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How does politics influence markets?

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In recent years, the world has witnessed an array of surprise election outcomes, sometimes accompanied by market reactions that are often behavioural in nature. **Tony Finding,** multi asset fund manager, highlights how these ‘episodes’ can create attractive opportunities as market prices and fundamental value diverge.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

The differing market impacts of political events

Political risk is often at the forefront of investment commentary. At times, markets can appear to move in tandem with the headlines, based on expected outcomes of elections or trade negotiations. While the oft-cited observation that ‘markets don’t like uncertainty’ is typically applied to these one-off or short-term events, the underlying notion is more fundamental. Politics matters to investors because the way societies are run heavily influences asset returns over the long term.

Recent inconsistency in market behaviour highlights the difficulty of interpreting political influences in the short term. In 2016, global markets were characterised by large price moves triggered by concerns over populist movements spreading throughout the US and Europe. However, in 2017, investors took similar events in their stride. Reactions to the inconclusive Germany election result and Spain’s Catalonia crisis were muted and confined to local markets. Yet 2018 has seen volatility return once more, with analysts citing concerns over a trade war between the US and China as the trigger for March’s stockmarket downturn.

Why did markets react differently to these events despite their similarities in political risk? It is not always possible to explain. People often seek to rationalise market movements when there is not always a clear reason. However, it would be fair to say that the broader environment matters. Markets can over or under-react to news depending on the starting point of valuation (‘cheap’ assets may be less vulnerable to ‘bad news’), prevailing sentiment, and the path of underlying fundamentals. In 2017, political developments arguably had less of an impact because underlying growth dynamics and market sentiment were supportive.

Taking advantage of opportunities

That market reactions to political events are inconsistent means investment opportunities can be created. In M&G’s Multi Asset team we believe that overreaction, when asset prices are driven by investors’ emotions rather than fundamental considerations, can provide attractive opportunities.

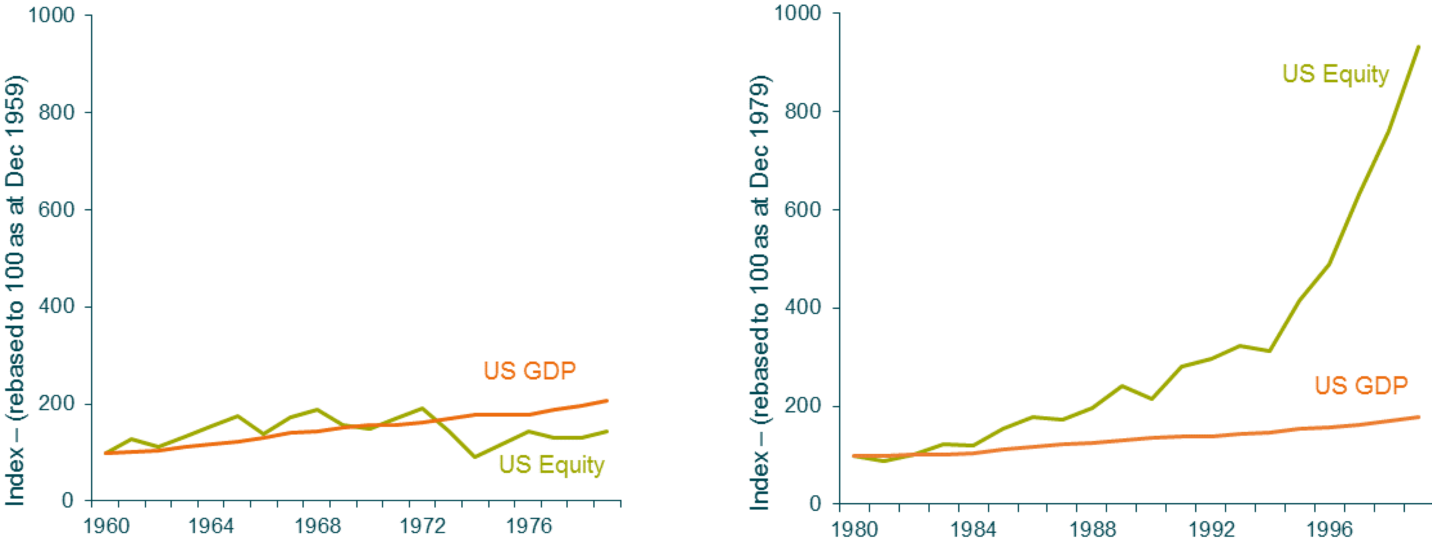
The period from late 2016 through to 2017 supplied notable examples. Following the US presidential election, Mexican assets sold off rapidly over fears of Donald Trump’s intention to ‘build a wall’ and renegotiate terms with fellow NAFTA members. This generated plenty of noise in the media, but without introducing new facts that could be used to re-evaluate the fundamental value of Mexican assets. The peso fell 20% between the US election result and January, recovering to pre-election levels over subsequent months as markets turned their attention elsewhere.

Similar volatile episodes occurred with Brazilian equities as news of a political corruption scandal broke in May 2017, and with South African government bonds and the rand during the African National Congress leadership election in December. In both cases, asset prices fell sharply before recovering to levels that better reflected fundamental valuations.

Episodes can also play out over longer time horizons. One could argue that European assets are still suffering from pessimism that has lingered since the 2008 financial crisis, despite a strengthening economy and the European Central Bank (ECB) plan to end monthly asset purchases. If Europe’s recovery continues as the data suggests it may, European equity valuations could appreciate materially while negative real yields on bonds look unsustainable.

Political and societal influences on an asset’s fundamental value therefore tend to represent more long-term trends that cannot necessarily be traced through government policies. A more efficient globalised economy, widespread domestic de-regulation and de-unionisation, however, all seem to have played a significant role in driving higher returns over the past 30 years or more. This is because each of these factors enables companies to share in economic success by channelling more of this growth into profits, and subsequently shareholder returns.

Participating in GDP growth? – US equity real returns vs. GDP (constant prices)



Source: Barclays Research, Datastream as at May 2015

For example, US GDP growth was roughly the same during the periods 1960-1980 and 1980-2000. Yet while real returns on equities remained broadly in line with, though ultimately underperformed GDP growth during the former, they outperformed GDP growth by more than four times over the second 20-year period.

Similar trends can be seen in Asia after the 1997 crisis, which in addition to financial sector reforms, brought an attitudinal shift that engendered improved corporate governance, increased competition and ongoing integration with the rest of the world.

The question arises as to whether these long-term political trends are now moving in reverse. Continuing growth in populism and protectionism would probably be less favourable for global markets.

However, we have limited insight into whether the influences that led to Donald Trump’s presidency or anti-EU movements will extend into the longer term. Instead, our focus is how we can assess valuations according to the observable facts. Should markets continue to exhibit behaviour that appears excessively pessimistic or exuberant, we believe opportunities could present themselves to patient investors.

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