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COLLECTIVE INSIGHT

INSIGHT INTO SA INVESTING FROM LEADING PROFESSIONALS

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POLITICS & ECONOMICS: SHOULD INVESTORS CARE?

Inside

By Steve Watson

INTRODUCTION

Politics and economics: Should investors care – and if so, what matters?

To what extent is political risk priced into investments, and how actively are managers engaging with these issues?

Political theatre, both locally and abroad, has bordered on farce over the past 12 months. The leaders of all four major political parties in the UK found themselves on the wrong side of history as the electorate chose to turn back the clock and exit the most ambitious political project Europe has ever attempted.

Locally, a subterranean power struggle burst into the sunlight, stunning the business community and the country as a whole. Donald Trump has defied the odds and has risen from reality television star to potential holder of the keys to both 1600 Pennsylvania Avenue and the most powerful military force on the globe.

In this environment, investors increasingly are asking to what extent political risks are priced in and how actively managers are engaged with these issues.

In this issue of *Collective Insight* we examine the intersection of politics, economics and investment, kicking off with a reminder of the importance of solid policy in the pursuit of both economic growth and investment returns. An examination of the current situation in South Africa by Nazmeera Moola points out that SA is at a critical juncture, as political uncertainty reins in confidence and delays investment while raising the cost of government debt, thereby limiting economic growth.

However, there is hope that this Christmas will be a little merrier than the post-Nenegate one of 2015.

Michael Streatfield closely examines fascinating research on whether markets ever actually price political risk accurately and consistently, before recommending strategies for managing the effects of the uncertainty on your own portfolio. But what is needed here for the lay investor is better clarity as to how policy decisions actually link to the markets.

This is where Melville du Plessis provides some practical insights. Robert Price suggests that investors ignore politics, and even more importantly, the voice of the people, at their peril. The question is whether this is actually an emerging phenomenon that might change our traditional assumptions regarding how to invest effectively.

But Patrice Rassou reminds us that in his view, while politics matters, economics matters more in terms of creating a profitable investment environment. We close with a long-term view from Michael Power, who reflects on current events and how these may play out – and where South Africans should be looking for opportunities for the long term. ■

Steve Watson is the Investment Marketing Director for the Africa Client Group at Investec Asset Management.

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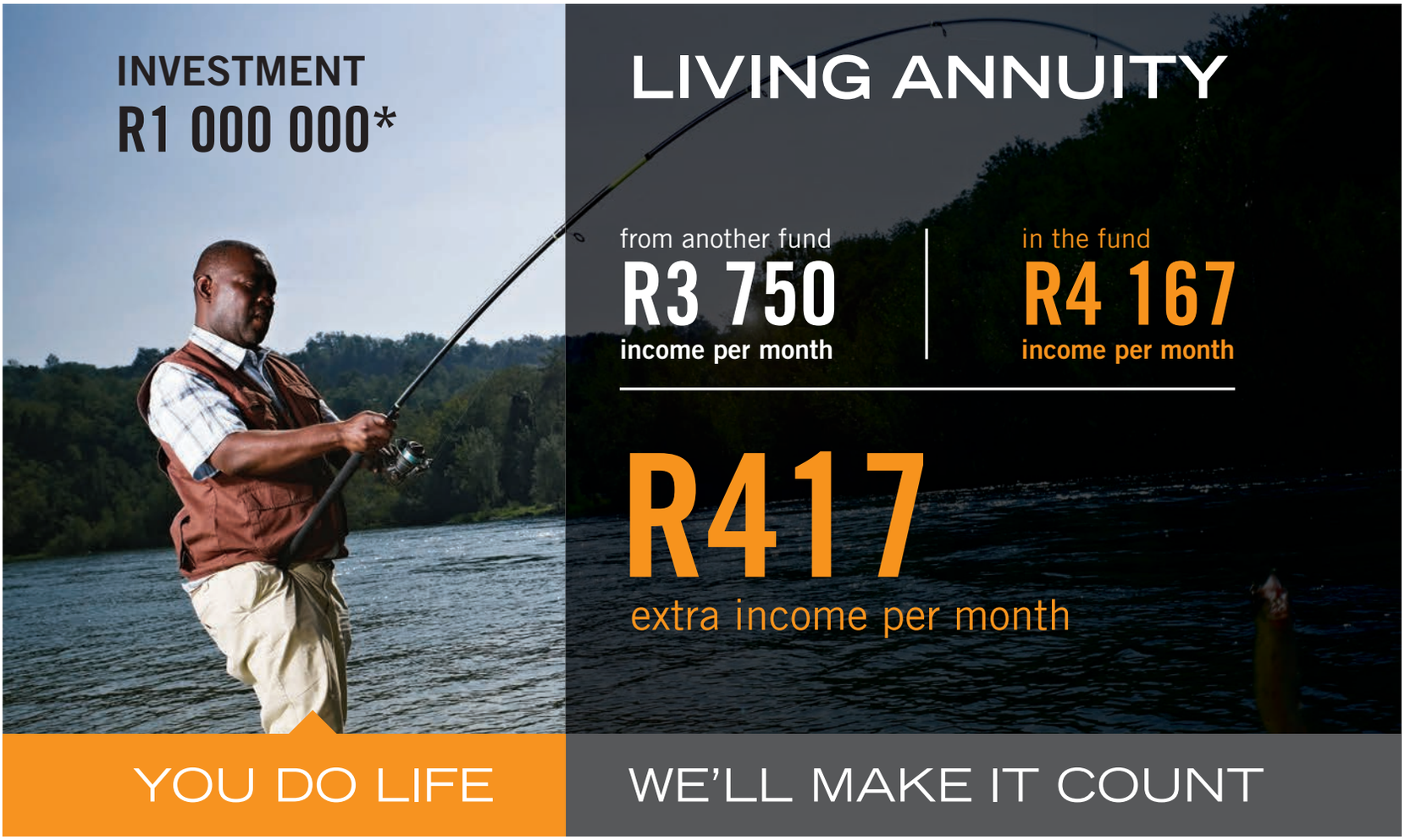

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By Nazmeera Moola

ECONOMY

Structural policy moves are needed to boost SA economy

Emerging-market economies appear to be benefitting as global investors search for yield. But self-inflicted wounds are keeping South Africa from capatilising on this.

Politics, economics and investment rarely intersect as incisively as they did halfway through 2016. If we had, the day prior to the Brexit referendum, asked a group of economists to predict the likely level of the rand, Brazilian real or the Mexican peso, should the British vote for Brexit, they would have said that a weakening of 10% to 15% from those levels was likely. Instead, most emerging-market currencies have appreciated – in some cases by around 5% to 10%.

In hindsight, the reason is clear. Fears around the impact of Brexit on global growth raised expectations of weak global monetary conditions, pushing bond yields negative in the UK, and lower in all the developed markets. Together with a slow, but notable improvement in emerging-market fundamentals over the past two years, this was enough to push global investors back into emerging markets in search of yield. Politics clearly matters for investors, but this insight must be balanced by the understanding that politics drives short-term volatility, while economics drives long-term returns.

A mix of local politics and global economics dampen South African growth

A combination of global and local factors will determine the fate of the South African economy over the next two years. Unfortunately, there is little clarity on either front. Will the global economy continue producing mediocre growth, which keeps a lid on commodity prices, thus dampening South African growth? And will money continue to flow into emerging markets in a search for higher yields than the negative rates being offered in many developed markets?

There is little South Africa can do about Chinese growth rates, the impact of Brexit or the US elections. All have the potential to significantly impact SA's growth rate. However, the downgrade in estimates of the country's potential GDP growth from between 4% and 4.5% in 2010 to 1.5% currently is due to both the sluggish global environment and self-inflicted wounds, including political and policy uncertainty.

One symptom of this uncertainty is private sector fixed investment, which has not grown since 2009. Unless confidence is restored, fixed investment (and thus potential growth) will remain low.

Unfortunately, the combination of local and global issues means that SA GDP growth is likely to be around 0% to 0.5% in 2016 – barely positive. There should be a rebound in 2017, but to around 1.3%. Policy uncertainty, as epitomised by the shock removal of finance minister Nene on 9 December 2015, shoulders much of the blame.

The combination of local and global issues means that SA GDP growth is likely to be around 0% to

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in 2016 – barely positive.

Business confidence at record lows

Electricity constraints due to the mismanagement of Eskom over the last decade (though there has been some improvement of late), labour unrest as a result of the poor relationship between labour and business, and the increasing regulatory burden on business are all factors that result in lower fixed investment. Together these local factors account for at least two percentage points of decline in SA's potential GDP growth rate.

Aside from the decline in growth, there are other lingering consequences related to Nene's dismissal. While both the rand and the cost of insuring SA's debt (measured by the cost of credit default swaps) are back to pre-9 December levels, rand-denominated bond yields in SA have not fully recovered. The spread between the SA 10-year bond yield and the JP Morgan emerging-market investment-grade index averaged 140 basis points (bps) between 2011 and late 2015. On 10 December 2015, it spiked to 310bps. Since then, it retraced somewhat to around 255bps.

This means there has been an increase of 100bps to 150bps in SA borrowing costs due to the uncertainty caused by Nenegate, immediately reducing the amount available for investment by government in infrastructure and services. This reduces the country's potential growth rate, and hence the potential returns available to local investors.

Can SA avoid a ratings downgrade?

In June, Standard & Poor's (S&P) cautioned that a downgrade would be inevitable in December 2016 if GDP growth did not improve in line with its expectations, if institutions became weaker on the back of political interference and if net general government debt combined with government guarantees to financially weak government-related entities surpassed 60% of GDP.

Fortunately, there are some positive signs. We've seen an improvement in SA's terms of trade. A continued trade surplus should ultimately reflect in a smaller current account deficit, lessening our vulnerability to external shocks.

Finance minister Gordhan announced a significant fiscal consolidation in the February 2016 Budget. So far, the revenue and expenditure targets are broadly on track. Unfortunately, there are no signs yet of any structural policy moves that are needed to boost SA's growth rate, create jobs and shore up the country's investment-grade rating for the long term.

That notwithstanding, while the country is facing growth and fiscal concerns, the economic problems are not quite as dire as we feared earlier in the year. If the recent political turmoil quickly quietens down, SA could potentially avoid a downgrade from S&P in December. In the meantime, a cautious approach and a well-diversified portfolio, both in asset allocation and geographic allocation, would be prudent. ■

Nazmeera Moola is co-head of SA & Africa Fixed Income at Investec Asset Management.

By Michael Streatfield

POLITICAL RISK

Politics: It does not matter... until it does

How does political risk affect investors – how do they view the situations in other countries? And in what ways can they benefit from this phenomenon?

In the global ocean of international investing, investors generally ignore politics and set their eyes on longer-term horizons. Yes, there are tidal surges of political chatter, like Fedspeak, which affect market sentiment, but these lift all investors' ships at once. Investment analysts focus on the numbers, and just consider politics as a welcome bit of choppy uncertainty that creates opportunities for mispricing. BTD – buy the dip!

We expect too much from foreign investors. Views on politics can be subjective when viewed from afar, especially when blown about by local sound bites. But we know from history there are times when the "Here be dragons!" warnings on the investing map bite.

How do you define political risk?

Early commentators defined political risk as discontinuities in the business environment that were both difficult to anticipate and could affect companies' profits or their ability to operate. Being difficult to predict and confounded with other economic environmental variables, political risk is hard to distinguish from general operating uncertainty or business risk. Wharton Business School professor S.J. Kobrin laments in his analyses that attempts to "integrate political information into decision making are all rather general, subjective, and superficial".

International investors view political risk on distant shores through their narrow telescope of subjective ethnocentric biases fed by their local media consumption.

What biases underlie 'political risk' assessment?

Kobrin argues that international investors view political risk on distant shores through their narrow telescope of subjective ethnocentric biases fed by their local media consumption. Such perceptions guide investment decisions with the simple strategy of avoidance of a country deemed to be too risky, whether that assessment is accurate or not.

It's incredulous – given the size of monetary flows – that not more time is taken and care is placed on untangling politics from investment decisions. Kobrin points to many papers and surveys supporting this lack of rigour. This research is dated, but with what we now know about behavioural finance, investors have probably not made much progress. Availability bias and overconfidence reinforce investor behaviour – they just continue to stick with what they know. And loss aversion looms large when storm clouds appear on the investment horizon.

In addition, local investors have to contend with how foreign investors see events in terms of their media outlets, irrespective of how the story is spun locally. Even in a global world, newspapers have regional editions. Subtleties of the story can be lost especially in this modern TL;DR (too long; didn't read) era.

Is political risk rewarded?

Investors appreciate that countries have different political ecosystems. However, the lure of crossing borders is the widening of trading opportunities.

Is this worth the risk for these less informed investors? The rush into international markets, and the rise of emerging-market debt and equity teams, suggests a business opportunity for asset managers. But, do investors benefit?

Claude Erb, Campbell Harvey, and Tadas Viskanta note in the *Financial Analysts Journal* that country risk is rewarded (this is broader than political risk) and has some measure of mean reversion, which could reward longer term investors.

Mixing business and politics...

Those investors who make an effort to mix politics with their investing economics may be getting it wrong. Textbook valuation approaches value a company's cash flows while ignoring any political interference, and then discount with a higher interest rate adding the sovereign spread (difference of your country bonds versus safer havens). This more aggressive discounting is supposed to take political risk into account. However, Geert Bekaert, Campbell Harvey, Christian Lundblad and Stephan Siegel point out in the *Journal of Corporate Finance* that this commonly used approach is flawed and overstates risk. The true political risk spread is far lower, as other elements like local liquidity and market risk contaminate sovereign spreads. Regrettably this residual political risk provides no strong statistical evidence that it leads to higher investment returns.

Foreign direct investment (FDI) is a longer-term commitment to a country than investing in bond and stock markets. One might expect that this capital would be more savvy about political risk as it is 'at risk' for longer. Not so. In their paper on political risk and foreign direct investing, Matthias Busse and Carsten Hefeker find "rather few indicators for political risk and institutions that are closely associated with FDI. The exceptions are government stability, law and order, and quality of the bureaucracy." For them quality of institutions should be top of mind for FDI investors.

Death by a thousand – or zero? – cuts

Corruption is another political reef threatening to shipwreck foreign flows. It negatively impacts FDI flows, but even where corruption is more part of the establishment, like areas of Southeast Asia, it does not prevent FDI flows. Shang-Jin Wei, in a study on the impact of

The real risk for investors is unforeseen penalties – the worst being the total loss of capital through expropriation, and lesser dramas such as imposed super-taxes on revenues, or capital controls.

Gallo Getty Image/iStockphoto

corruption on international investments, finds that US investors are not more sensitive to corruption than others, despite the US's more onerous local legislation. So even this threat does not scupper foreign investing.

...when it matters!

So it seems pure political risk (beyond country, market cycle and market trading idiosyncrasies) is as hard to pin down as the wind, is often misunderstood by those abroad, and even corruption does not keep you in the doldrums. So if politics is just hot air, does it mean smooth sailing? Campbell Harvey, in an excellent article on the allocation of assets to emerging economies, cautions there are some risks that are simply not diversifiable **(see http://bit.ly/2dwU5Ag).**

The real risk for investors is unforeseen penalties – the worst being the total loss of capital through expropriation, and lesser dramas such as imposed super-taxes on revenues, or capital controls. The market has a short-term memory. Doug Casey, American writer and the founder and chairman of Casey Research, reminds us of the litany of government failures that have happened in the last century. "The problem – your problem – is that any country can turn into a 1970s Rhodesia. Or a Russia in the '20s, Germany in the '30s, China in the '40s, Cuba in the '50s, the Congo in the '60s, Vietnam in the '70s, Afghanistan in the '80s, Bosnia in the '90s. These are just examples off the top of my head. Only a fool tries to survive by acting like a vegetable, staying rooted to one place, when the political and economic climate changes for the worse."

So set your sails to many ports (be widely diversified). Do not fear tales of pirates (separate subjectivity by understanding the investment's local media and not your local sources). But be willing to weigh anchor and cut your losses (government failures can happen) for then it's often foreigners, not local capital, who walk the plank of expropriation! ■

Dr Michael Streatfield, CFA, is writing in his personal capacity. He is a founding partner of the global hedge fund advisory Fortitudine Vincimus Capital.

STAY SHARP

WATCH OUT FOR ELECTION-TIME TAILWINDS

Watch the election cycles. A politician's goal is to get re-elected. Politicians often delay rate hikes (even when central banks are supposed to be independent!), avoid tax hikes in election years, and keep stock markets sailing. Use this to your advantage. (See legendary investor Jeremy Grantham's discussion of the US Presidential Cycle in the third-quarter GMO commentary.)

OUT THE BACK DOOR

Cyprus's banking crisis in March 2013 is a classic example of how investors can beat politics. When Cyprus imposed capital controls to limit deposits to tackle Russian grey money, it proved ineffective. Russians in London just cleaned out their accounts from the London branch of their Cyprus banks! (See http://bit.ly/2dH9LBX for more.) Stay sharp in times of trouble.

EXTREME DIVERSIFICATION

As a retail investor you may be invested offshore, but are your investment vehicles all in one jurisdiction? Under one regulator? If you have a South African offshore and a South African local unit trust, then you are invested geographically, but are not diversified politically. Appreciate the risks of being exposed to one country's beliefs and laws. ■

By Melville du Plessis

PUBLIC POLICY

Economics, politics and your portfolio

Investors should also consider public policy when making investment decisions.

Let's first reflect on what macroeconomic policy is about: economic growth, price stability, employment and viable external accounts. **These are important considerations when evaluating the potential outcomes of an investment decision:**

- Bonds – the impact of unexpected inflation;
- Companies – the economic growth outlook and consumer spending power;
- Foreign exchange rates – inflation differentials, balance of payments imbalances and the terms of trade.

But how does this fit together in practice?

Relative importance of policies

Macroeconomic policies are typically implemented through a combination of fiscal policy (budget balance between government expenditure and tax revenue) and monetary policy (interest rates and the supply of money).

The reliance placed on different policy frameworks varies from one country to the next and also changes over time. It reflects the dynamic nature of policy as economic and political circumstances change. Fiscal policy took centre stage globally in the 1930s to avoid a repeat of the mass unemployment in many countries – during the following decades, governments' expenditure as a percentage of the economy increased worldwide. Monetary policy was then given priority from the 1970s onwards to address inflation.

The global financial crisis of 2007 to 2009 and the ensuing Great Recession have forced policymakers to rethink their approaches. The focus has since shifted between fiscal policy dominating at times and monetary policy at others. Large fiscal stimulus packages were implemented to mitigate the risks of prolonged recessions – with accompanying budget deficits and increasing debt levels. Unconventional monetary policy measures such as quantitative easing and negative interest rates have been used. This has renewed interest in *coordination* considerations of monetary and fiscal policies.

In South Africa, the Reserve Bank's Monetary Policy Committee is responsible for monetary policy, while the National Budget (fiscal policy) is formulated by National Treasury. As we shall see next, the credibility and independence of these institutions are of critical importance for the country's prospects – and investment returns.

Investors can take some comfort in the fact that South African assets are already pricing in some of the political uncertainty and the potential for South African credit rating downgrades.

President Jacob Zuma and finance minister Pravin Gordhan during a meeting with Cabinet ministers and business leaders on 9 May at the Union Buildings in Pretoria.

Gallo Getty Images/Nelius Rademan

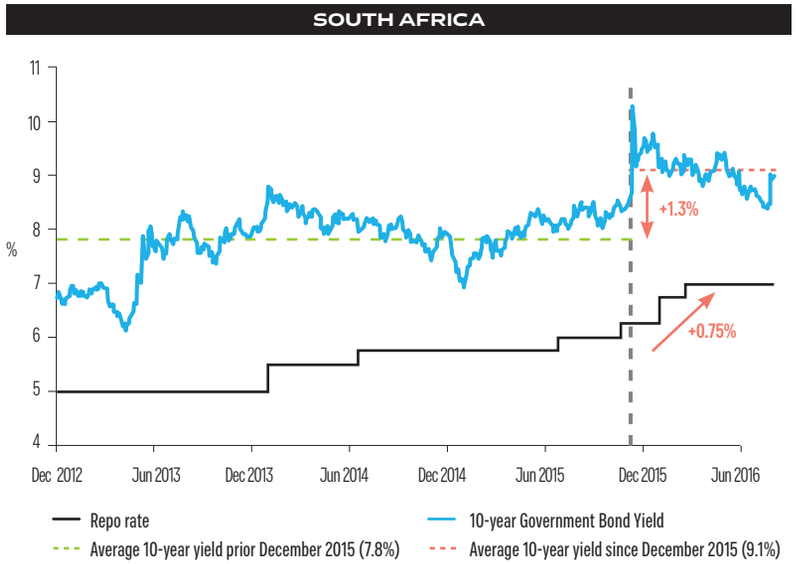
Credibility and independence

Both the policy framework and respective institutions implementing them need to maintain their credibility and independence to be successful. The less successful either fiscal or monetary policy, the more pressure on the other to achieve the overarching macroeconomic goals. For example, a loss of confidence in monetary policy could result in a self-fulfilling prophecy: if inflation expectations are not successfully managed then this could lead to inflation spiralling out of control resulting in higher interest rates, which in turn makes financing the fiscal budget deficit more expensive.

The political environment and actions are also important: in December 2015, when SA's finance minister was unexpectedly replaced, it led to a sell-off in financial assets, including substantial losses on the country's currency and government bonds. In fact, December 2015 was one of the worst months on record for local bonds while the rand weakened to previously unseen levels.

The loss of investor confidence has not yet been restored, with government bond yields trading 130 basis points higher so far during 2016 compared to the previous three years leading up to the event. Monetary policy actions for 2016 were also influenced as the weaker currency resulted in additional inflationary concerns – two policy rate hikes totalling 75 basis points ensued in the first quarter of 2016 (see graph).

The political decisions taken and macroeconomic policies implemented need to create a supportive environment that is conducive to economic stability.



SOURCE: INET BFA

The events during December 2015 were interpreted as a loss of fiscal credibility by the markets. This puts further pressure on government finances: according to National Treasury's February 2016 Budget Review the forecast increase in debt service costs has risen further on the back of the December events to R15.3bn for the following two years.

This means that government has less room to spend on items that support the economy in the long run, such as education. It affects the longer-term prospects in the country, as well as the outlook for bonds and the potential returns on equities and property.

But the question that interests investors is: how is my portfolio exposed to all of this?

Your portfolio

Investors can take some comfort in the fact that South African assets are already pricing in some of the political uncertainty and the potential for South African credit rating downgrades. Further weakness in government bonds and monetary policy tightening is possible, but there is a margin of safety priced in.

Looking at local companies, almost half of the larger shares listed on the JSE are dual-listed, with local share prices thus tied to the exchange rate, while another quarter are rand hedge shares. These share prices are somewhat insulated from negative sentiment and accompanied currency weakness. With almost two thirds of locally listed company earnings generated abroad, the ones left most vulnerable are locally orientated companies and interest rate sensitive sectors. This includes financials, as well as retailers and industrials whose earnings are sensitive to the performance of the local economy – however these sectors are already trading at a discount.

Shares with dual listings have their local prices tied to the exchange rate.

Listed property has been one of the best-performing asset classes and its continued strength has made this asset class more vulnerable – as has been highlighted by the increased volatility lately. The sector has diversified offshore over the last few years, but remains sensitive to local interest rate moves. An increase in bond yields combined with negative investor sentiment would lead to weakness in listed property counters.

What do we need at this point?

The political decisions taken and macroeconomic policies implemented need to create a supportive environment that is conducive to economic stability. One can only hope that the looming threat of South African credit rating downgrades will generate an even greater sense of urgency within the public and private sectors to address the legitimate concerns that credit rating agencies are highlighting, bearing in mind that the factors that are important for long-term economic trends aren't necessarily the same as those that are important in the short to medium term.

The implementation of credible and successful policies that stimulate broad-based economic growth is necessary to reduce rising tensions and are also key considerations when assessing the potential return on any investment in the country. ■

Melville du Plessis is a portfolio manager in the fixed interest team at Sanlam Investment Management.

By Robert Price

POPULISM

Coming full circle: Investments succumb to politics

Populism, which has reared its head in recent months, often has a profound impact on economies.

Political awareness has exploded in 2016 after Brexit sent shockwaves through financial markets. Yes, the UK economy will survive and financial markets have recovered post the decision, but the UK has been set on a completely different political trajectory. In this instance politics dictated investment performance and the decision could still shape the future of the eurozone.

Bookmakers and many money managers argue that Brexit was a 6-sigma "completely unexpected" event that happens once a decade. If this is true then we can put any potential relationship between politics and investments to one side. But what if Brexit, Trump, anti-immigration in Europe and the rise of the EFF in SA signal a trend in socioeconomics that have found expression in populism? If this is indeed the case, politics could be an increasingly important determinant of investment returns. Perhaps we require a greater understanding of the potential relationship and an appreciation of what strategies work under volatile political conditions in order to generate returns and protect capital.

The *Evening Standard* in London reporting on UK prime minister David Cameron's resignation following the Brexit vote.

Populist politicians find their voices

Some might argue that my political fears are merely a bias towards recent information and fear mongering from the media. However the number of extreme political parties with tangible power in their grasp is unprecedented in the last 50 years. The radical left-wing Syriza is in power in Greece. In Spain extreme leftists have garnered a third of votes in the 2016 elections. In France and the Netherlands extreme right-wing parties are leading the polls ahead of their 2017 elections, both with a strong anti-immigration stance. It's not just a European phenomenon. In the US Bernie Sanders won significant support in the primaries by offering radically socialist values relative to the Democrat establishment, while Donald Trump appeals to a segment of working-class voters due to his "say-it-as-it-is" anti-establishment brand. Right or left, what all these movements have in common is populism, appealing to the fears of disgruntled voters in their respective countries.

The Brexit vote was complex but it's difficult to deny that, as voting day neared, anti-immigration populism became a central pillar of the campaign in a desperate attempt by the "remain campaign" to appeal to working-class voters who were fearful in light of the recent European refugee crisis.

Donald Trump
Republican presidential candidate

The economy is not providing opportunities

Voters feel fundamentally disenfranchised by the economy. And rightly so. Whether the solutions being offered by the populists on either side of the proverbial political aisle will work is beside the point. Global economic growth remains pitiful post the global financial crisis and it isn't providing opportunities for social mobility.

The US is often applauded in economic circles because it is outperforming most of the developed world but even the world's biggest economy is only growing slightly above 1% per annum. This comes after dropping interest rates to zero and flooding financial markets with $3.5tr worth of liquidity via quantitative easing (QE). One percent real GDP growth is well below the long-term US average and closer to a recession than "normal" economic conditions.

In South Africa we have only narrowly avoided a technical GDP recession for a number of quarters. The economy has hardly gone anywhere during this period and SA has bled jobs, leading to increasing levels of economic distrust.

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1%

per annum.

Monetary activism by the major global central banks in response to the global financial crisis only intensifies this distrust. QE inflation found its way into asset prices where educated professionals easily profit through equity, pension and property holdings. On the other hand, the poor have suffered as a result of rising food prices and anaemic social mobility, which has resulted in rising inequality.

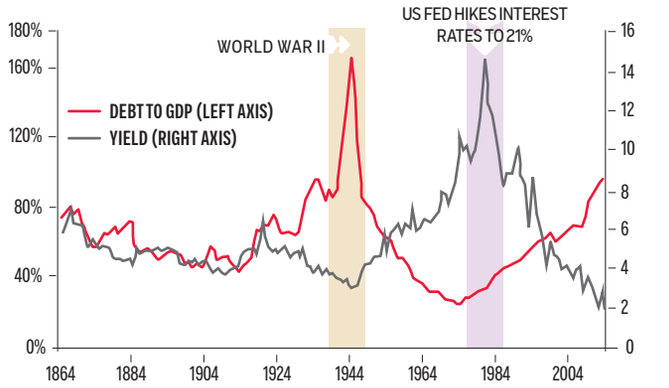
Political populism festers during periods of weak economic growth and intensification of both of these trends over the past year should give us pause to reflect before the trend is cast in stone. History tells us that the worst socioeconomic disasters usually happen when extremist politicians take advantage during troubled economic times to prey on the fears of the masses: Stalin in Russia after the fall of the tzar and Hitler in Germany after the post-World War I debt reparations are

Images: Getty Images/iStock Images

Getty Images/Christophe Morin/IP3

Investment managers must be able to question the status quo and interrogate whether there is a relationship between investments, politics and economic conditions.

IN THE MODERN ERA, PEACETIME DEBTS HAVE NEVER BEEN HIGHER AND NOMINAL RATES HAVE NEVER BEEN LOWER
G7 AVERAGE DEBT/GDP AND 10-YEAR NOMINAL RATES



SOURCE: Deutsche Bank; GDO; Haver Analytics, 2004

the clearest examples. Current political leaders aren't equivalent to the extremities of Hitler or Stalin but falling interest rates in the world's major economies and rising aggregate debt levels eerily mirror the troubled times of the 1920s and 1930s.

What can be done to arrest the trend? Growth policy déjà vu

The G20, IMF, Federal Reserve and World Bank tell us that further lower interest rates, higher inflation and greater debt funded aggregate expenditure are required to pull the global economy out of the current mire. It is possible that they are correct. However, it is easy to see from the chart above that this plan has been tried before.

Interest rates are already at multi-decade lows across the globe and are at zero in some places, which results in the perverse signal that there is no time preference between current and future consumption. It is no surprise then than aggregate debt levels are at multi-decade highs.

Just like a student who forgoes future consumption in the early years of professional life to purchase a university education in the present, nationwide debt accumulation is merely a decision to forgo future consumption in order to consume in the present. If the debt isn't put to productive enough use (clothing instead of education), we reach the future and earnings haven't progressed sufficiently to offset the loan repayment and consumption must be reduced.

The future is here. The globe has clearly made some bad investments, otherwise we would have repaid rather than exploded the debt stock. Lower consumption is the current economic truth we're digesting. Many mainstream analysts dogmatically ignore this economic truth and remain hopeful governments can paper over the cracks but the risk is that more debt will merely prolong the pain.

Marine Le Pen
President of the far-right French party National Front

Overreliance on 'consensus' is dangerous

One reason for the ineffectiveness of the market of bookmaker prediction models is the bounded rationality of mainstream analysts who cannot fathom why voters could choose an outcome so contrary to the analysts' own status quo worldview. However the majority of voters might hold a completely different worldview, seeing the political and economic status quo as their key obstacles.

Contrarians profit from the status quo

While the consensus analysts were puzzled by the Brexit, the best-performing managers during the Brexit period were the contrarian-style investors. Contrarians don't necessarily need to take a strong political stance between two opposing candidates. They merely question orthodoxy and have an ability to envisage non-standard outcomes. Contrarians also position portfolios to take advantage of asymmetric events like Brexit.

With developed market interest rates at historic lows, the cost of option strategies, which benefit from asymmetries, is incredibly low. Volatility has been suppressed by low interest rates and is a critical input in option pricing. For example, volatility on US equities (as measured by the Volatility Index or Vix) has only been lower 2% of the time through history. The pay-off from asymmetric events is usually handsome as the market quickly moves to price additional risk premiums into European banks, for example. If political populism continues to respond to weak levels of economic opportunity, then these handsome pay-offs might become more regular than the market is currently pricing.

Political appreciation is an increasingly important determinant of investment returns

It is a cop-out to say that investments are made merely at the whim of politics when it is possible that poor economics are the root cause of increasing populism. As custodians of clients' wealth, investment managers must be able to question the status quo and interrogate whether there is a relationship between investments, politics and economic conditions. Sitting on the sidelines and enjoying the fruits of low interest rates without considering the costs is imprudent. Brexit was interpreted as a 6-sigma shock by many investment professionals. But what if disenfranchised voters vote for Trump in November or Le Pen in France next year? Should we be surprised? Unsustainable economics has come full circle to encourage unsustainable politics. Investors should be acutely aware of these risks and positioned accordingly. ■

Rob Price is a macroeconomist at Investment Solutions, and provides portfolio research and strategies to the investment team.

By Patrice Rassou

SA IN CONTEXT

Yes, we got blindsided

History shows that bad politics can indeed lead to bad economic outcomes.

Ian Bremmer, the American specialist on global political risk, argues that "emerging markets are countries where politics matter as much as economics".

Acerbic! Scathing! For the majority of South Africans, the wealth and savings generated during our working careers will be determined by the performance of our economy. For young South Africans, life in a democratic society has resulted in many opportunities and yet, despite extensive measures focusing on poverty alleviation, inequality within our society has widened – a global phenomenon highlighted by French economist Thomas Piketty at the seminal Nelson Mandela lecture last year. We got blindsided.

So who's to blame? Many of you will say: "Politicians!" Other stakeholders such as union leaders may blame owners of capital or even capitalism as an economic system. Business owners complain about the volatility of the currency, structural rigidities or low economic growth. It is a plot fit for an Agatha Christie novel – featuring the shady politician, the boisterous union official, fat cat businessman, apathetic member of the public and the ambivalent economist vying for the "whodunit" tag. If in doubt, they say, blame the economist.

Is capitalism the best solution?

A system fuelled by free enterprise in which financial markets operate seamlessly was the textbook solution and may have been the recipe to get us out of our economic quagmire, supporting the idea of shrinking the size of government to minimise interference with market forces.

The economic success of the Western World and continued success of the US economy has been a poster child for capitalism and the basis for a democratic political system. Before the industrial revolution, the Western world was, at best, twice as wealthy than the rest of the world – now this gap has widened to 20 times! Many attribute the gains to globalisation and free trade. However, the global financial crisis has raised serious questions about the ability of an unbridled laissez-faire system to deliver sustainable growth. Despite capitalism's long winning streak, democracies are questioning how the gains are being shared, leading to more populist governments being elected to power. But is government always part of the problem or could government be part of the solution?

Despite capitalism's long winning streak, democracies are questioning how the gains are being shared, leading to more populist governments being elected to power.

Looking to the East

The rise of the Asian Tigers and China has led to a re-assessment of what constitutes the ideal political model and to some extent on the type of economic environment which promotes growth. In the 1950s, the average South Korean was not much better off than the average South African, operated within an unstable political system and their country had no industry to speak of.

North Korea was in fact more developed than its southern neighbour. What South Korea did was to provide for infrastructure via state-owned enterprises while allowing private enterprise to prosper. Government subsidised key sectors and protectionism was the watchword. A far cry from the free enterprise system described earlier and even further from the tea party ethic of small government.

South Korea has since grown the wealth of its inhabitants to triple that of South Africans. State capitalism was born and China has taken the baton as the role model for a new government-led economic model, growing the wealth of its giant population at 11% per annum since the 1980s (doubling the average income every seven years). Contrast this to South Africa, where average GDP per capita – a measure of standard of living – has gone up 3% per annum over that period.

How does corruption take hold?

The problem, as expounded by Bremmer, is that stability and openness in terms of political regime is never secure and states can vary over time. The risk is that during periods when the economic pie does not grow – as we are experiencing at the moment – there could be a rise in the level of corruption and patronage. During such periods, members of the political elite seek to exploit state resources for personal gain and the middle class gets hollowed out – a Zimbabwe-type scenario where redistribution of a shrinking economic pie becomes the political motive and the populace suffers from a complete lack of service delivery. So bad economics could cause bad politics – as much as bad politics would lead to bad economic outcomes.

For investors, politics matters but economics matters more in terms of creating the environment where we all prosper and generate the income required for a comfortable future.

Much to be done

So how do we avoid getting blindsided? We need politicians to implement public policies that will ensure prosperity for all in the long term, businesses have to allocate capital to deliver good returns and institutions have to remain free from undue interference. Members of society at large have to work together to create a climate conducive to growth.

While most households have to plan carefully to make ends meet each month, our government delegates this task to the minister of finance when it comes to managing the country's purse. While financial markets may have been blindsided by Nenegate in December, the pressure is now on from credit rating agencies for government to table a credible plan – until then, many South Africans will be sleeping with one eye open. ■

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A Difference That Matters™

By Michael Power

OUTLOOK

The end of the world as we know it?

The West seems to be declining while China and the rest of the world are on an upward trajectory. What could the future hold for the global economy?

A hundred years from now, will South African students studying 21st-century history learn that the Brexit vote – which saw an already-sceptical Britain turn its back on the dream of a United States of Europe – was a watershed event? The start of the process by which the West turned its back on its 200 year-long role of being the global economy's star player, exiting that stage and leaving it to new actors from the emerging Rest to move centre stage?

Will Brexit now be followed by a chaotic Italian referendum leading to a Renzi resignation, a Trump victory in the November US Presidential Election, Angela Merkel's loss of power in the 2017 German election due to the rise of the AfD, a right wing anti-immigrant party, and Marie Le Pen of the National Front winning the 2017 French presidential election? While the chances of all these events being realised are slim, the very fact that some might yet happen has radically changed the political narrative now being spoken in the West.

Will those future South African students perceive the West's middle classes as shouting, "Stop the world, I want to get off!"? And will a deeper analysis of their *cri de cœur* reveal a profound disconnect between the West's political elites and its electorates at large? All the leaders of Britain's big four political parties wanted to remain in Europe, yet 52% of the British electorate favoured Brexit.

It is generally the older, more rural, poorer, non-university-educated Western voters who have qualms about globalisation. Why? Because they have been most negatively affected by its dark side – widening wealth inequality and falling median wages leading to a growing sense of helplessness and alienation together with a feeling that their political elites live in cloud-cuckoo land, disconnected from the everyday nitty-gritty realities of the majority.

Is change on the horizon?

The ballot box frustration of Western voters is in stark contrast to the lofty rhetoric of Davos Man.

American business executive Jamie Dimon revealed the depth of this disconnect between the rulers and the ruled when he noted that Davos was where "billionaires told millionaires what the middle classes think". If nothing else, Brexit proved that the West's 1% has little idea of what much of the remaining 99% really feels.

Francis Fukuyama
American political economist

Since 2000 it has become apparent that Western liberal democracy might not be the perfect and permanent companion to "red in tooth and claw" capitalism.

In parallel, now there are questions being raised about the quasi-religion of free trade, which has dominated global commerce since Britain's repealed the Corn Laws in 1846. Both Trump and Clinton have questioned the Ricardian reasoning that free trade agreements benefit the US as the logic of comparative advantage has been washed away in a tsunami of mobile capital and integrated supply chains. Trump has even raised the possibility of the US leaving the World Trade Organization.

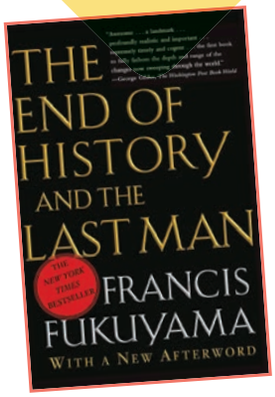
There are also growing doubts about the compatibility of free-flowing global capitalism with liberal democracy. This contradicts prevailing conventional wisdom: after the 1989 fall of the Berlin Wall, American political economist Francis Fukuyama told us in *The End of History and the Last Man* that the democratic capitalist model was the apotheosis of all political orders. He maintained we had reached "the end point of mankind's ideological evolution and the universalisation of Western liberal democracy as the final form of human government".

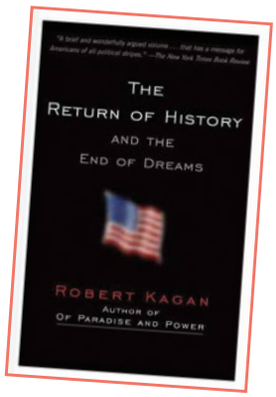
Yet since 2000 it has become apparent that Western liberal democracy might not be the perfect and permanent companion to "red in tooth and claw" capitalism. One must then ask whether the democracy the New West still wants is affordable if it is not underwritten by the productive capitalism it does not want, even if that capitalism is leavened by a redistributional state?

If this reversal of conventional thinking holds, does this mean that rather American historian and foreign policy commentator Robert Kagan is right in his 2007 book *The Return of History and the End of Dreams*, a pointed riposte to Fukuyama? Will the remainder of the 21st century become a battleground between the aging, liberal democracies of the West and more authoritarian states emerging out of the Rest, the latter seeking to avenge past offences and reassert its national identity and, exploiting the opportunity presented by the West turning in on itself, even expand its national space so facilitating the writing of a completely new chapter in the history of the world?

In particular, China will surely jump at the opportunity to fill the power vacuums now appearing

Images: www.fukuyama.stanford.edu





Will the remainder of the 21st century become a battleground between the aging, liberal democracies of the West and more authoritarian states emerging out of the Rest?

by pursuing its One Belt, One Road strategy in Eurasia and the Indian Ocean Basin.

Western bond market in disarray

From the perspective of the South African investor, the above implications are profound: the principal destination of the investment monies being taken offshore – the "safe havens" of the West – are starting to look less than safe and, because of darkening political clouds, less than havens. They are also – leaving aside the possible benefits of diversification away from the rand – starting to look sparse in terms of both opportunities to reap yield and earn capital gain.

The most obvious evidence of this is in bond markets, where some 30% of the global issuance of sovereign bonds now have had negative yields. The bond markets of most of the eurozone, Denmark, Sweden and Japan are dipping in and out of negative territory. Indeed the entire Swiss bond market is now underwater. The result is, as Morgan Stanley has noted: "Over the last 17 years, 10-year government debt in the US, Germany, the UK and Japan has produced a better return than the local equity market, with lower volatility."

True, from an equity perspective, the S&P500 Index has recently recorded all-time highs despite many quarters of falling revenues and profits. But valuations are stretched. Net flows directed towards equities – mostly in the form of share buybacks rather than institutional or retail investor flows – are being invested by default: "We companies cannot find anything better to do with our money." Corporate investment rates are at near record lows, suggesting that the certainties of the present outweigh the risk-weighted but now-clouded-by-politics opportunities of the future.

So where should one invest?

All these events are, for the South African investor, unfolding within a global economic climate that still exhibits more clouds than sunshine: in July, the IMF further cut global GDP growth estimates to 3.1% for 2016 and 3.4% for 2017. Aging demographics and lacklustre productivity growth are reducing Western trend GDP growth rates to almost zero. Yes, the US may outperform its peers and its 10-year Treasury bill still yield a positive 1.7%. But this is cold comfort: the US looks good only when measured against Western benchmarks; against its own economic record, current performance looks meagre. And since the 2008 breakdown, the West's economic "recovery" has been the shallowest in 60 years with US GDP growth averaging only a lacklustre 2.1%. And given that this recovery is the 4th longest on record since 1954, the next slowdown cannot be far away.

But just because the prospects for investment returns in the traditional destinations for South African capital are dimming, this does not mean opportunities elsewhere do not exist. Too often South African investors make the mistake of thinking that the world is the West and ignore the growing importance of the Rest. A more global perspective would suggest the outlook in the New World of Asia is brighter, particularly as the Asian consumer seems finally to be standing up to be counted.

Historically, South African investors have favoured Western equity and bond investments. In future, more exposure to Asia will be likely. Asian fixed income funds are underpinned by solid fundamentals both for macro government bonds and micro for corporate bonds. Because of their higher yields, Asian cash and credit opportunities will also attract attention. Asian currency risk exists but, with downside limited by the best macro prospects in the world, they are no riskier than – indeed they are probably better than – those of Europe and Japan. For those seeking greater equity exposure to Asia, there will be two broad strategies: a softer, more indirect approach and a harder more direct one. The former – call it the "cappuccino" option – involves increasing exposure to global multinationals whose strategy is increasingly focused on Asia, like Nestlé or Unilever. The latter – call it the "espresso" option – involves investing directly into Asian stock markets.

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As it is, all global investors will soon be "forced" to increase their exposure to China. Recently Beijing announced that it is "connecting" the previously-inaccessible-to-foreigners Shenzhen Stock Exchange (which houses many of China's best run companies, nearly all of them private sector and primarily focused on the tech, domestic consumer and service industries) to the already-accessible-to-foreigners Hong Kong and Shanghai Exchanges. This connection will henceforth allow investment by foreigners into nearly all of China's listed equities. It will result in the likes of MSCI lifting the China weight materially in all its global indices, thus obliging global funds – especially tracker funds but even to some extent actively managed ones – to increase their exposure to China.

With regard to their offshore investments, South African investors are facing an age when they need to start looking beyond the foreign and familiar to the foreign and unfamiliar. ■

Michael Power is a strategist at Investec Asset Management.

Images: www.fukuyama.stanford.edu