

GEOPOLITICAL AND POLITICAL RISKS

SOME IMPORTANT CHALLENGES AHEAD



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SUMMARY

A CONTINUAL SOURCE OF VOLATILITY

Over the past year and more, market fundamentals have managed to overcome the occasional, short-term bouts of volatility triggered by political and geopolitical factors. But we cannot dismiss the possibility that these factors will impinge more forcefully on economies and financial markets in the period ahead.

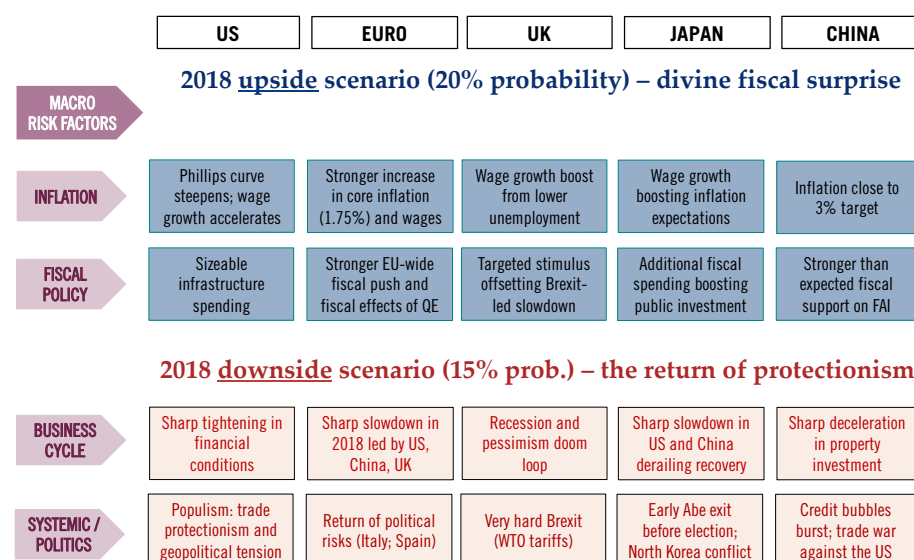
GLOBAL INSTABILITY PERSISTS

Many of the sources of risk and uncertainty are connected to the relative decline in the power of the US, its increasing unilateralism under Donald Trump, and the crisis in global governance. The most immediate sources of global instability continue to be found in places such as the Middle East, North Korea and the South China Sea. In addition, trade negotiations have hit a rocky patch and tensions between Russia and the West remain high.

KEY NEAR-TERM POLITICAL FLASHPOINTS

On the political front, as the Italian elections show, populism remains an issue in Europe. Elections in Sweden later this year will bear watching, and in Latin America voters in Mexico and Brazil likewise have the potential to create upsets.

DIAGRAM 1: RISK FACTORS MAPPING: 2018 ALTERNATIVE SCENARIOS



Source: Pictet WM - AA&MR

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INVESTMENT CONCLUSIONS

The new note of aggressiveness in the US's approach to trade, populism in Europe, the long-festering problems of the Middle East and electoral upheaval in Latin America all risk eclipsing the strong corporate and economic fundamentals that have pushed risk markets higher over the past year and more. Political and geopolitical uncertainty will contribute to the rise in volatility in financial markets we expect in the months ahead. We have outlined a 'downside' scenario for markets posited on a sharp economic downturn and political upsets. We believe there is a 15% chance of this scenario being realised this year.

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We highlighted at the start of 2017 that geopolitical instability was rising. We expect this long-run trend to persist throughout the remainder of 2018, both in terms of the persistence of its underlying drivers and through their expression in occasional crises.

Our core scenario for 2018, to which we assign a 65% probability, sees the continued synchronisation of growth and steps toward further normalisation of monetary policy in the major economies. But we also see two alternative scenarios—an ‘upside’ view to which we assign a 20% probability (largely based on a stronger-than-expected fiscal boost to economies) and a ‘downside’ situation, to which we assign a 15% probability (see *Diagram 1*). This downside scenario takes into account the possibility, however remote, of a sharp downturn in economies and financial conditions. It also takes into account the eventuality of a number of adverse political and geopolitical events, including a revival of populism, trade wars, and conflict with North Korea. In this paper, we examine some of these risks in more detail.

The US’s role as the world’s policeman is becoming too costly for it to sustain

Major geopolitical events in 2017 included Marine Le Pen’s progress to the second round of the French presidential elections, the escalation of North Korea’s nuclear programme, the Saudi-led blockade of Qatar, and Prince Mohammad Bin Salman’s ‘coup’ in Saudi Arabia. None of these resulted in a major or prolonged sell-off in the markets as fundamentals, in the form of economic expansion, earnings growth and central bank policies, remained supportive. However, geopolitical risk has led to spikes in volatility in the past (see *Chart 1*), and the danger of crises escalating into something more damaging for the markets meant that we felt it prudent to implement downside protection strategies in our portfolios for much of the year.

While our core scenario sees volatility spiking periodically, the danger is that a political or geopolitical crisis becomes so serious that it

triggers an alternative downside scenario for the economy and markets. All this represents a compelling reason to maintain a well-diversified asset allocation as the best way to protect a portfolio against risk and uncertainty.

THE DECLINE OF THE US HYPER-EMPIRE AND A CRISIS OF GLOBAL GOVERNANCE

The key geopolitical trend is a crisis of global governance. This is being reinforced by the ‘America first’ policies of the Trump administration, but more fundamentally reflects the long-term decline of US hegemony.

The US has dominated the globe largely unchallenged since the 1990s as a ‘hyper-empire’, exercising its dominance through a network of alliances and international institutions backed by pre-eminent American ‘soft’ and ‘hard’ power. But the US’s relative strength is slowly declining, and acting as the ‘world’s policeman’ is proving too costly to sustain—a fact that Trump, with his calls for America’s allies to share more of the burden, instinctively seems to recognise. For instance, the US Congressional Budget Office has estimated the cost of US wars in Iraq and Afghanistan to have been USD2.4trn, a huge figure bearing in mind the backdrop of surging US government debt, which rose from around USD5.0trn in 2001 to USD 20.5trn in 2017.

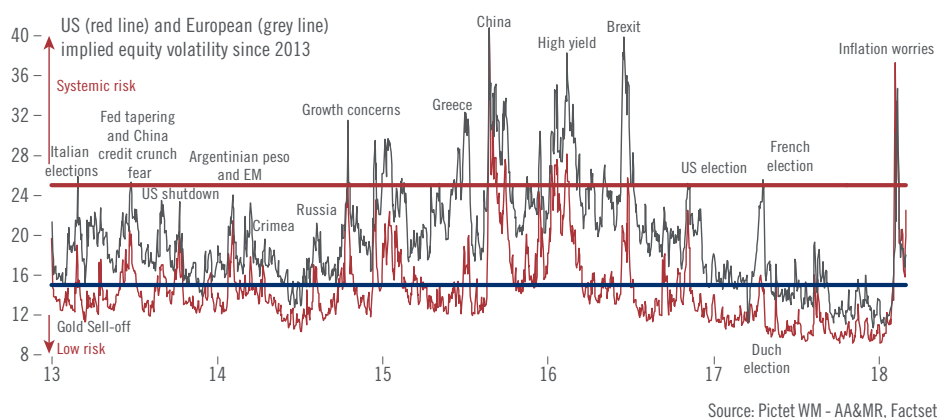
China is emerging as a challenger to US power, especially in the Western Pacific, but it is not yet ready to take the lead on a

global scale, not least because it continues to face considerable challenges to its internal stability. The EU, for its part, is too divided and un-coordinated to act as an alternative. The absence of a dominant power and the emergence of a multi-polar world provides more scope for pockets of destabilisation to develop.

This also means less co-operation on global issues. Under Trump, the US has already pulled out of the Paris climate agreement, and its commitment to the World Trade Organisation (WTO) and the United Nations (UN) is in question. Populism (of which Trump is a product) rejects international norms and institutions that do not meet its narrow interests. There is also a danger that the Trump administration finally makes good on some of its protectionist threats in 2018. In October, North American Free Trade Agreement (NAFTA) members abandoned their end-of-2017 deadline to sign a new trade agreement, with the result that negotiations have dragged into 2018. It remains unclear if Trump will be content to accept merely cosmetic changes to existing arrangements.

Uncertainties surrounding US trade policy look set to rise. The next economic recession could aggravate US criticism of ‘open’ trade policies and NAFTA in particular. The ongoing structural erosion in manufacturing jobs, due largely to technological progress and automation, could be blamed on

CHART 1: VOLATILITY SHIFTED REGIME IN EARLY 2018



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NAFTA, arousing further scepticism among the American people, and therefore in Congress, which remains, for the moment, a crucial bulwark in keeping the trade pact alive. Another risk to NAFTA in the coming years is that the US's neighbours grow more impatient with its ambivalent attitude towards them. The Mexican presidential elections in July should be watched particularly closely in this regard.

We expect Trump's trade tariffs to have a relatively narrow impact, but the danger of escalation cannot be fully excluded

Meanwhile, trade tensions between the US and China persist. They may even move closer to the top of the agenda if Trump decides to expand the scope of the trade tariffs on steel and aluminium products he announced at the start of March. Aside from China, the announcement of these tariffs is already causing dismay among America's closest allies. For the moment, we expect the tariffs to have a relatively narrow impact on economies, but the danger of escalation cannot be fully excluded.

This crisis of global governance is of concern to the markets for several reasons. First, it increases the risk of geopolitical crises spiralling out of control. Second, dealing with global economic imbalances requires policy co-ordination that appears unlikely in the current climate. Finally, globalised financial markets naturally rely on agreed rules and norms that could increasingly come into question.

KEY FLASHPOINTS

In January 2017 we highlighted several key sources of global geopolitical instability: competition between China and the US; tensions between Russia and the West; the Middle East; tensions between India and Pakistan; North Korea; failed states in Africa; terrorism; uncontrolled immigration; and the rise of populism.

These all look set to persist throughout the remainder of 2018, although the solid global economic performance that we expect as part of our baseline scenario should help to keep risks in check. The most immediate factors that could threaten the markets currently look to be instability in the Middle East, a potential reigniting of the still-unresolved crisis surrounding North Korea's nuclear programme, and populism.

Instability in the Middle East. Over the longer term, Asia could well be the main crucible of great-power competition. But for some time, instability has been most acute in the Middle East, and this is likely to remain the case in 2018, with both endogenous and exogenous factors at play. Syria's long civil war looks to be winding down, with opposition hopes of forcing out Assad thwarted by Russian and Iranian intervention, and a 'soft partition' of the country starting to emerge.

There are plenty of potential flashpoints in the ongoing confrontation between Saudi Arabia and Iran

But plenty of flashpoints remain in the ongoing confrontation between the two main regional powers and sworn enemies, Sunni Saudi Arabia and Shia Iran, most notably in Yemen and Lebanon (where Israel could also be drawn in). Meanwhile, the Saudi-led blockade of Qatar continues. The consolidation of power by Prince Mohammed Bin Salman in Saudi Arabia and popular protests in Iran add to the risk of a misstep. The Trump administration remains a wildcard for the region, as its recognition of Jerusalem as Israel's capital shows, while its attempts to derail the multilateral agreement over Iran's nuclear programme could also fuel instability. The main channel of contagion to the markets would be a spike in the oil price, particularly if conflict threatened tanker traffic through the Strait of Hormuz. In the short term, however, we see a low probability of further escalation.

North Korea. Tensions over North Korea's escalation of its nuclear programme remain unresolved. The regime's missile test in November reinforced the impression that it has developed missiles capable of threatening the mainland US—the big question is whether it has mastered nuclear warhead technology. Despite the heated rhetoric from both sides, we continue to believe a military conflict between the US and North Korea remains unlikely, but the stand-off could continue to rattle the markets periodically.

Populism. After the election of Emmanuel Macron in the French presidential election in May 2017, populism looked like it might fade after the success of Trump and the Brexit referendum the previous year. But the ongoing fallout from the latter two events continues to pose risks, just as populism has made breakthroughs in other places, including, most importantly, Italy. The continued impasse in Catalonia is, arguably, another symptom of populism's continuing appeal in Europe. Meanwhile, the threat of a messy UK departure from the EU in March 2019 will loom large as 2018 progresses, with talks on transitional arrangements and a new trading relationship likely to prove protracted. Our baseline scenario remains for a long transitional period followed by a bespoke free trade agreement that will resemble those negotiated by the EU with Canada or South Korea, in return for further concessions from the British. But the two sides in the negotiation are fractious and there remains a high risk of a 'no-deal' scenario.

And just as Trump's political rhetoric continues to pose risks to global stability, there is a risk of further populist breakthroughs in the elections to be held in Brazil and Mexico later this year. Globally, the key drivers of populism, notably rising inequality, economic insecurity and the consequent demand for social justice, are still very much alive, and as long as this remains the case the populist threat will persist in key elections.

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Even if there is currently no particular reason to expect them to escalate further in the short term, the following potential flashpoints will need to be monitored on an ongoing basis:

Competition between China and the US. Geopolitical competition between China and the US remains contained at present, and there is no reason to expect this to change in the near future. China will continue to gradually expand its global influence through a number of initiatives. These include the 'One Belt One Road' project of massive investment in trade infrastructure in countries from Asia to Europe and Africa; the development of parallel institutions (such as the Asian Infrastructure Investment Bank) to rival US-dominated multilateral bodies (such as the World Bank); the modernisation of its military; and the consolidation of its position in the South China Sea.

An important development has been the decision to drop term limits on the presidency, paving the way for Xi Jinping to remain in power beyond 2012. This could help the economy by ensuring policy continuity as China transitions from a low-income export economy, to a middle-income one where domestic consumption is more important. On the geopolitical front, the extension of Xi's rule implies that the Belt and Road initiative is likely to continue to be supported as it is Xi's signature foreign policy. This should benefit many smaller economies (especially in Central and Southeast Asia), but competition for regional dominance in the Asia-Pacific region between the US and China could further intensify in the coming decades. Geopolitical tensions over a few hot spots is likely to rise, including frictions in the South China Sea, Taiwan, the Senkaku Islands (known as the Diaoyu Islands by the Chinese) and possibly on the Indian-Chinese border.

Tensions between Russia and the West. Tensions, already running high over Russia's seizure of Crimea and stoking of separatist conflict in eastern Ukraine, have

been exacerbated by the revelation of how it influenced the 2016 US presidential and Brexit votes, notably through its extensive manipulation of social media using an army of online 'trolls' spreading disinformation and fuelling divisions. The US response has been to tighten sanctions—and any fresh revelations of ties between the Trump campaign and Moscow could further strain relations (just as worryingly, the ongoing investigations by Robert Mueller into the Trump campaign's Russian ties could further destabilise the US political scene itself). The EU is also concerned that Russia is stirring instability in the Balkans, a region that has long been a tinderbox in great power politics.

Markets would react negatively to an 'anti-system' coalition government in Italy

Africa. State failure and high birth rates in sub-Saharan Africa and Libya threaten a new surge of migration to the EU, which the Union remains poorly prepared to handle and which could lead to increased anti-immigrant sentiment and populist forces in EU member states.

Terrorism. ISIS has been defeated in Syria and Iraq, but could re-emerge in new forms; and as events in 2017 tragically demonstrated, attacks by local Islamic extremists are likely to persist.

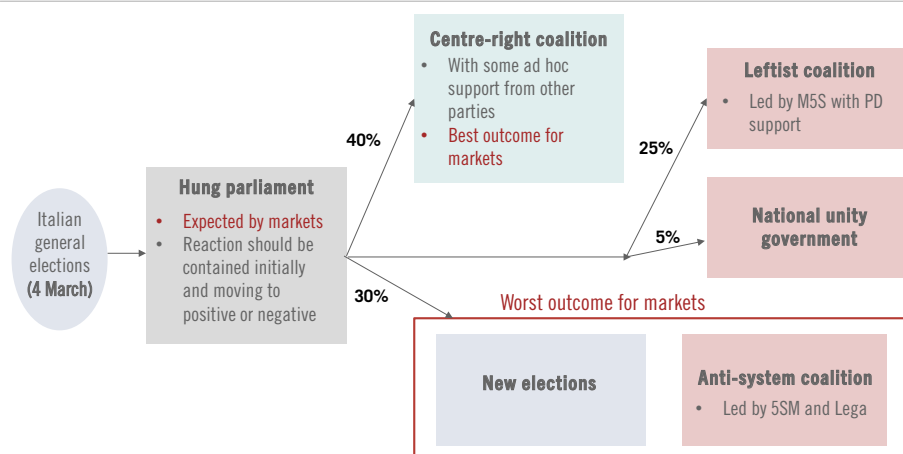
Inter-state tensions in Asia. Tensions between nuclear-armed neighbours India and Pakistan continue to simmer, particularly in the disputed state of Kashmir, with frequent exchanges of fire across the 'line of control', the de facto border. There is also a danger of conflict between China and other Asian powers, notably Japan and India—2017, for instance, saw a worrying stand-off between Chinese and Indian troops in disputed border territory.

IMPORTANT ELECTIONS

After elections in Germany, France and the UK in 2017, the main such event this year has been the Italian general election. As predicted, the result proved inconclusive, but cemented the rise in populism in the euro area's third-largest economy. For the moment, the election does not seem likely to pose a systemic risk for the euro area, but that might change if the populist Lega and Movimento 5 Stelle (M5S) end up combining their forces to form a government. Although

DIAGRAM 2: ITALIAN POLITICS, WHAT'S NEXT?

Italy: post-election political scenario



Source: Pictet WM - AA&MR

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they have gone quiet on threats to withdraw from the euro area, both these political formations have made ambitious fiscal promises. While we think it is more likely we will end up with a fragile centre-right coalition with some ad-hoc support from other parties, the markets would be likely to react negatively to an alliance between the ‘anti-system’ Lega and M5S or the call for new elections. We currently assign a 30% probability to a Lega/M5S coalition or new elections (see *Diagram 2*). What’s more, any signs of fiscal slippage could further heighten market concerns about Italy’s debt sustainability and lead to rising tensions with its European partners.

Sweden also goes to the polls in September to elect a new Riksdag: a key point of interest will be the performance of the far-right, anti-immigrant and Eurosceptic Sweden Democrats. In addition, there is Russia’s presidential election in March, but in the country’s authoritarian and heavily stage-managed political system, Vladimir Putin’s re-election for a fourth term is in no doubt—there will be no genuine opposition on the ballot paper.

In Asia, the most significant ‘election’ in 2017 was in China—the internal Chinese Communist Party machinations that completed Xi Jinping’s consolidation of power—while a snap poll in Japan reinforced prime minister Shinzo Abe’s position. In 2018, the most important vote to watch will be in Thailand, where the first elections since the imposition of military rule in 2014 have been promised for November. The populist Pheu Thai party has won every election since 2001, but a new electoral system could now result in a more fragmented parliament. It is questionable whether the vote will resolve Thailand’s protracted political crisis.

This will be a big year for elections in the Americas. Latin America’s two economic giants, Brazil and Mexico, both go to the polls, as will several other countries, most notably Colombia (with par-

liamentary elections in March and a presidential vote in May–June) and Venezuela (general elections due by December). The past couple of years have seen the centre-right in the ascendant in Latin America after the bursting of the commodities bubble ended a long period of dominance by left-wing populists. But 2018 will test this trend, with the potential for populist challengers to make breakthroughs in Brazil and Mexico, where incumbents Michel Temer and Enrique Peña Nieto face unprecedented levels of unpopularity. It is these two votes that probably pose the biggest risk of a shock to the markets in 2018. In the US, the mid-term elections in November could prove pivotal for the Trump administration.

**There is a high chance of an upset
in Mexican and Brazilian elections
this year**

Mexico, general election, 1 July. Voters in Mexico are fed up with corruption, crime and feeble economic growth, and left-wing populist Andres Manuel Lopez Obrador (sometimes described, probably unfairly, as a ‘Mexican Chavez’) is leading in the opinion polls ahead of the general election in the summer. There is still time for the candidates of the governing PRI and the traditional centre-right opposition PAN to close the gap, but the chance of an Orbrador win is likely to continue to weigh on Mexican assets ahead of the election.

Brazil, general election, 7 and 28 October. Brazil’s centre-right government is struggling with rampant corruption allegations (more than 60% of Congressional deputies have been charged with corruption or other crimes) and unpopular economic reforms. Former centre-left president Luiz Inácio Lula da Silva and far-right populist Jair Bolsonaro are leading in the opinion polls ahead of presidential and parliamentary

elections in October—although Lula might be barred from standing because of corruption charges. As in Mexico, there is time for candidates closer to the political centre to close the gap, but the risk of an upset is high.

US, mid-term Congressional election, 6 November. The Democratic Party could retake the House and potentially even the Senate, although the electoral map poses some considerable obstacles to the Democrats. If they do break Republican control of Congress it might not only further complicate the US political process, but also raise the chances of Trump being impeached if investigations into his campaign’s links with Russia lead to further damaging revelations.

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