

# Spotlight

## It's the politics...

Political risk has significant implications for economic growth and market sentiment, although factoring these risks into an investment process is complex.



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## Politics and markets

In six months' time, the world may look very different: there will be a new President of the United States; the Italian electorate will have voted in their constitutional referendum, which the prime minister has staked his job on; the UK may have triggered Article 50 to begin negotiations for exiting the European Union; there will be a new Dutch government; and the French presidential election campaign will be approaching polling day. Each of these political events carry substantial risks, with populist, polarised and fragmented political forces heightening the uncertainty of the outcome and the aftershocks. The sheer number of political risk events compounds the air of uncertainty, but what does they actually mean for the economic and market outlook?

While it is often acknowledged that political risk has significant implications for economic growth and market sentiment, factoring these risks into decision making is complex. At Standard Life Investments, we have established an in-house taxonomy of political risk. This involves identifying whether the risk is related to political institutions (institutional risk factors) or political cycles (cyclical risk factors) in line with best practice in political risk analysis. We then further identify the precise factors that converge to create a specific level of political risk in the relevant market. In particular, we have identified a set of key drivers of election risk, given the number and potential impact of developed market elections in 2016 and 2017. Our research into the structures and systems across the political landscape in different countries allows us to isolate the drivers that matter most for the election outcome. While we cannot predict the future, we can identify the boundaries of these political events by combining our understanding of political and policy systems with scenario analysis to test the effects of political events on investments.

Traditionally, political uncertainty, and the associated negative effect on asset prices, has been more commonly associated with emerging markets. This is because such countries tend to carry more institutional political risk, i.e. issues of transparency, democracy and corruption in political institutions that affect the ease of doing business for corporates and the risk/return ratio for potential investors in these markets. However, developed economies carry their own forms of political risk, most commonly in the form of cyclical risk. Well-established democracies in developed markets involve election cycles and ordinarily transparent policymaking. While these cyclical factors can be positive for investors in terms of ease of doing business, our taxonomy

isolates the recent rise in populism, fragmentation and polarisation in developed market politics in the wake of the global financial crisis. These factors amplify the risks that regular cyclical events carry.

## United we stand, divided we fall

Fragmented politics makes government formation more difficult (see Chart 1). A prime example is in Spain, where new political parties Podemos (a left-wing populist party) and Ciudadanos (a new pro-business reformist party) have transformed the Spanish political system from largely a bipartisan one, with a smattering of smaller parties, to a genuine multi-party regime. Furthermore, Podemos qualifies as a populist party, akin to say Syriza in Greece or the Five Star in Italy. Such parties set themselves up as challengers to the establishment and status quo, making the party the essential link between people and political change. The inability of the Spanish parties to agree to any form of coalition has meant the country has been without a government for over nine months and faces the possibility of a third election in the space of just 12 months.

In spite of this, the Spanish economy has performed well in the interim period, posting impressive growth figures. However, short-term economic performance should not be confused with medium or long-term growth potential. Modern democratic systems are built to function without significant legislative reform in the short term, while in this case European Central Bank policy has been very supportive. However, although Spain can function, policy reforms aimed at enhancing future potential growth are not carried out as these require government approval. The danger is that a government is eventually cobbled together but produces inefficient policy outcomes; coalition governments make decision making more complex as they must be approved by all relevant coalition partners. In countries where coalitions are not a historical norm, sustaining one across ideologically diverse partners can be a struggle. This increases the likelihood of yet more elections and further policy uncertainty.

## You say yes, I say no

Politics does not need to be fragmented to bring about policy uncertainty and inefficiency. The issue with fragmentation is that multiple parties with differing ideologies and goals can struggle to reach consensus. This can also be the case in a two-party system if the parties are extremely polarised by ideology or party loyalty and structures require cross-party collaboration. Illustrative of this, the US political system is built on the separation of powers between the president, Congress and the judicial system. Over the past decade it has gone through a period of polarisation across the two major parties (see Chart 2). This is the reason for the political gridlock we have seen in recent years, as a Democratic president has struggled to pass even basic budgetary legislation through a Republican-dominated Congress. This has gone so far as to result in a government shutdown.

Politicians in the US, and large parts of Europe, are increasingly discovering the impact that populism can have in this kind of system. Such movements can move the dial on key issues and introduce even greater uncertainty than fragmentation or polarisation can alone. The tendency in such a system is to find centrist policy positions drifting more towards the populist view than would otherwise occur in an attempt to capture votes. In the US, the Republican candidate Donald Trump is moving the dial in terms of the immigration

and international trade agenda. He proposes ending NAFTA, enforcing steep tariffs on China and Mexico, and much stricter, security-focused immigration policies. The support he has garnered has created difficulties not only for his Democratic opponent Hillary Clinton – who has had trade-policy pressure from both sides, with her primaries rival Bernie Sanders espousing a more protectionist trade agenda – but also within the Republican Party itself given the disparity between the candidate’s views and those of the party he represents. Ultimately, the difference between campaign promises and post-election reality can be stark if the president and Congress do not line up. This applies even if there is a Republican ‘clean sweep’ in the forthcoming elections.

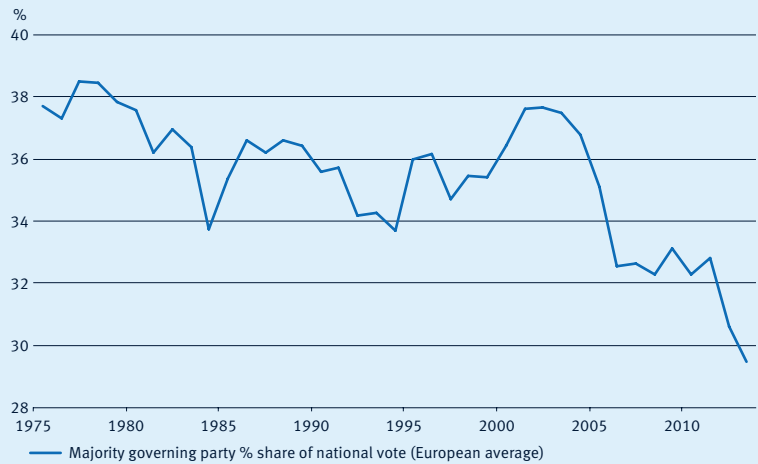
### Let’s get fiscal

Our approach to political analysis is based on the view that one of the key mechanisms through which political risk is transferred to the economic and market outlook is through policy uncertainty. The theory suggests that policy uncertainty can reduce growth prospects for an economy because corporate investment slows and consumers delay spending on big ticket items. The logic is clear: when the outlook is uncertain, it is worth waiting to see what environment you will be in before committing significant funds to goods or services with a longer-time horizon than the period of uncertainty. This policy uncertainty can affect different types of investors because, for example, economic policy can be macro (e.g. altering a fiscal deficit to affect expectations for the economy) or micro-focused (e.g. introducing a financial transactions tax).

In order to investigate the true extent of this relationship, we modelled the impulse response of a persistent policy uncertainty shock as part of a forthcoming Global Horizons publication on political risk. Using the Baker, Bloom and Davis Economic Policy Uncertainty Index, which tracks economic uncertainty using news text analysis, we found that a persistent policy uncertainty shock is associated with lower growth through the period of the shock in the US, UK and Europe (see Chart 3). This finding is in line with Bank of England and Federal Reserve analysis. Furthermore, we assessed a number of major economic and market factors; the results indicate that while a policy uncertainty shock does not tend to affect consumer price inflation significantly, it is associated with downward pressure on national equity markets, interest rate outlooks and the real effective exchange rate.

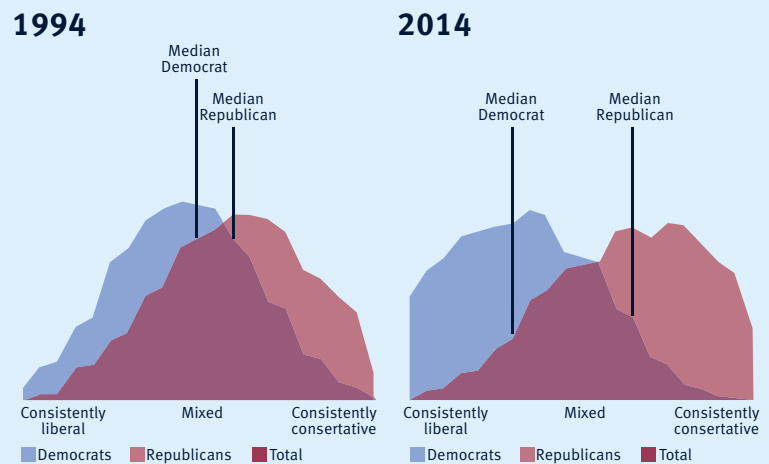
Given that policy uncertainty has a tangible effect on economic and market indicators in developed markets, understanding the political dynamics and structures that drive this uncertainty is crucial. The rise of populism, fragmentation and polarisation in the aftermath of the global financial crisis was striking, but the persistence of these themes has been especially notable. Until underlying issues, such as income inequality, trade worries or migration concerns, are addressed, these forces will continue to disrupt and drive policy uncertainty, and so financial markets, through 2016 and beyond.

**Chart 1**  
Losing voter attraction



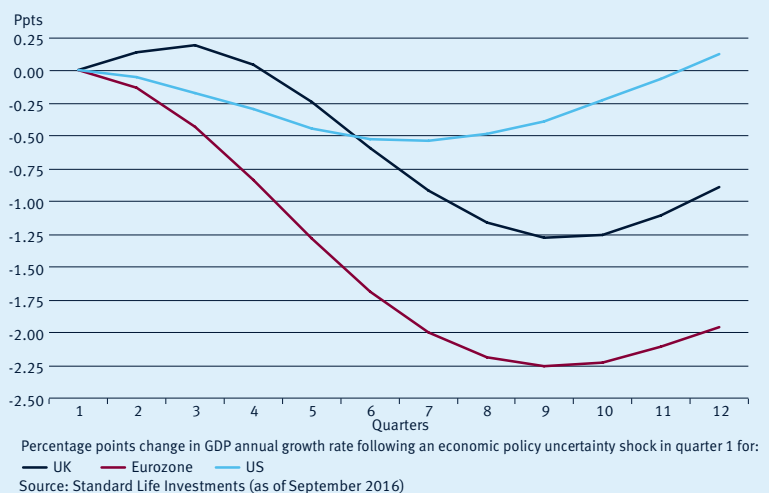
Source: World Bank, National Sources (as of 30 September 2016)

**Chart 2**  
Amplified misalignment



Source: Pew Research Center (as of 2014)

**Chart 3**  
Shock to the system



Source: Standard Life Investments (as of September 2016)

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