A Look at Today's Primary Global Risks

We continue to see unimaginable political events taking place and countries around the world on edge. There is an uneasiness which permeates the global economic and financial backdrop. To bring some clarity to this opaque market environment, we focus this month's Thinking Man on identifying and discussing today's primary global risks.

During October's International Monetary Fund meetings in Washington, plenty of macroeconomic ideas were presented. A very interesting appearance from Mr. Axel Weber, former head of the Bundesbank, now chairman of UBS, argued that several issues are shaping markets. The first global risk facing investors today is the global banking system. Although it is currently strong in the United States, and the most stable it's been over the last decade, problems remain particularly in Europe and Japan. Secondly, heavy central bank intervention has created an unhealthy market environment, distorting asset valuations. The last, and most crucial issue concerns political risk, driven mainly by the lack of economic growth. This has given rise to populism, creating uncertainty in the political sphere and significant volatility in the markets.

1. The first issue is a net positive: the global banking system is much stronger today than it was a decade ago, thanks to post-crisis reforms. But there are evidently problems that remain in the system, particularly in Europe. Deutsche Bank is grappling with a threatened $14bn US regulatory fine, Italian and French banks remain plagued with bad loans, and almost all institutions are struggling to find a profitable business model. This last point is demonstrated by the fact that the top 5 European investment banks had pre-tax profits of $4.2B in 2015, while the top 5 US investment banks had pre-tax profits of $33.5B.[1] The market sees European banks as much riskier – as of October 21st, US bank stocks are up 5.5%, while European bank stocks are down 8.4%.[2] But leaving aside those (big) caveats, the fact is that banks in the Western world now have far more spare liquidity and capital. If you look at pre-crisis, you could run a global bank on 1 or 2 per cent of core tier one capital, while now most of the banks are well above 10 percent. Regulators in

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The main threat facing global investors today in the world post- QE (quantitative easing and heavy central bank intervention) is political risk. Investors and investment groups could be wiped out by wild price swings from an unexpected political shock, be that central bank policy swings, trade bans, election results or Brexit. Two ways to address this is through diversification (the only free-lunch in investing), some smart hedging as well as in taking advantage of the high illiquidity premiums (investing in private equity, private debt and other illiquid assets).

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[1] https://www.ft.com/content/65eb0710-e3bd-11e5-a09b-1f8b0d268c39
[2] Data as of 10/21/15. Source: Bloomberg. Proxy for the US banks: KBE, Proxy for European Banks: Amundi

Europe continue to raise standards for banks- in early October the Basel Committee on Banking Supervision announced additional bank safety reforms, which would limit banks' ability to use their own internal models to assess risk.[3]

Such reforms reduce the chance of banks collapsing over macroeconomic shocks; indeed, these higher capital and liquidity ratios have already blunted some of panic around the recent Deutsche Bank woes.

2. The second issue on Mr. Weber's list is concerning: while the banking system looks healthier, markets do not. The issue that investors need to understand now is that many "markets" are not true markets because of heavy government intervention. It is evident in government bond markets, where the central banks of Japan, US and the Eurozone currently hold a third, a fifth and a tenth of the outstanding local government bonds.

Central bank purchases are distorting the price of European corporate bonds and Japanese equities, with knock-on effects in numerous other asset classes. It is difficult to appropriately value an asset without taking into consideration the distortions brought on by the massive central bank intervention.

The markets have shown several signs of their unhealthy status. While volatility has been low in recent years, "volatility-of-volatility" has remained elevated. This is demonstrated as tranquil periods are occasionally punctured by violent sell-offs that seem to feed on themselves, until they suddenly stop. Just to cite 3 recent examples that signal this market dynamic: in the bond markets the Bund Tantrum of April 2015; in the equity markets the Chinese Sell-off of January 2016; in FX markets the Pound Sterling move of this month (October 2016).

Another factor contributing to the unhealthy dynamic in the market is that dominant market participants include computerized trading that leverage market moves. One example is risk parity funds. These funds come in many forms, but in essence are passive, systematic and computer-controlled vehicles that weigh their investments equally across asset classes (stocks, bonds and commodities) according to their mathematical volatility, applying leverage on the various components to ensure "parity". In theory, this ensures a well-diversified portfolio that should over time perform in most market environments. These funds have strong long-term records, polishing their attraction. Alliance Bernstein estimates that there is about $400 billion of capital in risk parity funds (excluding the in-house funds that pension funds and other large institutional investors may have). With leverage this implies that the risk parity industry now controls about $1.4 trillion of assets

[3] https://www.ft.com/content/36214b94-8c9a-11e6-8cb7-e7ada1d123b1

(again, excluding in-house vehicles).[4] While they have strong performance, the nature and objective of risk parity funds contribute to the unhealthy dynamic of the market. By targeting a specific level of constant volatility, they actually exacerbate turbulence, by dialing down their exposure when markets are already falling. This becomes especially dangerous in a market dominated by "risk on/risk off" mentality and spiking correlations amongst assets. One manager describes the cycle of sell-offs to the Financial Times, "Should correlations turn positive, with stocks and bonds declining at the same time, the risk contribution of each one would rise. Managers would then have to sell both to maintain their risk targets. In other words, selling begets selling."[5]

Another trading strategy that leverages market moves is a volatility-focused investment strategy called "vol control products," also discussed in the Financial Times. These are pools of money that have a set volatility target; if the vehicle has a volatility objective of 10%, but volatility is only running at 5%, they will turn to "risk on" mode and buy more stocks. When turmoil erupts, they pull back by selling futures. The crucial differentiation of these products is the speed at which they ratchet up and down their exposure, which is often far quicker than the rest of the "volatility-targeting complex", like risk parity funds and trend-following hedge funds. Forcing funds to sell stocks when turbulence explodes and equities are already sliding may seem unintelligent. But in practice, it has proven a successful risk management technique, which is why it has grown in popularity among sophisticated insurance companies and computerized trend-following hedge funds (or CTAs).

3. This leads to the third and today most critical issue: these distorted markets are increasingly hostage to profound political risk. These political cycles are deeply entwined in the commodity and credit cycles in ways that become so obvious in retrospect, but are very difficult to anticipate. Inflection points in political cycles are so often driven by low probability, black-swan type events. And with these market dynamics, asset value price changes might get over-amplified.

A decade ago, investors thought they could price assets by analyzing underlying economic values with spreadsheets, using ratios and intrinsic valuation metrics. Alex Kazan, Managing Director of Emerging Markets Strategy at Eurasia Group points-out that political risk was only something that Emerging Market investors worried about. The post 1989 "end of history" mentality prevailed and Francis Fukuyama's argument that after the Cold War western liberal democracy was the end of the evolution in governance was very influential. It was the neo-liberal moment in EM – democratic capitalism had arrived and was here to

[4] https://www.ft.com/content/74471ab6-4835-11e5-af2f-4d6e0e5eda22
[5] https://www.ft.com/content/74471ab6-4835-11e5-af2f-4d6e0e5eda22

stay. It was accepted wisdom that political and economic reforms were permanent and irreversible. This seems so naïve in retrospect, but the sharp turn back to the left in Latin America in the 2000s came as a surprise, and now we're seeing the political cycle in the region shift back the other way.

Today, political cycle and political risks are a key issue, not only for Emerging Markets countries but for the US, Europe and Japan. Investors holding US, Japanese or European assets (which represent two thirds of the global market capitalization) need to ponder questions about:

Monetary Policy

- How much further can central banks take quantitative easing and NIRP (negative interest rate policies)?
- How will the unwinding of these monetary policies impact markets and economies?

Social Science

- Are the US and UK governments becoming anti-business?
- Does the rise of Donald Trump and the likes of Le Pen herald a new era of protectionism?
- How will Brexit evolve and its consequences?

Trade and globalization

- Why is global trade growth decelerating?
- Is there a process of de-globalization occurring?

Most investors are not well equipped for an analysis of this kind. They built their careers by crunching numbers, not pondering social science and unorthodox monetary policy experiments. They now face an unpredictable world.

Conclusion

Today, the real danger in finance is the not that banks will topple over (as they did in 2008). It is, rather, the threat that investors and investment groups will be wiped out by wild price swings from an unexpected political shock, such as central bank policy swings, trade bans, election results or Brexit.

Investors have been driven into investments where they have very little capability for dealing with what is on their plate. You can nowadays see the entire return that you expect for a year being wiped out for a single day move in the market. And that is an unprecedented situation.

This surge in populism is best explained by problems like income inequality, trade, immigration, wages, etc., rather than the actual problem: lack of economic growth. If the economic pie is growing, issues that bother voters such as trade policy become more tolerable. According to Bloomberg, starting in 2008, the world GDP transitioned from a long-run growth rate of 3.4% to 2.1%. Historically, recessions lead to voters removing the party in power, then growth resumes and the political environment goes back to normal. But since the financial crisis, economic growth has not returned to normal and this situation has persisted for eight years. As such, the world is $6tn poorer at this new, slower growth rate. It's no wonder we are seeing unimaginable political events taking place.

Our colleagues from "Strategas" have named this state of affairs: "Angry Is The New Hope" as voters demand more growth.[6] And this trend is global. Unfortunately, this trend is not going away until growth resumes back to pre-2007 levels. We expect more volatility in the years ahead.

At BigSur we believe that the fundamental ways to address this is through diversification (the only free-lunch in investing), some smart hedging as well as taking advantage of the high illiquidity premiums (investing in private equity, private debt and other illiquid assets). We've discussed this theme in several of our past Thinking Man pieces. For more on the ideas we are currently pursuing, please speak to your advisor.

[6] https://www.strategasrp.com/Home/PDF?strResearchProductID=Z1lDNrcBVYO77gDXyKlmDQ%253d%253d. Published 15/03/2016

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