



Tariffs, Trump, North Korea and other global political risks in the Year of the Dog

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Key points

- > Geopolitical issues generate much interest as dinner party conversations but don't necessarily have a significant impact on markets, apart from a bit of noise.
- > But given a backlash against economic rationalist policies, the falling relative power of the US & the ability of social media to allow us to make our own reality, geopolitical risks are higher than they used to be.
- > Key issues this year are: around President Trump given the mid-term elections, particularly tariffs & the Mueller inquiry; the Eurozone after the messy Italian election and the likelihood that Merkel and Macron will work to build a stronger Europe; North Korea; and China.

Introduction

Geopolitical events like Brexit and Donald Trump's election in the US "surprised" investors in 2016 but had no lasting negative impact on global financial markets. By last year investors were well focussed on geopolitical risks – Trump taking over as US President, Eurozone elections, the Communist Party Congress in China and rising risks around North Korea – but again they did not have much lasting negative market impact. In fact, in most cases it turned out to be a positive impact.

Now in 2018 it's already clear that geopolitical events remain significant, for example with Trump's tariffs and the messy Italian election result. Despite their benign financial market impact over the last two years they are worth keeping an eye on. This note takes a look at why geopolitics is more important for investors these days and what to look out for this year.

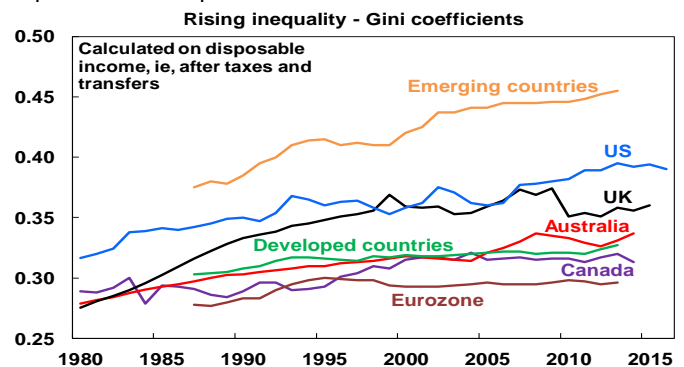
Why geopolitics is more important now

While not to deny the influence of various geopolitical events in the 1980s and 1990s the broad trend was reasonably positive with the embrace of free market/economic rationalist solutions (after the failure of widespread government intervention in the 1970s), the collapse of communism and the associated surge in global trade and the peace dividend and the dominance of the US as the global cop. However, while the last 2 years highlight the importance of not getting too distracted by geopolitical events, in recent times geopolitical risks have arguably become more elevated. There are several reasons for this:

First, the slow post global financial crisis recovery, rising inequality (see the next chart which shows the Gini coefficient - a measure of income distribution) and stress around immigration have all led to a backlash against establishment politics and economic rationalist policies.

This is showing up in support for re-regulation, nationalisation,

increased taxes and protectionism and other populist responses, which could slow growth and share markets. While aspirational politics ruled in the 1980s & 1990s it's since been replaced with scepticism about trickle-down economics.



Source: OECD, Standardised World Income Inequality Database, AMP Capital

The swing of the political pendulum to the left is most acute in Anglo Saxon countries as it was here that the pendulum swung most towards free markets in the 1980s and 1990s. It's messy in the US as while Trump has tapped into popular discontent and is more protectionist, his policies around de-regulation and tax cuts go in the opposite direction – for now, as this could just set the scene for a more left-wing president in 2020. And Macron in France is going in a fundamentally more pro-business direction, which is very positive for French assets.

Second, the relative decline of US economic and military power is shifting us away from the unipolar world that dominated after the Cold War when the US was the global cop and most countries were moving to become free market democracies. Now we are seeing the rise of China, Russia revisiting its Soviet past and efforts by other countries to fill the gap left by the US in parts of the world, all creating tensions.

Third, social media is allowing us to make our own reality. The danger is that, as politicians pander to this, economic policy making will be less rational and more populist.

Finally, with the mid-term elections in November, Trump is back in campaign mode. And he is not your normal politician.

Global geopolitical issues to keep an eye on 2018

President Trump – Trump faces two big challenges this year. First, the mid-term Congressional elections in November risk the Republicans losing control of the House and also the Mueller inquiry is closing in. These in turn put pressure on Trump to create distractions and return to focussing on his base after the pro-business focus of last year. The tariffs, dealing with North Korea and maybe Iran fit into this.

Tariffs – much has been written about Trump's steel and aluminium tariffs, but a full-on global trade war is unlikely. First

the steel and aluminium tariffs are trivial amounting to less than 2% of US imports. They are nothing compared to the tariff hikes of 1930 and 1971 that covered most US imports. Second, there is more to go on trade with NAFTA renegotiations, a review of China's alleged theft of US intellectual property likely to result in broad tariffs on US imports from China and restrictions on Chinese investment in the US and possible tariffs on vehicles, shipbuilding, aircraft and semi-conductors are also possible. Finally, Trump is trying to appeal to his base ahead of the mid-terms, but a full-blown global trade war is unlikely. There are few political constraints on Trump imposing tariffs and his Republican base tends to support it. However: the exemptions to his steel and aluminium tariffs suggest he has listened to criticism of his initial plan including around the threat it poses to US alliances; his approach on this issue smacks a bit of The Art of the Deal – go in hard, then back down to something that sounds more acceptable and the same is likely in relation to China with initial harsh measures likely designed for use as a bargaining chip; Trump won't want to go too far on tariffs as the resultant price increases won't go down well with his supporters; a plunging stock market in the face of a trade war will also constrain Trump (as he likes to take credit for it going up); and other countries are likely to be cautious in retaliating and China may want to come across as the "good guy" on trade. Of course, this issue could roll on all year, and Australia is vulnerable via its exposure to China. But a full-on global trade war is unlikely – but there may not be much peace on the trade front either. And a US-China trade war is the main risk.

The Mueller inquiry – this is getting closer to Trump. However, our view remains that while the Democrats may find something to impeach Trump on if they get control of the House of Representatives, in the meantime the Republicans are unlikely to impeach him. And even if the Democrats do impeach him post the mid-terms it's doubtful they will find the 70 votes in the Senate to remove him from office. And even if Trump is removed from office, VP Pence will not mean a big change in economic policy (just less tweets!). In the meantime most of the big market friendly policies Trump has to offer have been done.

The US mid-term elections – these will be watched closely as a guide to whether US politics is swinging back towards the Democrats taking the Presidency in 2020. If the GOP loses the House, it will leave Trump as a lame duck president. On the one hand most of his big market friendly policies have already been done so no great impact on domestic policy until post 2020. But being a lame duck could encourage him to seek relevance globally (more tariffs or action on Iran?).

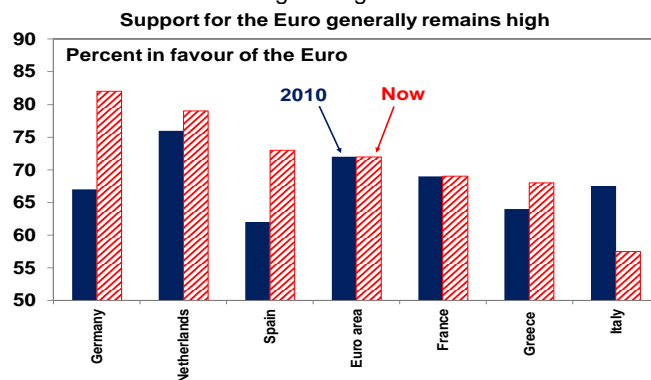
US shutdown risk – by March 23 funding will again have to be renewed for the Government to avoid a shutdown. But neither side wants to be blamed for a shutdown so expect funding to be granted, another extension or any shutdown to be brief.

North Korea – news that Trump will meet Kim Jong Un before May and that NK is open to denuclearisation is welcome. Whether it comes to anything though remains to be seen given numerous false thaws with NK over the decades. Or maybe Kim John Un read The Art of the Deal and its development of nuclear weapons was all just a negotiating ploy, so this is really a very big deal. At least it will be "quiet" on this front for a while.

Iran – the US deadline to remain compliant with the Iran nuclear deal expires in May. It will probably be renewed but if it's not and sanctions on Iran return it potentially means a sharp reduction in Iranian oil supply which could put upwards pressure on oil prices. Meanwhile, tensions and proxy wars between Iran and Saudi Arabia will continue with occasional flare ups but open warfare between the two is unlikely.

Italy and Europe - the messy Italian election outcome is not great for Italy, but it's unlikely to threaten the Euro. There are now three major blocs in the Italian lower house. None of these blocs are near a majority and it may require a new election (not

that most parties want that). Barring a worst-case coalition between the Five Star Movement and the far-right Northern League, which given their huge political differences is unlikely, it will be the Democratic Party that will decide who forms government and given its pro-Euro and left of centre bias it's more likely to lean to 5SM but only if it remains supportive of Italy remaining in the Euro. But it may take months to get to this point. This is not great for Italy, but there is unlikely to be a short-term threat to the Euro. In any case support for the Euro remains strong across the rest of the Eurozone so even if Italy does leave, a contagion across Europe looks very unlikely. This and the German Social Democrat Party's solid support for a coalition with Angela Merkel all leaves Germany on track to work with France on strengthening the Eurozone.



Source: Eurobarometer, AMP Capital

Terrorism – The impact of terrorism on investment markets has been declining since the 9/11 attacks to the point where attacks in recent years have had little impact. Economies and markets seem to have become desensitised to them to a degree.

China – The Chinese Government's focus on its reform agenda - shifting towards less investment intensive growth, reducing pollution, reforming state-owned enterprises and reducing financial risk - has long run hot and cold, speeding up in good times only to slow down if growth slowed. However, the reform agenda now looks likely to see another step up posing a short-term threat to growth (albeit with a long-term benefit) and with President Xi Jinping's status enhanced in October's National Communist Party Congress and leadership term limits now abolished it's likely that the leadership's tolerance to a slowdown in growth may be greater than in the past. So the growth/reform nexus bears watching in terms of the outlook for global growth, commodity prices, etc.

Australia – the main risk in Australia is an early election and the adoption of less business-friendly policies (higher taxes, more regulation) under a Labor Government which may be taken badly by financial markets. The May budget is likely to promise income tax cuts but in the absence of better polling it's hard to see the Government calling an early election.

Implications for investors

These geopolitical issues have the potential to keep volatility high this year and so are worth keeping an eye on. However, there are several key points for investors to bear in mind. First, turn down the noise. Geopolitical issues create much interest, but as we seen in recent years (with eg Brexit, North Korea and Catalonia) they won't necessarily have significant negative impacts on investment markets. Second, it's hard to quantify geopolitical risks. You have to understand each issue separately. Finally, given the difficulties in trying to predict geopolitical shocks and their impact it often makes more sense for investors to focus on the opportunities they throw up, rather than taking long term shelter from them in low returning cash.

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