

## ‘Peak Politics’: Another Chance to Buy the Dip?

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*"Political risk is hard to manage because so much comes down to the personal choices of policymakers, whether prime ministers or heads of central banks."*

-JAMES SUROWIECKI, American journalist

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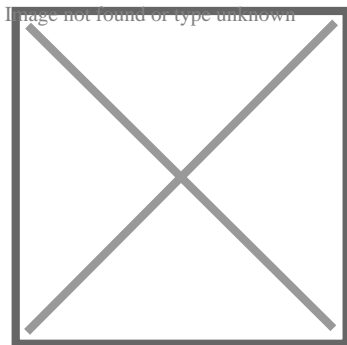
Given the spectacle that played out in Singapore at the beginning of this week, it's easy to forget the state of uncertainty that markets and individuals lived in at times last summer when Kim Jong-un and President Trump traded nuclear war intimidations. These pages even went as far as to warn of a possible [North Korea EMP threat](#) should "Little Rocket Man" test "the Don" in a battle for global supremacy. But, like a good science fiction movie – something Kim Jong-un equated the buildup of these events to – this story seems destined for a happy ending, not an apocalyptic climax, should North Korea make good on its denuclearization promise (a big "should", of course).

The events in North Korea show us how intricately tied politics – and the whims of a select few leaders around the globe – are to the stability of financial markets. This is perhaps true more so now than at any other time in world history. The author of this week's Gavekal EVA, Anatole Kaletsky, even recently made the claim that political risk is currently the driving force of financial markets. The question that we must confront given this reality is whether markets have baked political risk into already lofty valuations, and if subsequent speedbumps should present buying opportunities for investors.

When looking for an answer to this question, it's important to take a macro-perspective and understand the political, cyclical and structural state of markets globally. For example, we strongly believe and have often shared that most of the world is in the midst of the Biggest Bubble Ever (BBE) in terms of equity, bond and real estate markets. (However, as we've also noted, the monster bubble is in overseas bonds, especially Europe, while the frothiest stock market globally is the US; nearly all major real estate markets are exceedingly overheated, almost certainly reflecting an absurdly low cost of money.)

Recent events in Italy underscore the continued threat that populist movements present to European markets. Therefore, slight dips in these markets due to political circumstances might not present a favorable medium- to long-term buying opportunity. However, as Anatole concludes, several emerging countries show signs of prosperity and provide reason to consider "buying the dip". In particular, a number of Asian stock markets look very interesting to us (who said we are perma-bears?!).

Now to Anatole, Gavekal's resident perma-bull...



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## 'PEAK POLITICS': ANOTHER CHANCE TO BUY THE DIP?

*By Anatole Kaletsky*

Could it get any worse? In principle, the answer is always 'yes', whatever "it" is. When it comes to investment, however, what matters is whether a negative outcome will turn out to be even worse than what the markets already believe. This is a longwinded way of saying that the investment view I expressed on May 21st —that "political risk is now the main driving force of financial markets"—may already have reached its sell-by date. In the week after I wrote those words, investors plunged into a state of panic about a possible Italian bond default, or even a break-up of the euro and the European Union. In the two weeks before that, a panic in the oil market drove prices above US\$80 a barrel after the US announcement of Iran sanctions. And last week, President Donald Trump's administration's trade conflicts with Europe and China have offered investors in Europe and emerging markets cause for anxiety, if not yet outright panic.

Against this background, it seems worth asking a contrarian question: Is it possible that the political risks are by now so thoroughly understood and absorbed by the markets that politics will create risk-on buying opportunities, rather than reasons for further caution? To see what I mean consider the ten main investment risks that I highlighted last autumn:

**Macroeconomic risks:** (1) The US economic cycle descends into recession or secular stagnation; (2) The Federal Reserve tightens monetary policy aggressively to preempt inflation; (3) Inflation accelerates or the bond market panics because the Fed is behind the curve of rising inflation.

**Political risks:** (4) Trump's fiscal easing over-stimulates the US economy; (5) Trump's protectionism triggers trade wars; (6) Saudi-Russian cooperation pushes oil prices above US\$80/bbl; (7) Regulation as technology companies start to be viewed as monopolists instead of innovators; (8) Populist politics moves from right to left and shifts from nationalism to redistribution.

**Market risks** if nothing goes wrong with policy or macroeconomics: (9) A boom-bust in technology stocks, as in 1999; (10) A boom-bust in all equities, as in 1987.

In early April, when I re-assessed these risks after February's market panic, I suggested that

“buying the dip” might be a good idea. All the macroeconomic risks had diminished, and market complacency had been eliminated by the correction. That only left the five policy risks, none of which at the time seemed too severe. Buying the dip in early April turned out to be a good call for US equities. The S&P 500 re-tested its February low on April 2 and gained around 7% in the next two months. Unfortunately, non-US equity markets did not enjoy a similar rebound. Today, MSCI Europe, Japan and Emerging Markets are still within 1% of their March-April lows in US dollar terms (although in local currencies, both Europe and Japan have recovered by 6% or 7%, like the US). The most plausible explanation for the underperformance of international equities in dollar terms is the intensification of political risks. Most of these were inflicted on the rest of the world by US actions, at least until Italy shot itself in the foot.

### **The State of Political Risk**

The key question now for financial markets is whether these political risks have been sufficiently discounted, or whether worse political shocks still lie ahead. To try and assess this, let us consider each of the five political risks mentioned above (numbers 4 to 8):

**US fiscal policy:** Everyone outside the White House now understands that the US is moving into an unsustainable fiscal situation in the long run, but bond markets show no sign of trouble in funding these deficits in the year or two ahead. Moreover, the Fed has a powerful tool that it could use at any time to ease the fiscal situation: It could simply slow down the pace of its balance sheet reduction, or even stop “quantitative tightening” completely, thereby redressing any imbalance between bond supply and demand. This implies that US fiscal policy is very unlikely to create any unanticipated financial problems in the next year or so.

**Protectionism:** This is now the biggest threat to the world economy and financial markets, but how much worse is it likely to get in the months ahead? The US has already implemented steel and aluminum tariffs against the EU, Mexico and Canada, as well as numerous protectionist measures against China. And tit-for-tat retaliation by all these countries has already been announced. The conflict with China could certainly get even uglier. But Trump’s *modus operandi*, which is to make loud threats but back away from them once they generate bad headlines, suggests that he will not impose what are effectively big tax hikes on US consumers—especially before the Congressional elections in November. Such political calculations will probably also rule out tariffs on European and Canadian cars.

In sum, although global trade relations are unlikely to improve as long as Trump is in the White House, the probability of trade wars escalating much beyond their present intensity seems to be quite low. And past experience of tariffs, export limits and other protectionist measures applied to specific sectors such as metals and agriculture suggests limited damage to the world economy from the present scale of the trade wars. Moreover, insofar as US tariffs do cause real damage, this will mainly be felt in the US. Tariffs are equivalent to a tax hike on US businesses and consumers and will also add to US inflation. In Europe, by contrast, US protectionism should promote a healthy shift in demand from exports to domestic consumption. And in China, efforts by Washington to prevent technology transfer or slow innovation will simply encourage even more government investment and subsidies in the sectors subject to US pressure.

**Oil prices:** The retreat of oil prices to US\$75/bbl from the peak of US\$80/bbl three weeks ago is consistent with my view the day after Trump announced his Iran sanctions: The US-Iran confrontation has created an overwhelming incentive for Saudi Arabia to manipulate oil prices downwards. The Saudis will certainly want to avoid suffering a political backlash against the Iran confrontation in the event of a spike to US\$90 or US\$100/bbl, as was widely expected two

weeks ago. The US pressure on Saudi should in turn weaken OPEC's coherence and its cooperation with Russia, as I argued a month ago.

This sequence of events began two weeks ago, when the Saudis suggested reviewing the OPEC production limits. The Saudi-Russian tensions I anticipated a month ago [have now started to materialize](#) and US political pressure for lower prices [was confirmed](#) last week. Assuming that it is right to attribute the surge in oil prices since last summer mainly to Saudi politics, rather than supply-demand fundamentals, the shift in the oil cartel's incentives should protect the world from even higher oil prices. That will remove the single biggest risk to the world economy and financial markets in the year ahead.

**Technology regulation:** Nothing much has changed on this front and this probably remains a risk for the next decade, rather than the year ahead.

**Populist politics** is a genuine new threat to Europe that has emerged in the past few weeks. The question is whether the market panic of Tuesday, May 29 was a climax or a prelude to future crises. The market action had a climactic feel. Italian bond yields recorded their biggest one-day jump since the breakup of the European exchange-rate mechanism in 1992 and trading volumes escalated to crisis levels not only in Europe but even in the US bond market. More importantly, the political fundamentals did not really justify this level of panic.

The new Italian government will not even start revising the budget until the fall and will not manage to implement most of its promises because of the contradictions between its left-wing and right-wing leaders and between the policies their voters demand. On the other hand, the EU authorities are likely to be frightened into a show of flexibility. Italy should enjoy some more fiscal headroom, more support for refugee costs and more freedom to subsidize or recapitalize its banks. Nevertheless, the populist government will probably do serious damage to the Italian economy: Further distorting the industrial structure, making labor markets even more sclerotic and undoing valuable pension reforms. Thus, anyone brave enough to start buying Italian assets should now favor bonds, which the new government will not default on, rather than equities, whose improving prospects the populists seems determined to ruin.

### **The Political Risk Discount**

All of which leads to an investment conclusion: The upsurge of Italian populism last month will surely create more short-term volatility, uncertainty and random noise, but it is very unlikely to trigger a financial crisis, threaten a breakup of the euro or damage the world economy as a whole. The same is true of Trump's trade wars. Therefore, if we look around the world and compare the likely political challenges with the risks now discounted in financial markets, the gap between expectations and reality does not seem particularly daunting. Assuming that the economic fundamentals of growth, inflation and monetary policy remain pretty favorable around the world, which still seems to be the case, the recent panics over politics in financial markets seem more like a climax or a false alarm than the beginning of a systemic crisis.

In short, the markets may have reached "peak politics" and we could find in the months ahead that political risks have been almost fully discounted. The chaos in Italy means investors rotating out of US assets should favor emerging markets over Europe, which will probably suffer more financial volatility in the next few months than most developing economies. On balance, however, this seems like a good time to "buy the dip" in non-US assets, just as "buy the dip" was a good decision to make on Wall Street and the US dollar two months ago.

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## OUR CURRENT LIKES AND DISLIKES

Changes highlighted in **bold**.

### LIKE

- Large-cap growth (during a deeper correction)
- International developed markets (during a deeper correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 6%-12% (buy carefully after the recent rally; long-term, however, future returns look highly attractive)
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (as with MLPs, be selective given the magnitude of the recent rally)
- Mexican stocks
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Investment-grade floating rate corporate bonds
- One- to two-year Treasury notes
- Canadian dollar-denominated short-term bonds
- Select European banks
- **Short-term investment grade corporate bonds (1-2 year maturities)**

### NEUTRAL

- Most cyclical resource-based stocks
- Mid-cap growth
- Emerging stock markets; however, a number of Asian developing markets appear undervalued
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos
- Large-cap value
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Intermediate municipal bonds with strong credit ratings
- US-based Real Estate Investment Trusts (REITs)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds; neutral rating now due to the recent strength of China's currency)
- **Emerging market bonds (local currency)**

### DISLIKE

- Small-cap value
- Mid-cap value

- Small-cap growth
- Lower-rated junk bonds
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)
- Preferred stocks
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds (moving to “dislike” on longer bonds due to recent breakout above 3% on the 10-year T-note)
- BB-rated corporate bonds (i.e., high-quality, high yield; in addition to rising rates, credit spreads look to be widening) \* \*\*
- Long-term municipal bonds
- **Short yen ETF**

**\* Credit spreads are the difference between non-government bond interest rates and treasury yields.**

**\*\* Due to recent weakness, certain BB issues look attractive.**

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