GEOPOLITICS

Wide awake

Today's resilient pension funds should be able to cope with any storms that the West's unstable political scene has whipped up. But there are still dangers ahead requiring caution

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"Brexit took us weeks to get over; Italy took us days; and Trump, just a few hours.

"We're brushing away political uncertainty a little more easily these days," SEI Investments director and investment strategist Cai Rees says.

His words come at a time when rising populism is leading to the real possibility of major economies turning their backs on globalisation. This tendency towards insularity is matched by an urge to tear up the rulebook, as it were, whether that be through Brexit's aim to forge new trade agreements, or President Trump's focus on deregulation.

Nevertheless, says Invesco Perpetualhead of institutional business in EMEA Colin Fitzgerald, now is a time for calm reflection.

"Despite these concerns, the West has continued to thrive and deliver returns to equity and fixed-income investors alike," he says, backing up Rees.

"The rulebook has always been changing for investors and the rate of change appears to have increased. In spite of that, one shouldn't lose sight of the fact that most funds are better prepared to absorb and accommodate the changes as compared to a decade ago."

PAAMCO vice chairman Stephen Oxley is equally sanguine. He points out that as long-term investors, pension funds would expect to ride out current political instability. Unless we see evidence of permanent reshaping of the global economy because of political events, then it's more likely that there's going to be a short-term impact on the equity, fixed income and credit markets, which pension funds can be expected to take in their stride, he says.

And in the long run, says Fitzgerald, the most successful pension funds have been the ones who have stuck to their asset allocation plans.

"Pension funds that have not followed through with their asset allocation plans or have had a significant portion of their portfolio in cash haven't been able achieve the same level of success," he points out.

Waiting patiently

Some pension funds' investment managers have also been playing their own, albeit somewhat shorter, waiting game.

As Rees explains, SEI went overweight with European equities recently.

"We've been reluctantly neutral and have been looking for a chance to go overweight and finally pulled the trigger *[in March]*. What was holding us back was the political uncertainty in the Dutch elections and the Italian referendum," he says.

"Italian populism seems to be held back to a certain extent, and we don't think Le Pen will happen in France. That political overhang has kept us on the sidelines and that has waned now."

The data coming out of Europe, he says, is looking very positive. Forward-looking price to earning ratios are about three points lower than they are in the US; earning momentum is the highest it has been since 2010; and the major European economies' indicators appear to all be flashing green.

"One of the problems we had with Europe was that the market couldn't sync up," says Rees. "For a while, Spain or France or Germany would each have a bad quarter. But for the first time since 2009, all the major economies are in sync."

Trumponomics

If mainland European politics will probably end up being "all right on the night" as Insight Investment senior fixed income specialist Emma Du Haney puts it, then the real story

for investors will be over in the States.

As Trump has already run into trouble with this healthcare bill, Du Haney and her colleagues are anxiously awaiting to see what more barriers he comes up against. In particular, how much appetite will Republicans have for massively increasing the US budget deficit?

"At some point he's going to get pushed back on that," says Du Haney. "So it remains to be seen if Trump's various stimulus policies such as tax breaks, changes to cooperation tax and boosting infrastructure, are going to come to fruition."

If they do, then investors can bank on stronger US growth, which would support already strong global growth. This would lead to a stronger US dollar and a normalisation of US treasury yields.

"If that doesn't happen, then we will have weaker growth in the US and globally, plus ongoing political uncertainty and a change in expectation of how much hiking the Fed is going to do.

"Those are two very different outcomes. On balance, it looks more likely that there will be some success. But it's definitely not a given."

And if growth disappoints, argues Kames Capital global investment strategist Patrick Schotanus, then the global economy risks almost grinding to a halt. If inflation remains elevated, even at its historically low levels, then political stalemate in Washington D.C. could lead us to something akin to "stagflation light".

Immediate dangers

Such a scenario would of course play out badly in the equity markets which, Oxley highlights, have enjoyed their longest bull run in the US since the 1930s.

"It's outlasted the former record bull market, which ended in 1987, by over two years. I think the next 10 years are likely to be different. How different, it's hard to tell."

Added to that is Newton Investment Management head of defined contribution Catherine Doyle's argument that asset classes are priced for no uncertainty – and have been distorted by the effects of extraordinary monetary policy.

Doyle says that many pension funds have already sniffed out this danger.

"In a world of differentiated investment returns, active, flexible approaches make sense, hence the rise in popularity of absolute return, high-conviction portfolios," she explains. "The approaches that warrant caution are chasing cyclicality, taking on additional credit risk and attempting to harvest the illiquidity premium."

One particular short-term risk can be identified in the private equity space, says Oxley. "Institutional investors are increasingly allocating to private equity based on some very good historic returns and yet, at the same time, there is an unprecedented level of investor capital yet to be invested. Which indicates there may be concerns about valuations going forward.

"Private equity valuations are reflective of market valuations, and if markets are going to re-rate, which many people think they are – then clearly equity markets are at risk."

And then there's the small matter of Brexit.

In a recent overview of the implications of Brexit for institutional investors, M&G multi-asset manager Steven Andrew says that it was hard to believe that anybody really knows how Brexit negotiations will resolve themselves, or how the world will look when they finally do.

With that in mind, he advocates leaving others to participate in the game of forecasts and concentrating on identifying the scope for surprise, as he calls it. This opportunity for pension funds and their managers to benefit from any short-term fallout from Brexit was made clear by the mood immediately following the referendum result. Both economic forecasts and asset prices implied a more gloomy view about the UK, despite a factual improvement in fundamentals.

"This should be encouraging for investors; when markets suggest more weight is being given to forecast than facts it often means the scope for surprise is higher than normal," says Andrew in his overview.

Investors, he maintains, need to assess whether asset pricing suggests such a degree of pessimism that they will be well rewarded if outcomes are not as bad as expected, or even positive: "We need to expect that attention on Brexit will wax and wane in the coming years and be prepared to respond as it does."

However, he says, as with the wider political environment, the long-term should always be at the forefront of trustee and fund manager minds.

"Historically there have been many political movements that have had a lasting impression on markets. Events such as the fall of the Berlin Wall and the establishment of the euro represented substantial shifts in the underlying regime.

"That does not mean that the market should be ebbing and flowing and listening to every utterance over whether it is going to be a hard or a soft Brexit.

"It is more important to get into the underlying value of assets and see what is truly driving things." ■