insightpaper

POLITICS IN THE YEAR OF THE MONKEY

MARCH 2016

Politics always has the capacity to create uncertainty and unset markets. There are a number of upcoming political events that could unsettle markets and, depending on the outcome, influence the economic outlook for the countries affected. Chief among these are the upcoming UK referendum on continued membership of the European Union (EU) and the US Presidential election.

These two events sit aside a number of existing political and geopolitical concerns, including the rise of populism in Europe, tensions in the South China Sea, the humanitarian crisis in Syria and the flood of refugees into Europe, as well as heightened tensions between Saudi Arabia and Iran, and the continuing risk of terrorism.

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"BREXIT"

Following the EU agreement on the 'special status' of the UK in Europe, the date for the "Brexit" (the possibility of the UK exiting the EU) referendum has been set for 23 June. A vote to leave would be a big negative for the UK given the threat it would pose to its access to EU markets, its financial sector and labour mobility.

This would have immediate implications for firms' investment and hiring plans with wider implications for household spending. The size of this impact would depend on what sort of exit is negotiated with the EU, but has been variously estimated at somewhere between -0.6% and -2.8% of UK GDP. It would also adversely affect UK assets, which explains the sterling's recent fall. However, Britain is not in the Eurozone so a "Brexit" would not pose the threat to the currency union that an exit by Greece has threatened in recent times.

We believe the outcome of the referendum is too close to call, especially given the recent decision of popular London mayor Boris Johnson to support the "leave" campaign. Our guess is the UK will vote to stay in the EU, but by a slim margin.

POPULISM IN EUROPE

The Eurozone sovereign debt crisis might be out of the headlines but the political fallout of years of austerity, declining living standards and high unemployment continues. As a result, anti-EU sentiment is already high in many EU countries, especially among the periphery where the social costs of austerity and high unemployment are greatest.

Political backlash was evident in both Spain and Portugal late last year. In Spain the party of incumbent Prime Minister Mariano Rajoy, while still the largest party in the parliament, had insufficient support to form a government. The Socialist leader Pedro Sanchez was given the mandate to form a new government, but the entry of two new parties into the parliament, the left-leaning Podemos and the liberal Ciudadanos, has complicated coalition negotiations. Fresh elections look set for June with a prolonged period of political uncertainty potentially damaging Spain's nascent economic recovery.

Portugal's pro-austerity centre-bloc government lost power, with the Socialist leader Antonio Costa the new Prime Minister. He has promised to achieve the challenging mix of delivering a "socialist programme" while at the same time delivering a "sustainable reduction in deficits and debts". Brussels will be watching fiscal developments closely.

At the same time, there are growing concerns about the strength of the Greek government's commitment to the reforms required to meet its fiscal targets. The International Monetary Fund, which has not formally signed up to the third bailout, appears particularly concerned Athens is not doing enough.

With anti-EU sentiment already high, a vote in favour of "Brexit" could have broader political ramifications. The European migration crisis has seen a rise in support for populist anti-establishment parties. This could subside though given a harder line on immigration from centrist leaders like Angela Merkel. A UK exit from the union could contribute to further dissent and EU fragmentation.

There are no major national elections in Europe in 2016. Next on the agenda is parliamentary elections in Germany and a presidential election in France, both of which are scheduled for 2017. German Chancellor Angela Merkel has been sent a strong message about the lack of popular support for her position on the refugee crisis in recent regional elections. The anti-immigration Alliance fur Deutschland has performed more strongly than expected, recording as a much as 24% of the vote in some regions. Merkel finds herself on the wrong side of public opinion on the refugee crisis which will make for an interesting election next year.

THE US ELECTION – POPULISTS VERSUS THE ESTABLISHMENT

US politics is seeing its own version of the current trend for voters in developed democracies to rail against the political establishment. Both Bernie Sanders (Democrat) and Donald Trump (Republican) are tapping into a sense of disenfranchisement and dissatisfaction with the ruling elite, combined with a lack of economic (real income) gains in middle America over a long period of time.

At the time of writing, Hillary Clinton is gaining momentum for the Democrat nomination while Trump remains ahead in the Republican race. Should Trump secure the nomination, the risk is a major split in the Grand Old Party, far greater than that presented by the Tea Party. Already there is a number of high profile Republicans who say they will not be able to support a Trump candidacy for President, putting the leaders of the party in an awkward position come the party convention. There is still a chance Trump doesn't secure the nomination but that requires the 60-70% of voters who don't support Trump to consolidate behind one candidate (Cruz or Rubio), but time is running out fast.

More generally, the risk of significant policy change from any new President is limited by the checks and balances of the US political system. The House and the Senate are the real decision makers. At times over the last few years this has caused much frustration to markets as important processes (eg debt ceiling debates) have been derailed by political shenanigans. But it's those same processes that may halt wild swings in policy should a less business/markets friendly President eventuate.

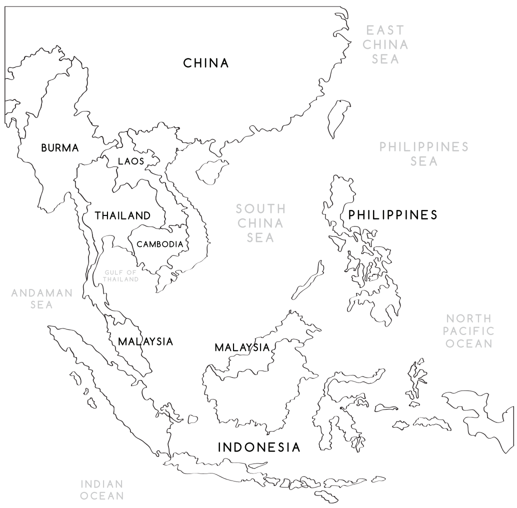
IRAN V SAUDI ARABIA, IS VERSUS THEM ALL

The Middle East has long been an area of tension and conflict. In recent times the dynamics have changed as the US has 'pivoted' to Asia and trade bans on Iran have been eased or removed. As a result, a long-time tension between Sunni Saudi Arabia and Shia Iran has come to the fore.

The defeat of IS could worsen this tension as it will further entrench Iran's influence on Iraq along Saudi Arabia's border. This in large part explains why OPEC has fallen apart as Saudi Arabia has sought to maintain its market share versus its Shia rivals of Iran and Iraq.

This suggests to us that while Saudi Arabia may be keen on capping oil production, we are unlikely to see any drop in production anytime soon. At the same time Iran is ramping up its own production. On balance this supports the view we may have seen the low in the oil price, it's too early to be confident of a sustained recovery. Against this, even though Saudi Arabia has been ramping up its defence spending as the US commitment in the region has declined, direct conflict between Saudi Arabia and Iran still looks unlikely.

Meanwhile, the terror threat from IS remains and could intensify if it looks like being defeated in Iraq and Syria. Then again, the world has become used to this, with the impact on financial markets of terrorist attacks since 9/11 seemingly declining.



SOUTH CHINA SEA

Tension over disputed islands in the South China Sea involving China has been brewing for years. At its core, China feels blocked in by the geography of the South China Sea and, as a rising geopolitical power, is seeking to flex its muscle and take a stand on the issue. Of course, this falls foul of its neighbours who also have claims on the islands and the declining geopolitical power, the US, which would prefer to contain China and guarantee sea traffic through the disputed area. Hopefully common sense prevails, but the risk of an escalation or occasional flare-up in this dispute is clearly there.

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