Do we need to worry about Populism?

We live in a world characterised by increasing tension around immigration, wealth disparity, unemployment and corruption. These tensions have taken functional form in the increasing power of 'populist' political parties.

A populist politician or political party is one that seeks to highlight the difference between the "have's" and the "have not's", and to use this as a way to gain mass-market support amongst voters who can relate – typically a substantial part of any population.

We see this with the rise of the 'EFF' in South Africa, the success of the "leave" campaign in the vote for the UK to leave the European Union, 'Podemos' in Spain and even Donald Trump's bid to be president in the USA. Each of these entities have begun to wield real power by playing on the fears of ordinary citizens, be they the loss of jobs from technological progress or the perceived threat of immigrants. Populism is closely linked to radical change and upheaval in society and markets. In this quarterly commentary, we seek to elaborate on the real effect of populist politics on investment markets and how we should factor it into our approach to investing.

What are the risks that populism bring to investing?

Populism and the policies that underpin it expose markets to a new set of risks that one would not ordinarily consider. Firstly, it is key to note that populism is net-negative for markets. Populism is disruptive, it involves the changing of the status quo in society and repositioning wealth away from the current holders of that wealth to those currently without. Populism brings with it increased risk to valuations as uncertainty rises, whether it be uncertainty over government policy decisions, regulation, nationalisation or even trade deals.

Populism is negative for global trade, as it is often centred on policies aimed at the protection of local industries, the closing of borders and the protection of the local population relative to outsiders. This view is in stark contrast to the push for increased globalisation and trade which has characterised the world for the last 25 years. Although populism is net negative, there can be some positives taken out of this push against globalisation: stronger local industries with less global trade means that regional diversification of investments is easier to achieve and there is more support for the home economy - a good outcome when searching for diversification in client portfolios.

The increased move towards populism also speaks to a loss in faith by some in a capitalist market system. This is resoundingly negative for financial assets. One outcome that is consistently seen when a populist party is elected, or a populist policy is put into place, is that the country in which this happens is re-rated downwards by the global investment community.

Why does populism find support?

Wealth Gap

The first reason is that there exists a persistent and increasing wealth gap around the world. At the beginning of 2016 an Oxfam publication claimed that the top 1% of the world's population held an equal amount of wealth to the other 99% combined. The poorer majority is questioning the fact that they seem to be the only ones hurting from austerity measures after the recent great recession while the 1% appear to only be gaining wealth.

Job Security

Secondly there are increasing fears relating to potential loss of jobs in blue collar industries in developed Western nations due to the globalisation of world trade. The natural progression of these jobs has been towards developing nations in the East, where populations are willing to do the same jobs for less money. When jobs are threatened and the ability to feed a family comes under pressure, then populations tend to react passionately. This has been the popular narrative used recently by both Donald Trump in America and the 'leave' campaign in England.

Immigrants

The third major reason that populism has gained so much traction in recent times is that there is a perceived threat from immigrants. War in the Middle East has left entire countries devastated and the developed world has been called to take in refugees from the crisis. This line of thinking leads to anger and resentment towards immigrants as they perceivably threaten both the safety and jobs of the locals.

Underlying these three reasons there is a constant narrative of loss of faith in the political parties who have let the current status quo develop. People want an alternative and populism presents that alternative world view to many people.

Region	South Africa	Europe	UK	USA
Loss of Public Confidence in Mainstream Political parties	✓	✓	✓	✓
Perceived Immigration Issues	✓	✓	✓	✓
Wealth Gap	✓		✓	✓
Unemployment	✓	✓		

Table: Conditions for populism to find support

The above table summarises some of these key issues and whether they are present in the various key regions around the world. Can we really be surprised with the rise of populism when these issues exist, and should we be preparing for the same in South Africa considering that all of the conditions for populism to rise are present in our country?

How does the market react to populism?

The best way to represent the market's reaction to populism is to break down the stages from when populism emerges in an election or key decision until that decision is made, throughout these stages we evaluate how investment markets are likely to react.

Stage	Equities	Bonds	Currency	
1. Underestimation	↑	↑	↑	Business as usual
2. Growing Concern	↑	→	→	Exposed assets under pressure
3. Realistion	↓	↓	↓	Heightened risk aversion
4. Panic	↓↓	↓↓	↓↓	Sellers>buyers
5. Rationlisation	↑	↓	↓↓	Return to new status quo

The above table represents illustrative performance of 3 key asset classes through each stage during an election/referendum process in which populism emerges. It shows the natural progression from underestimation, in which asset classes ignore the potential impact, to growing concern, realisation, panic and lastly rationalisation – where a degree of normality and the new status-quo emerges.

It would be interesting to follow this thought process across the pending US elections. Have we really considered the investment implications of a Trump win? Most investors have significant US$ exposure, the consequences are material.

In environments like this, equities are best protected due to their diversified nature. Interest rate dependent assets and currency are most exposed as the risk premium attached to the country rises, directly impacting bonds and currency.

How should we respond to the risks of populism?

Populism is not the only risk in global markets, and likely not the most severe either. There are simply too many potential risks to consider and individual risks like this can't and shouldn't be singled out. What we can do is evaluate the basic building blocks of a portfolio to ensure that it is not overly skewed towards the more obvious risks. For the rest, diversification is the only real solution.

30 September 2016

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	0.5%	4.8%	6.6%	8.8%	15.3%	12.0%	11.1%	15.1%
FTSE/JSE SA Listed Property	ZAR	-0.7%	8.8%	3.8%	14.5%	17.9%	17.6%	14.2%	15.8%
SA All Bond Index (ALBI)	ZAR	3.4%	15.0%	7.6%	6.8%	8.0%	8.5%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.9%	5.4%	7.1%	6.4%	6.0%	7.3%	0.2%	0.6%
Balanced Benchmark[2]	ZAR	0.3%	4.8%	7.9%	10.3%	14.9%	11.9%	6.2%	6.2%
SA Inflation (1 month lag)	ZAR	1.3%	5.3%	5.9%	5.7%	5.7%	6.1%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	4.9%	5.6%	11.4%	5.8%	11.6%	4.5%	12.0%	16.5%
Emerging Markets Equity (MSCI EM)	USD	9.0%	16.0%	16.8%	-0.6%	3.0%	3.9%	17.3%	23.6%
Global Bonds (Barclays Global Bond Index)	USD	0.8%	9.8%	8.8%	2.1%	1.7%	4.3%	4.2%	5.7%
Global Cash	USD	0.1%	0.4%	0.4%	0.2%	0.2%	1.2%	0.0%	0.5%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.5%	4.8%	6.6%	8.8%	15.3%	12.0%	11.1%	15.1%
Global Equity (MSCI World)	ZAR	-1.5%	-6.3%	10.7%	17.5%	24.3%	10.6%	13.4%	13.7%
Emerging Markets Equity (MSCI EM)	ZAR	2.4%	3.0%	16.1%	10.3%	14.7%	10.1%	13.2%	15.7%
SA All Bond Index (ALBI)	ZAR	3.4%	15.0%	7.6%	6.8%	8.0%	8.5%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	-5.3%	-2.5%	8.2%	13.3%	13.3%	10.4%	12.3%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	2.0%	26.1%	18.9%	-0.2%	-3.9%	8.3%	18.0%	19.2%
Gold (Rands)	ZAR	-4.3%	11.9%	18.3%	10.7%	7.0%	14.6%	18.9%	21.7%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	-6.9%	-11.2%	-1.1%	11.0%	11.3%	5.9%	14.3%	16.6%
Rand / GBP Pound	ZAR	-8.8%	-21.8%	-15.1%	3.2%	7.3%	2.1%	13.5%	14.9%
Rand / Euro	ZAR	-5.5%	-8.2%	-0.5%	4.3%	7.4%	4.6%	12.8%	13.7%

Spot Rates

30-Sep-16		3-Oct-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ag
Rand/US$	Rand	13.59	13.72	13.82	8.09	7.74	4.54
Rand/GBP	Rand	17.47	17.59	20.93	12.60	14.51	7.08
Rand/EUR	Rand	15.25	15.42	15.46	10.83	9.84	5.39
Rand/Aus $	Rand	10.45	10.51	9.68	7.82	5.79	3.60
Libor 6m $	US$	1.25	1.24	0.53	0.56	5.37	N/a
Prime	Rand	10.50	10.50	9.50	9.00	11.50	19.50
Repo Rate	Rand	7.00	7.00	6.00	5.50	8.00	N/a
All Bond Index Yield	Rand	8.73	8.79	8.54	8.62	10.00	14.03
Gold ($/oz)	US$	1,311.26	1,312.00	1,115.05	1,624.40	598.30	378.40
Palladium	US$	N/a	722.00	661.00	614.00	315.00	118.75
Platinum	US$	1,007.00	1,026.50	906.50	1,525.50	1,140.50	382.50
Oil (Brent Crude) $	US$	50.76	50.00	48.54	105.94	60.76	23.36
SA Inflation	Rand	N/a	5.90	4.60	5.70	5.30	8.40

data provided by Profile Data Analytics and INET BFA