-EU tensions.

Although investors increasingly express concern about political risks, they still seem to count on central banks to step in and prop up markets whenever there are signs of instability. In other words, assuming that central banks are unwilling to bear the risks associated with a downturn, markets have internalized the expectation that the central bank always blinks. Taken to extreme, such expectations would turn every political event into a buying opportunity: a positive political event directly supports market valuations; a negative political event will force the central bank to intervene to limit market volatility.

Both in the US and in Europe, the turning of the rate cycle is a question of when, not if. Monetary normalization will proceed cautiously, as central banks want financial markets to adjust gradually to life without a monetary policy safety net. Careful, forward-looking communication will also be part of the normalization strategy.

Having said that, the degree of monetary easing has been unprecedented. The balance sheets of major central banks amounted to USD 18 trillion in April 2017, and it is still unclear how exactly monetary unwinding will proceed. Moreover, in case of another financial, economic or political shock in the near future, central banks would have little firepower left to bolster growth and market confidence. There are signs that markets are already losing confidence in the efficacy of monetary policy in the case of shocks.

5. Peak complacency?

Political pundits are gloomy while markets remain broadly optimistic. Does this imply that one of them is wrong? Not necessarily. News about the strength of the global recovery has recently swamped concerns about political developments. Even with the prospect of rate rises in the US and tapering in Europe, markets still assume that central banks will reverse course promptly in case of a political shock and do 'whatever it takes' to prevent an asset meltdown.

In eight years of ultra-expansive monetary policies, investors have learnt to see political dips as a buying opportunity. Also, the fact that many feared political events did not materialize, while those that did materialize did not produce immediate negative economic consequences, has bolstered investor optimism.

Yet, we believe that the current disconnect between political risk assessment and market valuations is ultimately unsustainable.

Assuming that the increase in political risk is driven by underlying long-term trends, such as economic inequality, global power shifts and weakening institutions, we expect political uncertainty to remains high, perhaps even increase, in coming years.

Once central banks withdraw their support, financial markets will become more sensitive to economic and political risk. In an environment of flattening economic momentum or even setbacks, volatility will return. Unexpected political events could then lead to market overreactions and volatility spikes. Herd behavior might temporarily exacerbate market reactions after years in which investors have paid scant attention to political developments.

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