NO MORE SAFE HAVENS?

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Key points

The fallout from the UK's vote to leave the European Union (EU) illustrates how political risk – once regarded as the safe sanctuary of emerging markets – is now a pressing concern for investors in the developed world.

With the rise of populist political movements in Europe and in the US, investors may need to look in new areas to protect their capital and diversify returns.

Investors are increasingly seeking emerging market assets, where political risk is often priced in.

In an environment of heightened political risk, the notion of a single safe haven to which investors flee in all circumstances may be becoming an outmoded concept.

Diversification, and the flexibility to shift portfolios in response to political developments, is becoming more important.

*Investment professionals listed are members of AIA/AIC's participating affiliate, Aviva Investors Global Services ("AIGSL").

The UK's vote to leave the European Union (EU) has put the spotlight on the interplay between politics and financial markets. As political risk increases across Europe and the US, investors may need to rethink the concept of safe havens.

When the polling booths closed across the UK after the Brexit referendum on June 23, financial markets were optimistic. Most bookmakers and political pundits appeared confident that Britain had voted to remain in the European Union. They were wrong.

After the "Brexit" result was announced on June 24, a wave of panic swept through the markets. The FTSE 100 and 250 share indexes nosedived, while sterling plunged more than 10% against the dollar.[1] In the midst of this, Prime Minister David Cameron announced his resignation.

The chaos unleashed by the UK referendum on Europe illustrated again how political risk – once regarded as the safe sanctuary of emerging markets – has become a consistent and pressing concern for investors in the developed world, too. Of the ten biggest threats to global markets identified by the Economist Intelligence Unit this month, five pertain to political trends in advanced economies, including the after-effects of Brexit, a potential fragmentation of the Eurozone, and the controversial policies of the presidential run of Donald Trump in the US.[2]

Fearing the economic consequences of these developments, investors have sought the security of government bonds. But if political risk worsens, even these assets could come under threat. Which begs the question: Do investors need to start rethinking the concept of so-called "safe-haven" assets?

"Political risk has been massively underestimated in developed markets," says Trevor Leydon*, Head of Investment Risk and Portfolio Construction, Multi Assets, at Aviva Investors. "Traditional safe havens – such as the UK, the US, Switzerland, and Japan – are seeing increased risk. Investors tend to assume that the apparatus of state is a stabilizing force in these countries. But that apparatus is reliant on political direction, which is becoming more uncertain."

Unsafe havens?

The post-Brexit turmoil in the UK demonstrates how quickly perceptions of safety can change in an environment of heightened political risk.

At the beginning of 2010, the UK was widely regarded as an anchor of stability as the Eurozone pitched and heaved its way through the sovereign-debt crisis. As a perceived safe-haven currency, sterling appreciated by 5% against the euro in 2010 thanks to inflows from risk-averse investors. The pound also gained in value during the uncertainty surrounding the Greek referendum on the terms of a proposed Eurozone bailout package in 2015.

[1]Source: The Guardian, 6/24/2016, https://www.theguardian.com/business/2016/jun/23/british-pound-given-boost-by-projected-remain-win-in-eu-referendum
[2]Source: The Economist Intelligence Unit Global Forecasting Service, July 2016 http://gfs.eiu.com/Archive.aspx?archiveType=globalrisk

Fast forward to July 2016, and the situation looks very different. The referendum result has cast doubt on the UK's own economic and political stability. On June 27, the Monday following the vote, credit-rating agency Standard & Poor's stripped Britain of its triple-A rating, and sterling hit a 31-year low against the dollar.[3] Over the following week, the pound – the world's oldest currency still in use – became briefly more volatile than Bitcoin, the digital payment system launched in 2009.[4]

Post-Brexit, capital flowed towards currencies such as the dollar and the yen, as well as other perceived havens such as gold and government bonds. The yield on 10-year US Treasuries dropped to 1.3% on July 6 – an all-time low, according to Reuters data – while the return on 10-year German bunds fell to -0.2%.[5] The yield on 20-year Japanese government bonds turned negative for the first time.

The appetite for sovereign bonds shows that they continue to be prized for their liquidity and relative stability during times of stress in the financial markets. But they are not risk-free. With yields at such low levels, a rise in inflation over the coming years would leave bond investors vulnerable to capital erosion, for example. And the returns on offer may no longer provide an accurate measure of creditworthiness. Almost perversely, gilts became more expensive in the wake of Brexit, despite the slide in the UK's credit rating.

James McAlevey*, Senior Portfolio Manager of Fixed Income at Aviva Investors, says investors may be buying bonds almost out of habit during periods of market volatility. "Gilt yields have fallen even though the UK has been downgraded. This indicates a 'Pavlovian' response among investors – an almost instinctive tendency to buy fixed income whatever the original source of global risk aversion."

"If investors can start to differentiate between the sources of risk aversion, they will see that the traditional response might not actually be the correct one," says McAlevey.

While the prospect of sovereign defaults in former safe havens is, for now, remote, the contagion threat Brexit poses to other European countries is very real. Investors will be monitoring the forthcoming re-run of the Austrian general election – which is being repeated because of irregularities in the counting process during the previous vote in May – and the referendum on Italy's constitution in October. The outcomes are likely to be viewed as tacit pronouncements on European political integration and the single currency.

"If Prime Minister (Matteo) Renzi loses [the Italian referendum], the impact could be profound," says Charlie Diebel*, Head of Rates at Aviva Investors. "His government would almost certainly fall. That could propel the Five Star Movement, which is calling for a referendum on Italy's membership of the Eurozone, into power."

Japan, meanwhile, is involved in a standoff with China over the sovereignty of islands in the South China Sea. Tensions in the region have escalated after a United Nations tribunal rejected China's claims to huge swathes of the waterway in a ruling on July 13.

And even the US is vulnerable to political risk. Donald Trump is now the Republican presidential candidate, and his controversial policies may not endear him to financial markets, even if Washington's system of checks and balances may constrain Trump's ability to implement his controversial policies were he to occupy the Oval Office.

Flight to emerging markets?

As the risk profile of developed markets changes, do investors need to look for new ways to protect capital and diversify their returns? The rise in political risk across the developed world has raised an intriguing prospect – that emerging markets might become the new sites of refuge for investors. While it is a stretch to portray emerging markets as safe havens, it could be argued that the political risk is priced in to investment assets in these economies.

There are signs that many investors are already seeking emerging market assets during periods of heightened political risk in the developed world. The MSCI Emerging Market Index has outperformed the MSCI World Index in 2016, despite the uncertainty surrounding Brexit; rising 7.8% between January 1 and July 13, compared with 1.9% for the world index.[6] Emerging market debt is also in demand. During the week following the referendum, emerging market debt funds received more than $3.4 billion – the biggest weekly inflows on record.[7]

[3]Source: BBC, 7/27/2016, http://www.bbc.com/news/business-36644934
[4]Source: Independent, 7/10/2016, Bloomberg data on 10-day historical volatility, http://www.independent.co.uk/news/business/news/brexit-pound-sterling-bitcoin-prices-unstable-volatile-exchange-referendum-a7129311.html
[5]Source: Reuters, 7/06/2016, http://uk.reuters.com/article/uk-global-markets-idUKKCN0ZL00S
[6]Souce: MSCI, 7/13/2016, https://www.msci.com/end-of-day-data-search
[7]Source: Financial Times, July 2016, http://www.ft.com/cms/s/0/13af0032-483f-11e6-b387-64ab0a67014c.html#axzz4E5P7JV87

"Emerging markets have outperformed developed markets this year, and that's interesting, because usually investors sell what they perceive to be their highest-risk assets during periods of heightened volatility," says Will Ballard*, Head of Emerging Markets and Asia-Pacific Equities at Aviva Investors.

There are several reasons for this. Emerging markets in Asia and Latin America have limited trade links to the UK – Britain receives just 3.4% of India's overall exports, for example – so these regions are relatively insulated from the effects of Brexit.[8] And any policy decisions that directly or indirectly result from the heightened political and economic risk in the developed world could actually be conducive to emerging market growth. If, as expected, the Federal Reserve defers interest rate hikes because of the uncertain political and economic environment in Europe, emerging economies will be able to cut their own rates to stimulate domestic growth without worrying about capital flight. The Malaysian central bank has already taken this step, lowering the benchmark rate by 25 basis points to 3% on July 13 – the country's first rate cut since 2009.[9]

Political risk, of course, remains a significant problem in some emerging markets; witness the recent events in Turkey, where President Recep Tayyip Erdogan is cracking down on opposition to his rule after surviving an attempted military coup on July 15; corruption scandals engulfing Brazil's Dilma Rousseff, who is currently in the midst of impeachment proceedings; and Jacob Zuma, the South African President. But in these countries, unlike the developed world, political instability tends to be factored in to asset valuations, offering investors a measure of compensation for the risk.

"The line between emerging markets and developed markets is more blurred than it has ever been," says Aaron Grehan*, Senior Portfolio Manager in Aviva Investors' Emerging Market Debt team. "The difference is that in emerging markets political risk has always been a consideration and is often priced in. There's also the fact that positive political change can occur in emerging markets, whereas in developed markets the risk is mostly on the downside." Grehan cites Argentina, Indonesia, and the Dominican Republic as examples of countries where positive political developments have resulted in much improved outlooks.

Ballard adds the Philippines to this list. The Philippines' newly-elected president Rodrigo Duterte has promised to tackle corruption. "Duterte has a strong mandate to tackle crime. A fall in corruption would be a big win for investors," says Ballard.

"Relative havens"

Recent history suggests it may be premature to designate emerging markets as oases of safety, however. The idea that emerging markets might become new safe havens was widely touted in early 2011, during the Eurozone crisis, when developing economies' high growth rates and comparatively low debt levels made them look relatively robust against their increasingly-indebted developed world peers.

However, when global economic growth slowed in August and September 2011, capital rushed back to the perceived safety of the US – and emerging markets were hit hard, particularly in illiquid sectors such as corporate debt. In September 2011 alone, investors withdrew more than $4 billion from emerging market debt funds.[10] This suggests that when problems in developed markets escalate into concerns that affect global growth as a whole, capital tends to flow back to more liquid markets.

Nevertheless, the perception of the risk differential between developed and emerging markets is undoubtedly shifting, and developed market investors are paying greater attention to political developments in a way that has long been second nature to emerging market teams. Trevor Leydon says investors should seek to make better use of "big data" to analyze demographic trends and voting patterns in order to more accurately assess the likelihood of various political outcomes and position their portfolios accordingly.

As political risk grows in the developed world, investors will need to think of safety in more relative terms. Instead of simply parking capital in a notional safe haven in times of strife, it will become more important to seek broader exposure to a range of assets. "It's time to speak of the 'relative safe haven,'" says Leydon. "Diversification will become more important, as will the flexibility to execute a range of strategies."

[8] Source: Data from the Indian Department of Commerce, http://commerce.nic.in/eidb/iecntq.asp
[9] Source: Bloomberg, 7/13/2016, http://www.bloomberg.com/news/articles/2016-07-13/malaysia-unexpectedly-cuts-rate-to-shield-growth-as-risks-mount
[10] Source: Financial Times, November 2011 http://www.ft.com/cms/s/0/25d8a884-0565-11e1-a429-00144feabdc0.html#axzz4EC8TYwGc

Flexibility is crucial. In an environment in which the risk profile of former safe havens is liable to change, investors will need to be able to nimbly shift their allocations in response. Leydon points to the challenge faced by UK pension plans, which tend to be restricted from taking on much overseas exposure. After the British referendum, they had little option but to pile into gilts – despite the fact that assets elsewhere may have looked safer on a relative basis.

Safety measures

As investors seek to diversify their portfolios across a range of relative havens, they will need to consider more carefully the criteria they use to define safety in the context of specific sectors and asset classes. For investors in equities, for example, companies with diversified global cash flows will provide a measure of safety during political convulsions. After the initial and widely anticipated dip post the referendum, the FTSE 100 recovered thanks to its constituent companies' broad global exposure. By contrast, the FTSE 250, composed of smaller firms whose cash flows are more dependent on the domestic economy, fell 14% in the first two days following the referendum and has yet to return to its pre-Brexit level.[11]

"After Brexit, we're favoring companies with experienced management teams and strong and robust business models," says Helen Driver*, portfolio manager on Aviva Investors' Global Equities team. "We're also keeping an eye on companies that derive a large share of their profits from overseas markets, which have performed relatively well since the fall in the pound."

The performance of traditional safe-haven assets in the wake of the Brexit vote shows that investors still prize liquidity when the going gets tough. But it's also clear they are thinking more carefully about what safety means in the context of their own portfolios – and the notion of a single safe haven to which investors flee in all circumstances may be becoming an outmoded concept. As the financial markets are spooked by political risk, diversification may still hold the key to capital preservation.

[11]Source: Financial Times, 6/27/2016, https://next.ft.com/content/314ed068-3c2d-11e6-8716-a4a71e8140b0

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