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Political Risk: A Tale of Two Cities

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It was the best of times economically; it was the worst of times politically. Where Dickens contrasted the thrones of England and France, we look at how political risk is influencing financial markets today.

By examining the recent presidential turmoil in the U.S. and Brazil – and comparing their drastically different outcomes – we hope to glean useful insights for investors:

- **IN WASHINGTON,** new disclosures about Russian interference in the 2016 election were perceived to reduce President Trump's effectiveness. A memo left by the former FBI Director James Comey surfaced on 16 May, alleging that Trump tried to stop the FBI investigating former national security adviser Michael Flynn's involvement.
- **IN BRASÍLIA,** a corruption scandal emerged the following day, which arose from President Michel Temer's alleged endorsement of political bribery, triggering investigations, violent protests and talk of impeachment.

What we find is that political risks can trigger extreme short-term volatility. The volatility may offer opportunities for investors to capture value, or it can be a warning sign of prolonged risk to be avoided. The underlying economic environment appears to be the determining variable.

"It was the best of times, it was the worst of times... we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way..."

—Charles Dickens, A Tale of Two Cities

Two spikes, somewhat alike

Prior to the disclosure of Comey's memo, volatility across major equity markets – the US, Europe, Japan, emerging markets and also Brazil[1] – was at historically low levels. Taken together with

[1] As measured by the following indices of the Chicago Board Options Exchange (CBOE): VIX, VSTOXX, Nikkei Stock Average Volatility Index, Emerging Markets ETF Volatility Index and Brazil ETF Volatility Index.

generally low volatilities for currencies, rates and commodity markets, investors seemed generally confident about the global outlook.

Against that backdrop, continued political upheaval within the U.S. administration, caused the VIX to jump 46% to 16 on 17 May – not terribly high for the VIX historically, but nonetheless a significant spike.

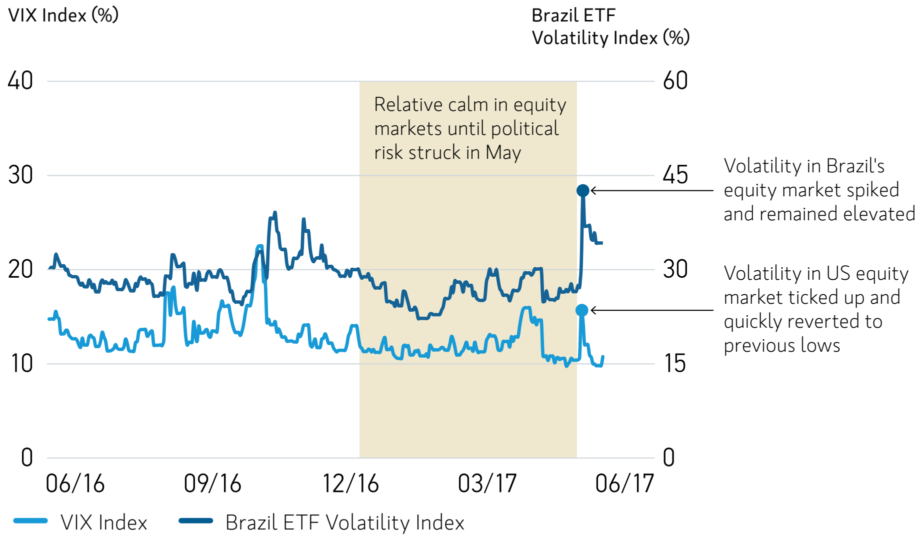
U.S. equities as measured by the S&P 500 Index fell 1.8%. Yet almost immediately, the VIX reverted back to below its long-term average, and the S&P 500 Index actually ended the period from 16 May to 24 May up *(Display 1)*.

The story unfolded differently in Brazil. Contagion from the U.S. turmoil caused Brazil's equity volatility to rise 13%[2] on 17 May, and the IBOV index of Brazilian stocks dropped 1.7%[3]. However, on the following day, the country was hit by news of bribery allegations against President Temer. This pushed Brazil's equity volatility up another 38% *(Display 1)*, and IBOV[2] stocks down 9%. The initial plunge caused officials to halt trading activity briefly. The Brazilian real also dropped on the Temer allegations, which was worse than the sell-off after Trump's election victory.

Unlike the U.S., Brazil did not recover beyond a small initial rebound – from 16 to 24 May, the IBOV was down *(Display 2)*.

DISPLAY 1

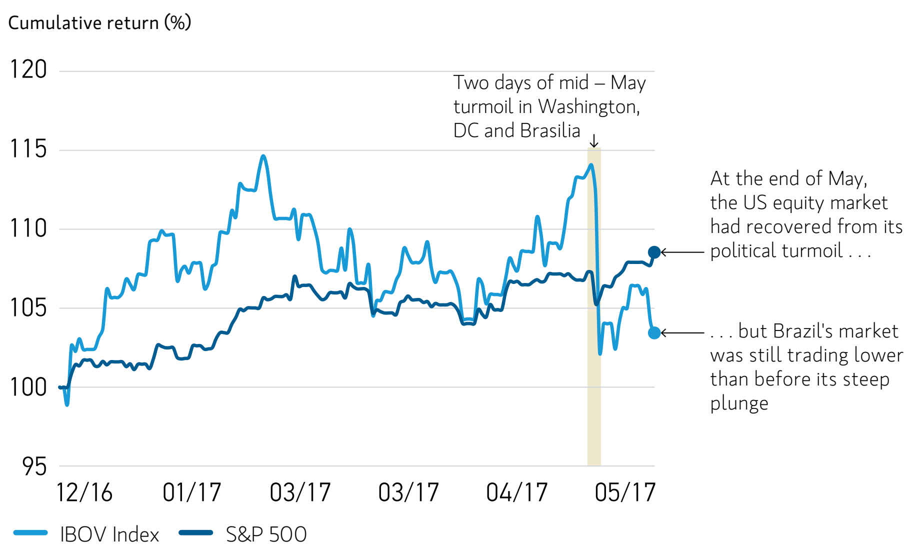
Calm before the storm



This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See disclosure section for index definitions. Source: Bloomberg, data as of 30 May 2017. The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index ®, (VIX ®) a key measure of expected volatility using S&P 500 stock index option prices. The CBOE Brazil ETF Volatility Index (VXEWZ) reflects the expected volatility for options on the iShares MSCI Brazil Capped ETF (EWZ ETF).

DISPLAY 2

Two different market responses



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[2] Source: Bloomberg. Measured by the Chicago Board Options Exchange (CBOE) Brazil ETF Volatility Index (VXEWZ), which reflects the expected volatility for options on the iShares MSCI Brazil Capped ETF (EWZ ETF).

[3] Source: Bloomberg. Ibovespa Brazil Sao Paulo Stock Exchange Index.

"There were a king with a large jaw and a queen with a plain face, on the throne of England; there were a king with a large jaw and a queen with a fair face, on the throne of France."

—Charles Dickens, A Tale of Two Cities

Two economies: One fair, one plain

As we have posited recently, the underlying U.S. economy is healthy. Business fixed investment has increased sharply, with Q1 2017 estimates showing a striking increase in investment growth that can be attributed mainly to infrastructure and equipment spending *(Display 3)*. Given the attractiveness of its underlying economy, we believe the U.S. is not in need of specific reforms. In fact, the kind of significant stimulus being contemplated by the Trump administration would risk overheating the economy, arguably making political gridlock preferable.

Moreover, if there were serious risk to the Trump presidency, the U.S. has a well-defined and tested succession plan. Investors are not worried about the U.S. government being adrift for any length of time, even if there were to be a change in leadership.

In contrast, Brazil's economic scenario is relatively unattractive with reforms being crucial for economic improvement. The positive returns that we have seen in Brazil have been directly linked to economic policies that investors were expecting Temer to pursue. If he is weakened, the chances for these reforms to be implemented are greatly reduced. If he were to be impeached, it is not clear who would succeed him. Although a snap election might resolve a messy succession situation, it would require a difficult constitutional change.

Analysts speculate that an interim president could keep Termer's highly credible economic team, and ensure that the reform programme stays on track. However, the risk of prolonged uncertainty during a potential impeachment process, amid rising social tensions, is tangible. A return to an economic scenario akin to the second half of 2015 would postpone reforms. This would not be welcome news for investors.

Contagion: Not all markets are created equal

Brazil's economy, though large, can sustain a major crisis without spilling over into the rest of the world. A crisis in the U.S. tends to have global ramifications due to its position as a global economic engine and a safe haven for investors in times of crisis.

Observing the effects of the U.S. turmoil on emerging markets, for example, shows that volatility rose by 26% on 17 May. However, when the Brazilian scandal broke, though emerging market volatility remained elevated, it did not increase, indicating that it appears to have had little effect.

Looking at the effect on European markets, volatility rose by 19% due to U.S. contagion. On the day of the Brazilian scandal, volatility rose by only 6%, and it is not clear that this rise can even be attributable to Brazil, or if it is further volatility in the wake of the U.S. situation.

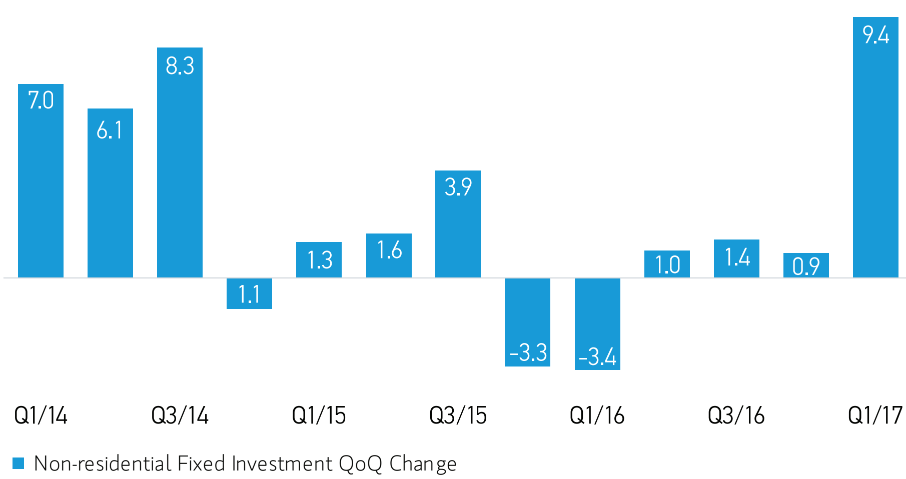
Emerging markets: Not homogeneous

Brazil appears not to have caused contagion to other emerging markets. When the Brazilian markets went down on the alleged Temer tape, Brazilian bond yields rose significantly, yet yields in other emerging markets appeared to remain stable. This could be taken as a sign that

DISPLAY 3

U.S. business fixed investment is picking up significantly

Quarter-over-quarter change %



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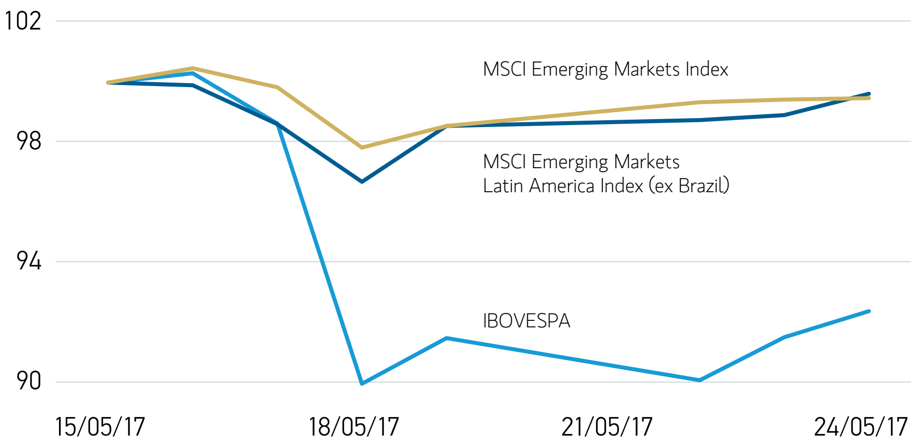
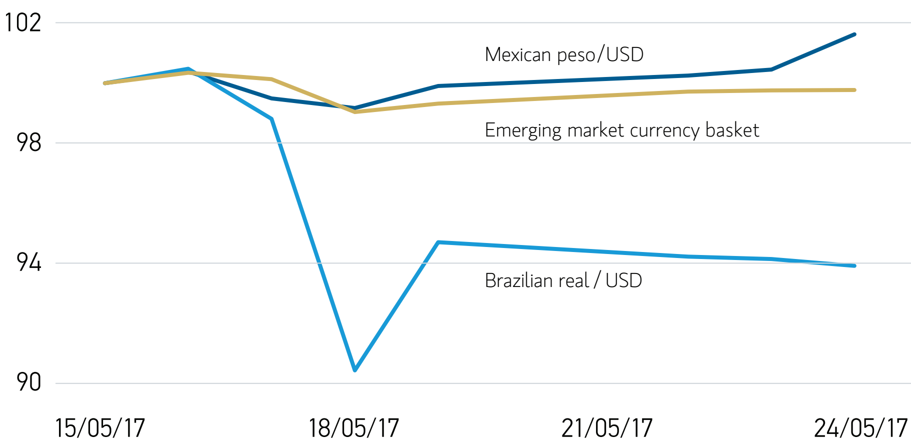
DISPLAY 4
What happens in Brasilia stays in Brazil

Cumulative return of stock markets (%)



Cumulative return of currencies (%)



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Source: Bloomberg, data as of 24 May 2017. Stock market returns based on Ibovespa Brazil Sao Paulo Stock Exchange Index; MSCI Emerging Markets Latin America ex Brazil Index (USD); MSCI Emerging Markets Index. Currency performance based on Brazilian real – US dollar; Mexican peso – US dollar; MSCI Emerging Markets Currency Index.

investors see this as an idiosyncratic risk only associated with Brazil.

Excluding Brazil, the Latin American equities market as a whole was down on the day the U.S. market fell, but the following day, when the Brazilian market crashed, it fell, only to regain the entire day's losses the day after. Over the entire period from the 16 to 24 May when all this political turmoil was occurring, Latin America ex Brazil was only down 28 bps. We saw similar behaviour in the other markets *(Display 4)*.

Contagion from the U.S. is obviously a lot greater than it is for a nation like Brazil. When it came to currencies, however, neither nation's political risk event caused a significant drop in the Mexican peso or other emerging markets currencies, aside from the Brazilian real *(Display 4)*. This was a big change from the currency reactions to the U.S. election last year.

UK: Election volatility

The UK election created uncertainty as the Tories' lead in the polls fell apart, creating ample scope for political risk. The U.K.'s prime minister, Theresa May, called the election because she expected the Conservatives to win easily, with a large majority, and her rapid loss of support was a surprise to many investors.

Eurozone: More integration

Because the UK was always the most reticent European Union (EU) member, Brexit has allowed European integration to accelerate. The remaining powerhouses, especially France and Germany, are in favour of increased cooperation and political integration. With the UK out of the picture, we expect European integration to get a second growth spurt.

It is worth noting that the UK left the EU, not the eurozone. When Greece first started running into trouble, pundits expected it to become the first domino to fall as Europe broke apart. But Greek willingness to accept incredible economic pain so that they could remain in the eurozone despite a nationalistic left-oriented government reveals how strong the ties are within the eurozone. These factors seem to indicate that the disruptive forces within Europe that had been gaining strength are now weakening in the face of economic incentives for a stronger union.

France: Macron is pro-business

President Emmanuel Macron's strong majority win in the National Assembly, means that he should have the support to implement the pro-business reforms, which he pledged during his election campaign. This should provide a boost to France's economy and the EuroStoxx 50 spiked following the results.

Japan: Labour reforms and executive equality gaining traction

Japan is seeing significant changes in work practices, with more women in senior positions as the government's policies to encourage women to enter the workforce seem to be gaining traction. Additional reforms called "Elder Care," are allowing women to remain at work in situations where in the past they would need to stay at home to care for a sick parent. These politically-driven domestic reforms are having positive effects on the Japanese economy. With Abenomics now being viewed as a success, these reforms, coupled with Prime Minister Abe's push for labour reforms, raise hopes that this will strengthen the economy.

China: Downgrade no cause for alarm

The volatility we are seeing in China is not related to political risk. Rising bankruptcies and the curtailing of some wealth management products has caused Moody's to downgrade China, but these deliberate steps are part of the government's effort to control some of the excess debt in the economy. We view these as a long-term positive.

We do not expect to worry about the Chinese economy through November at least, given how important the 19th National Congress meeting is for China's president Xi Jinping, as he consolidates power. We expect that between now and then, he will use every lever that the party has to keep the economy on track.

The general pattern in China is to stop market reforms and stimulate the economy when growth starts to fall. When the economy is back to growing at a target pace, they return to market reforms and try to control dislocations, such as excess debt. We are not overly concerned about the seesaw back and forth, though we do keep a lookout for signs of the government actually losing control over aspects of the economy, as occurred in 2015.

How the tale ends

The impeachment of a president is the modern version of the dethronement of a king. It bears significant political risk. However, the tale of Brasilia and Washington illustrates how political risks often have only limited, short-lived effects. They may initially jolt markets, but then are quickly shrugged off.

The prevailing economic environment in periods of political unrest is important, as illustrated in the clear contrast between the U.S. and Brazil. In a vibrant economy, market overreaction to political risk presents investors with buying opportunities. In weaker economies, political uncertainty has the potential to prevent recovery.

In the end – whether they are in "best of times" or the "worst of times" – we believe that investors who discern the difference between the two types of scenarios are more likely to come out ahead.

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