Politically Driven Markets

September 30th, 2019

- **Politics dominates many of the regional equity markets**
- **Any Brexit outcome could spur a better performance from UK equities**
- **Maybe, just maybe the German government will expand spending**
- **A broad EU fiscal boost would help eurozone equities**
- **A cornered President Trump may not turn out well**
- **Indian equities seeing support from the government and the central bank**

The markets continue to be a sideshow to global political sagas. I was asked this past week on a radio show what I thought about Hong Kong's problems. My answer was to contextualise Hong Kong's issues in the broader picture of deep concern amongst ordinary people about the direction of the political elite.

From east to west, north to south, many traditional politicians and political parties are struggling to appear relevant to the needs of the population. President Trump's problems stem from his seeming decision to overreach his executive privilege. In the UK, Parliament seems to think it knows better than the voters about whether a clean break from the EU is really needed. In Germany, a recent opinion poll (Politbarometer published by public broadcaster ZDF) showed that German Chancellor Angela Merkel's CDU/CSU party was neck and neck with the Green party at 27% of the popular vote.

What do political problems mean for investors? – Higher volatility. We have seen more so-called 'left tail' risks – meaning more risk of downside. UK sterling and UK equities at multi-year relative lows are a testament of how wrong things can go. It can also lead to some positive surprises even if these might prove transitory. President Trump's electoral victory was a populist vote against mainstream politics – the reward for the markets was the sharp rise in the equity market on the back of populist tax cuts and spending increases. The US enjoyed a spurt of remarkable growth, and the equity market responded with an 10% return in a matter of weeks.

It may only take a chink of good news for the UK equity market to reward brave investors with some good returns. In our view, global investors cannot afford to ignore UK equities given the marked underperformance and cheap valuation. On the price-relative UK equities sit at a 46-year low against global equities exUK. The market has a dividend yield of over 5% the highest amongst major global markets. A great contrary indicator is that in a recent survey, 63% of UK investors and industrialists are either negative or very negative about the economic outlook over the next two years. Only 9% are positive! At the edge of the market some people are saying that if you take a five-year view there is value in UK equities. We note that investors at investment companies such as Aviva are starting to see the value. They argue that healthy domestic growth, the self-help of companies restructuring to deal with Brexit volatility, and vigorous M&A activity are all factors that may boost the equity market.

The German Chancellor may be about to find ways of digging herself out of the hole of unpopularity. Indeed, in the past week, former German Finance Minister Wolfgang Schaeuble suggested the need for a reappraisal of fiscal policy to meet today's challenges. Mr Schaeuble was previously as finance minister, a proponent of fiscal frugality. The fact that even he has turned about face suggests there is a growing movement for increased government spending.

Those advising the Chancellor are reported to want to frame the increased spending around economic social and ecological considerations in part to see off the challenge from the Green party. Commentators have in mind the government could spend as much as €5 billion euros in 2020.

The business lobby has also been keen to encourage the government to spend money. In a recent speech, Dieter Kempf the head of Germany's business lobby called on the government to rethink its mantra of no new borrowing.

Should Germany relax its fiscal stance, this could bring about political shifts throughout the EU. Were Germany also to relax its opposition to other European countries increasing spending there could be a much broader boost to EU growth. Increased government spending could be reinforced by increased corporate investment spending. Industry is clearly looking for the leadership of government without which Europe could be struggling with near recession-like conditions.

Eurozone equities could take great heart from more relaxed fiscal policy across the region. The region already has accommodative monetary policy with the ECB committed to negative interest rates and quantitative easing. The Europe ex UK equity index has a good measure of performance to catch up against the United States over the past five years. Since the start of 2014 European equities have underperformed by around 25% relative to the US.

Could US equities be held back by President Trump's likely political challenges of impeachment proceedings? Much will depend on how the President decides to fight the fight. After all he is not just trying to avoid impeachment, he is trying to win the next Presidential election. Quite simply he may try to curry favour through another fiscal boost to the economy. However, the President's ability to cut taxes and increase spending is limited by the Democrats' control over Congress. He could help the financial markets and the outlook for growth by reducing the aggressiveness of his trade war with China. It would be more worrying if he used foreign policy as a way of showing he was a strong leader. Antagonism of the Iranian situation or sabre-rattling against the Chinese might increase his domestic support, but would, in our opinion, lead to downside in risk markets.

There are high hopes that the Reserve Bank of India (RBI) will cut rates further at its meeting on October 4th. The Reserve Bank governor has already indicated that the burden for increasing growth will fall on cuts in interest rates given that government exhausted its near-term policy flexibility by cutting corporation tax. The RBI is likely to cut rates by 25bps to 5.15%. The RBI has also started initiatives to ensure that cuts in interest rates are fully passed on to industrialist and consumers.

Indian equities should continue to make solid progress. The equity market was up a further 2.1% last week building on the recovery post the government's surprise announcement of a cut in corporation taxes. Last week's 4% drop in the oil price also helped sentiment. Typically, global investors are happy to invest in emerging markets that show a determination on the part of policy makers to support their economy.

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30th September 2019

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