Global Market Watch: Political Uncertainty Remains the X-Factor

Author:
Markus Schomer, CFA
Chief Economist

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At the beginning of the year, rising political risk was looming over a fairly bullish underlying macroeconomic backdrop. Yet, overall, politics has turned out to be quite growth supportive. The latest political event was Germany's parliamentary elections, but the political calendar has a few more potential market-moving events on tap. In Japan, Prime Minister Shinzo Abe called snap elections to exploit the opposition party's disarray and renew his own mandate. And EU heads of state are set to convene for the union's biannual European Council meeting, at which members are likely to decide whether the Brexit negotiations can move to trade talks.

Germany may finally enjoy some fiscal easing

The return of Angela Merkel as German chancellor for a record-breaking fourth term was never in doubt. Her center-right Christian Democratic Union (CDU) remained the strongest political party. Nonetheless, she faced the same populist challenge that has disrupted the political establishment in many developed-country elections in the past twelve months. Merkel now has to forge a coalition with the pro-business Free Democratic Party (FDP) and the Greens. Given the ideological difference between the three parties, it may well take until Christmas before the EU's largest and politically most dominant country has a new government. However, the outcome could likely be a more growth supportive fiscal policy with tax cuts and more infrastructure spending that could boost eurozone growth in 2018.

Even Japan might not be immune to political surprises

Japan wasn't on the list of countries representing a source of political risk this year. But that was before Prime Minister Abe called snap elections to be held in late October. Abe is looking for a new mandate to pursue a more forceful military policy despite commanding two-thirds majorities in both houses of parliament. However, as the Conservatives in the UK found out, electoral outcomes are never certain, and Abe is suddenly facing a serious challenge from a newly formed conservative party headed by Tokyo governor Yuriko Koike. Out of nowhere, her Party of Hope is polling between 15% and 18%. Still, that may not be enough to dislodge Abe's Liberal Democratic Party (LDP) from power.

If he loses seats, Abe could face the kind of leadership challenges that have dogged UK Prime Minister Theresa May. Abe can point to the recent improvement in Japan's economy and the lowest unemployment rate in 25 years. Yet a series of elections in countries such as Poland and New Zealand have shown that economic performance alone doesn't guarantee re-election, and Abe may be in trouble.

Brexit reaches its first crossroads

Europe's other major political event, Brexit, has reached a critical decision point. At the October European Council summit, EU heads of states are set to determine whether sufficient progress has been made in the first round. The focus so far has been on: EU citizen rights post Brexit, the border between the Republic of Ireland and Northern Ireland (which is a part of the UK), and the amount of money the UK needs to pay for future pension liabilities and committed EU projects.

Prime Minister May tried to unblock the talks in a speech in Florence, indicating her willingness to compromise on the most critical issues. Yet the remarks lacked sufficient specificity, and it's unclear what the EU summit will make of it. European Council President Donald Tusk has already stated his view that progress has been insufficient, indicating that talks may need to be extended and that the start of trade talks will have to be pushed into 2018. Such a decision could increase the risk of a “No Deal Brexit.”

Markets continue to be risk-on

Despite the political noise, investors are keeping faith with the equity bull market. The MSCI all-country index posted a strong 1.9% gain in September. It was the second best month this year, taking the index’s year-to-date gains close to 12%. For only the second time in 2017, developed markets outperformed emerging markets – and that despite the fact that most of the political risk is in the developed world. Interest rate sensitive fixed income markets lost money in September. Citbank’s World Government Bond Index declined 0.4% and the Bloomberg Barclay’s Global-Aggregate Credit index was down 0.3%. Emerging market (EM) fixed income performance was mixed with sovereigns generally losing ground, while the JP Morgan EM corporates index (CEMBI) posted its tenth consecutive monthly gain this year. US dollar performance was also mixed in September. Among the major developed world currencies, only the British pound, Canadian dollar, and New Zealand dollar appreciated against the greenback. Others – including the euro, yen, and Asian tiger currencies – lost value versus the dollar.

The global growth trend remains bullish

The business investment driven re-synchronization of global growth continued to gather pace in September. Asian export growth remained strong, and industrial metals prices rebounded from August’s minor set back. However, there are also clouds on the horizon. US gross domestic product (GDP) growth is slowing in the current quarter as a result of the hurricane-related disruption to economic activity. Japan’s initial, impressive 4% second quarter growth rate has been revised down to a more average 2.5%. Meanwhile, domestic activity indexes for the eurozone have shown strong and still improving growth momentum. In fact, the European Commission’s economic confidence index for the eurozone has risen to the highest level in ten years and is within a whisker of the previous business cycle high from 2007.

Strong fundamentals dampen political noise

It seems the string of political events hasn’t done much to disrupt the risk-on investor sentiment. And not all of them have been bearish. Germany’s election could open the door for more growth-supportive fiscal spending, though that positive sentiment could be offset by more political paralysis in Japan and the threat of a more disruptive Brexit outcome. The underlying growth story remains strong. The regime change from a world of excess supply to one where supply and demand are more in balance is driving a rebound in business investment. If those cyclical growth drivers could be amplified by looser fiscal policy next year, the current business cycle could stretch a bit further before rising global policy rates kick in.

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