Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Look Left, Look Right, Look Left Again – Avoiding Being Hit by Political Risk

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2017 has seen markets continuing their upwards march, with volatility still near all-time lows. A recurring theme of ours is that this boisterous mood contrasts with the deeply uncertain state of the world, with a particular area of concern being political risk. Most of the attention has been on the threat from right-wing populism, but we would argue that the longer-term threat to the markets comes from the left.

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It is true that in 2017 politics was the 'Dog that Didn't Bark', or at least the dog that didn't bark much. The right-wing populists were clearly defeated in the Netherlands and France, and in the latter case Macron won with an explicitly internationalist and pro-European agenda. There was a bit of a sting in the tail more recently, with the turbulence in Spain from the pro-independence Catalans and in Germany, the far-right AfD winning seats in Parliament. While weakened, however, Merkel remains the dominant figure in German politics – the AfD still only got 13% of the vote. Even Italy did its bit, managing to not have an early election. More broadly, the European project continues to survive as Brexit proves not to be infectious – so far.

Combined with a cautious economic revival on the continent, Europe's confidence is back. In the U.S. the populist element of the Trump agenda, much of which is around trade, has largely been confined to Twitter, while actual policy has been more conventionally Republican - not a great surprise given a cabinet heavy in Goldman Sachs alumni and ex-Armed Forces Generals.

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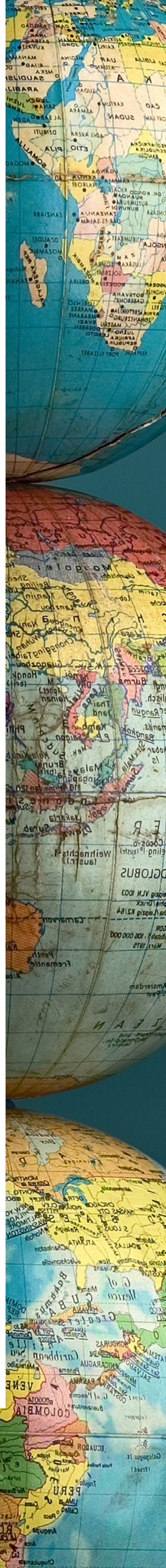

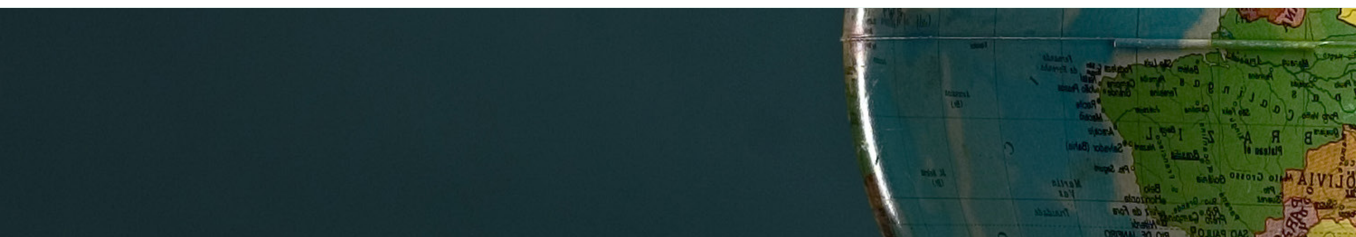

However, behind this overall picture of relative stability is a sharp decline in the traditional political parties. In Germany, the centrist CDU/CSU/SDP 'Grand Coalition' lost a combined 14% of the vote, forcing Merkel to attempt to form an unwieldy 'Jamaica Coalition' (so called because the party colours match the Jamaican flag) with the free-market FDP and the environmentalist Greens. In France, the existing party system was destroyed, as Macron won the presidency, and then a majority in parliament, with a brand new political movement 'En Marche.'

The damage to the existing party system has been particularly severe on the centre-left. The most dramatic collapses have been in the Netherlands and France. The Dutch PvDA scored a miserable 5.7%, down from 25% in 2012, while the French PS saw its support fall to 7% from 29% in the previous cycle. The German SPD and the Spanish PSOE are in a less disastrous state, down to 20% and 22% respectively, but this is half their strength a decade ago. This decay creates a void that threatens the pro-business consensus that has ruled for a generation.

"In both Germany and the U.K., the population now has a net positive view of socialism and a net negative view on capitalism"

The three decades up to the Global Financial Crisis saw politics that were incredibly favourable for the wealthy, corporates and financial markets. Large swathes of the world entered the market economy, helping trade and the globalization of both production and consumption. In the West, starting with Thatcher and Reagan, state assets were privatized, tax rates were cut and trade unions were weakened. In addition, inflation was conquered, allowing the dramatic fall in interest rates and the accompanying explosion in debt levels. The centre-left bought into this policy shift, be it Bill Clinton's Third Way, Tony Blair's New Labour or Schroder's SDP bringing in the Hartz labour reforms in Germany from 2003. It reached the point where Peter Mandelson, a senior Labour Minister in the UK, could say that he was "intensely relaxed about people getting filthy rich."

This consensus is cracking in the wake of the Global Financial Crisis and the resultant stagnation in living standards. Even in supposedly thriving Germany, the median household income has not risen over the last decade.[1] Up to now, there have only been isolated signs of left-wing populism gaining traction, for instance with Syriza in Greece or Podemos in Spain, but this may well change. The U.K. Labour party shows the potential rewards for moving sharply to the left. Under Jeremy Corbyn's leadership, its programme of renationalisation and higher public spending funded by taxes on the rich helped its vote share rise from 31% in 2015 to over 40% in 2017. Indeed, in both Germany and the U.K., the population now has a net positive view of socialism and a net negative view of capitalism.[2] These trends are even reaching the U.S., the 'land of the free', where the same is true of the under-30s. It is far too early to have any clear view as to the identity of the Democratic candidate for the U.S. Presidency in 2020, but it looks like a reasonable bet that he or she will come from the left of the party. Any economic downturn would further strengthen the case for radical economic reform.

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The timing and extent of any left-wing threat to corporate profitability is unclear, but it does seem to be growing. It is also arguable that it is not in current market prices. The MSCI World Index is trading at 16.7 times[3] the next 12 months' earnings, close to all-time highs, with those earnings assumed to be up over 10% over the next year. Aside from the potential effects on the market as a whole, increased vigilance about the threats from potential governmental action is required at the individual stock level. We have always had a focus on compounders, companies that can steadily grow earnings at high returns across cycles and are robust against potential threats. We would argue that this focus is more valuable than ever in this uncertain world, particularly as the compounders' valuation relative to the market has improved further after the cyclical reflation rally of the last quarter.

[1] Source: OECD.

[2] Source: YouGov.

[3] Source: FactSet, 30 September 2017.

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