SALT INSIGHT

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Geo-Political Risks: what to watch and the importance of active management

As we look to the future and try to determine the outlook for economies and markets, we keep a keen eye on political developments. Economies operate in an environment bound by rules and regulations set by politicians. Economics and politics are inextricably linked.

Since the Global Financial Crisis, political developments have become more important. The rise of populist politicians and the sharp shift of policy to the left, borne of the deep-seated dissatisfaction with the lack of real economic progress of significant proportions of the voting public has meaningful implications. The rise of China and the battle for economic and political supremacy with the United States is seeing heightened political tensions between the world's two largest economies. Climate change and the decisions politicians will make as they meet their (and therefore our) commitment under the Paris Agreement will change the underlying fundamentals of the economy.

These are just a few of the issues we are thinking and, in some cases, worrying about as we look ahead.

The shift to the left and the rise of populism: the end of economic orthodoxy

The global political pendulum has been swinging to the left since the Global Financial Crisis. As patience for change wore thin, populists were in the ascendancy in many countries. We have already witnessed the rise of Beppe Grillo's 5-Star Movement and the premiership of Silvio Berlusconi in Italy, the rise of the Syriza party in Greece and the risk of Grexit, the reality of Brexit and Donald Trump's tumultuous 4-years as US president.

The reasons have been well canvassed and are generally accepted. Stagnant real income growth in western democracies, rising inequality (both income and wealth) and poor job security are all seen as the outcomes of Thatcher/Reagan-style polices that promised the trickle-down benefits of a free-market orthodoxy that embraced deregulation, privatisation, globalisation and lower taxes. For most, the promised rewards proved nothing but illusory.

Memories that no longer stretch back to the chaotic, interventionist 1970's means the obvious answer to the dissatisfaction with the status quo is regulation, nationalisation, protectionism and higher taxes. Populists, by definition, have been happy to embrace the change in mood.

But as populists have failed to deliver the promised solutions, political leadership has swung back to a more orthodox centre-ground. However, the shift to the left - specifically willingness to deploy regulation and re-distribution - remains firmly entrenched. Furthermore, the pandemic has been the catalyst for more expansionary fiscal settings in many parts of the world.

In the United States President Biden's American Jobs Plan and American Families Plan are unashamedly

fiscally expansionary and part-funded by higher taxes on business and the wealthy. His policy agenda has enjoyed comparisons with Franklin Roosevelt's "New Deal" and Lyndon Johnson's "Great Society".

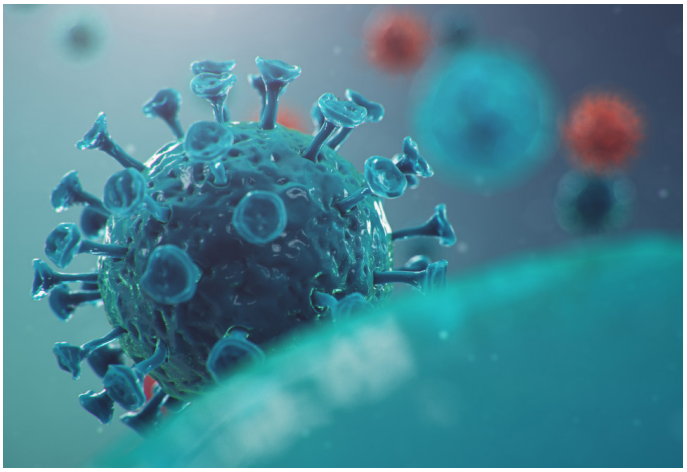
The true test of the success or otherwise of his and other government's running expansionary fiscal programs will be the extent to which those programs deliver sustainably higher growth so that higher debt levels do not get "baked in". That would create an even greater burden on future generations and reduce the capacity of government to respond to the next crisis, whatever that may be.

There is also a tendency for politicians to try to solve the wrong problem. Globalisation has undoubtedly contributed to greater inequality within countries, but it has significantly reduced inequality between countries through increased trade opportunities.

The public policy failure is not globalization. The failure has been government's inadequacy in designing and implementing education and skills development programs to assist those displaced by globalisation to find new career paths.

The bottom-line is that while voter dissatisfaction remains high, so too does the risk of sub-optimal or even perverse political and policy outcomes.

Covid: requires global collaboration



Covid has been a significant game-changer. Economic and social restrictions have fundamentally changed how we live and work and some of these changes may prove permanent. The start of vaccination programs has allowed many countries to gradually re-open, but the emergence of new variants of the virus, such as Delta, continue to pose new challenges and delay or reverse steps towards normalcy.

Economic costs have fallen unevenly within countries as jobs in retail and hospitality, generally low-skill, low-wage jobs, have been most impacted, widening inequality within countries.

Inequality between countries has also been exacerbated by the combination of under-resourced health systems and poor vaccine availability in poorer developing countries. A recent meeting of the G-7 committed one billion vaccine doses to developing countries, at least acknowledging the pandemic as a global problem requiring ongoing global collaboration.

Covid has thus exacerbated existing inequalities and increased the political pressure to respond. Furthermore, the world has not fully emerged from the pandemic. The risk of a variant that is resistant to the current range of vaccines is real. The good news is that while people who have been vaccinated have still been contracting the virus, the symptoms at least at this stage are less severe and hospitalisation and mortality rates have not risen to the same extent as new cases. The degree of protection provided by vaccination should prevent over-loading in hospital systems at moments of outbreak peaks, thereby making Covid infection a more survivable event in the more vulnerable parts of the population.

Climate change and going green

The urgency of the need to act on climate change has risen, especially as we have witnessed ever more frequent and devastating extreme weather events, embracing the full gambit from wildfires to floods.

As the fiscal response to Covid has morphed from pandemic response to supporting the recovery new initiatives are, in large part, aligned with various governments pre-Covid priorities. This includes climate change mitigation and adaption. In that sense, the Covid cloud has some silver linings, in suspending or removing potential barriers to public investment that would have been a restraint in more normal times.

Targets for the reduction in greenhouse gas (GHG) emissions have been agreed under the auspices of the Paris Agreement and they are ambitious. Our concern is that the required technological innovation followed by the implementation and scaling of that new technology will take too long for those commitments to be met.

That increases the likelihood of regulatory responses and with that, the risk of unintended consequences. Countries with emissions trading schemes will also rely on the rising price of carbon to encourage firms to adapt to the new world. These schemes are much less fraught than carbon taxation.

The fundamental structure of economies will change. Reducing GHGs will require a fundamental change in the energy value chain. The operational dynamics of nearly every business will change to some degree. This will lead to shifts in firm competitive advantage with the key metric of success being a firm's ability to minimise its carbon footprint. There will be losers, but there will also be winners.

Failure to adapt to the changing climate will bring new potential sources of regional conflict around food and freshwater availability. This increases the risk of regional conflicts, particularly in poorer parts of the world.

The world has seen various migrant crises in the past which have proven destabilising. To date most have been the result of politics, religion or economics. Climate-related migration is a new and worrying prospect.

Digitalisation, social media and the rise of cybersecurity threats

The world has been "going digital" for some time now. Social media is becoming more pervasive, supplanting more traditional and, we would argue, more reliable news sources. The Covid pandemic saw a step change in the adoption of digital technology as hundreds of millions of people around the world were forced to work from and connect to work digitally. At the same time, the prevalence of cyber-security breaches, many state-sponsored, are on the rise.

The first real sign we saw of the power of social media to gain the ascendancy in public discourse was during the 2016 US presidential election, although arguably the BREXIT referendum earlier that year was a trial run. Traditional and mostly unbiased news sources were branded "fake news" amidst a flood of online information. The underlying motivation of this information was to maximise the number of "pings", rather than preserve the inerrancy of the information being distributed, but misinformation is nonetheless easily protected under the guise of free speech.

Regulators are left with the challenging job of preserving free speech while also preventing the spread of divisive and at times, dangerous misinformation being circulated by individuals, organisations and even governments with ulterior and sometimes nefarious motives.

Regulators are also having to respond to the increasing incidence of cyber-security breaches, often now perpetrated by state agents with political motivations aimed at social, economic and political disruption in other countries. Examples here in New Zealand recently include the Waikato District Health Board and a number of schools whose security was breached by a connection to an offshore service provider.

This is not something that just governments need to work at. There are increasing incidences of business systems being breached, which could then provide pathways into government agencies or government itself.

There is considerable opportunity for agents, whether they be individuals, criminal organisations and even state sponsored agents to cause considerable damage and create significant instability. At the same time, a burgeoning industry in cybersecurity solutions and constant online vigilance is creating novel opportunities for investment.

The waning of America and the rise of China

In the aftermath of the Asian Financial Crisis 25-years ago, China set out to be a global economic and political superpower. Fast forward a quarter of a century and the United States and China are now vying for supremacy.

China has been the fastest growing economy in the world for many years. As it has grown it has aimed to spread

the gains. According to the International Monetary Fund, China has lifted 800 million people out of poverty. As the export-led growth model reached its zenith with the Global Financial Crisis, China set out to reform the economy by reducing its reliance on investment and exports, while transitioning to consumption and better-quality growth. That has lifted many hundreds of millions of Chinese into the ranks of the middle-class.

A key part of that strategy was incrementally allowing the Chinese currency to appreciate, leading to higher imports (supporting growth in the rest of the world) and a reduced trade balance, a key source of the pre-GFC global savings imbalance. Nevertheless, Chinese consumers and enterprises have taken on a considerable amount of debt in the process of integrating with global trade and capital flows, and the quality of these loans has not yet been stress-tested.

The definition of a true superpower is wielding both economic and political might. China's key political play has been the Belt and Road Initiative. Starting in 2013 this initiative was announced as the solution to much needed investment in economic development and infrastructure in China's neighbours and other strategic relationships.

While the program remains a key initiative for the Chinese leadership, its influence as a political bridge has waned as accusations of interreference in other countries domestic affairs has led to increased skepticism around motives and the nature of China's long-term objectives.

More recently China rapid economic growth and structural transformation has seen it fast forward to some western-style economic challenges. Rising debt, slowing productivity growth and a recent census showing slowing population growth and ageing of the population sees China now battling the same problems as America, Europe, and most of the developed world.

With higher productivity the key policy question, innovation is the only answer. Technology is already a key battleground between the two protagonists and competition for supremacy is likely to heat up and provide an increasing source of tension. Restrictions on access to US technology has seen China turning to technological independence, but it remains to be seen how successful this will be.

Former US President Trump took a hard line against China. Increased tariffs imposed by the Trump administration remain in place and President Biden is taking a similarly hard line, as demanded by public opinion, and now backed by majority opinion ion Congress. Indeed, China's weak point is its dependence on the rest of the world for its energy and food needs.

Assuming the United States wishes to frustrate China's aspiration of regional hegemony, the US has its own diplomatic efforts at its disposal, which are more likely to be successful under President Biden. The US and its allies have also acknowledged the loss of fervour for China's Belt and Road Initiative by committing funding for infrastructure financing under the G7 "Build Back Better World" initiative.

The battle for supremacy will be with us for some time, the risk being it becomes heated from time to time.

Europe after Merkel

The fight against Covid has united Europe in a way that hasn't been seen for a long time. Long-term tensions both within and between countries on the continent have been borne of economic and social diversity across the continent. This has been highlighted within the narrower Eurozone by the imperfect construct of the common currency, which was nearly brought to breaking point by the Eurozone debt crisis.

It might have been Mario Draghi, the former President of the European Central Bank, who famously said during the crisis that he and the ECB would do "whatever it takes to save the Euro", but it was German Chancellor Angela Merkel who did most of the doing, and in so-doing, almost single-handedly saved the common currency and avoided a messy break-up of the Eurozone.

Mrs. Merkel's 16-year tenure as German Chancellor ends with the German parliamentary elections on September 26th. For a brief period, the Green Party was leading the polls though Mrs. Merkel's CDU party, under new leader Armin Laschet in coalition with the CSU, has staged a bit of a comeback more recently.

The Bundestag is a proportional parliament so a coalition of at least two and probably three parties will be required to form a government. With the Greens likely to play a prominent role in the next parliament a shift to the left along with higher fiscal spending appears likely.

A potentially bigger question is who will be the new, albeit unofficial, leader of the Eurozone. While the

currency-bloc has unified during the Covid emergency, old problems have seen some progress but have not been fixed: banking union, taxation-rate convergence and fiscal integration along with debt mutualization all require further attention. Without that attention it is only a matter of time before Europe faces its next crisis and that will need someone to champion the collective commitment to the common currency.

That responsibility seems to us to fall to Emmanuel Macron in France. He has sensible things to say which seem to line up with sensible policy for Europe, for example the need for labour market reform. The problem is what is good for Europe is not necessarily popular at home where his approval rating sits at 37% and he faces elections in April 2022. It could also be his policy positioning is playing to the political risk presented by Marine Le Pen who recently did well in the 2019 European elections and in the 2020 French Municipal elections, but it is having limited effect so far.

It seems to us that not all that needs to be fixed in the Eurozone is fixed. This will lead to inevitable future crises that will need strong leadership at the regional level to resolve.

Terrorism and regional conflicts

Terrorism: it has been relatively quiet on this front recently, though that's not to say the risk has gone away. Markets were increasingly taking these events in their stride, though that doesn't make them any less tragic at a human level.

Russia: As well as China, President Biden has taken a similarly hardline against Russia. It has even been suggested the US could encourage Germany to cancel the Nord Stream 2 gas pipeline, though Germany has more recently stated it won't do this. The issue is the risk of President Putin using the pipeline as a "geo-political weapon" against Ukraine. Tensions are also high between the US & Europe and Russia over cyber-security.

China/Taiwan/US: Tensions are high with both the US and China recently increasing their military presence in the Taiwan Strait, while some in China are advocating a forcible reunification with Taiwan by force. This is probably the hottest regional risk right now.

North Korea: it's been a while since we've seen missiles firing out of North Korea. But as with terrorism, that doesn't mean the risk has gone. Former President Trump went down the face-to-face diplomatic route with the North Korean leader. President Biden seems to be taking a more circumspect approach.

Iran/Israel: Former US President Trump's Iran strategy was to apply maximum pressure by exiting the 2015 nuclear deal (the Joint Comprehensive Plan of Action or JCPOA) and applying harsh unilateral sanctions aimed at generating greater concessions on the nuclear program and containing its regional influence. The only thing sanctions achieved was the devastation of the Iran economy while its nuclear program grew unconstrained. President Biden wants to return to the JCPOA while Iran wants to return to the deal to take the pressure off its economy. Israel and Saudi Arabia are not keen on the US returning to the deal, preferring Trump's hardline approach. Risk of increased tensions in the regions flowing through to higher oil prices is significant.

Israel/Palestinians: Tensions are always high between Israel and the Palestinians. There are many issues to be resolved, not the least of which is whether a Palestinian state should have been created alongside Israel. Peace talks have been on and off for the last 25 years with little progress. The most recent peace plan put forward by Former US President Trump and endorsed by now former Israeli Prime Minister Benjamin Netanyahu as "the deal of the century" was dismissed by the Palestinians as "one-sided". Any resolution will need the agreement of both sides but until then, further periods of violence as we saw in May cannot be ruled out.

Implications for investors

As we monitor and assess risk within our portfolios, we keep a close eye on political developments.

Markets will often react to major news events, especially if they are a surprise and don't see them coming. In many cases those issues are over quickly, and the market impact unwinds just as fast. Markets have even become desensitised to terrorist attacks to a large extent, though they are tragic for those involved and are usually symptomatic of a bigger problem.

Other geo-political risks, however, have the potential to change the course of economies, sectors, firms, and markets. In this category we include:

- the political break with economic orthodoxy occurring in many countries;
- the ongoing risk of Covid, especially given the need for collaboration at the global level to combat the virus;
- the decisions politicians will make with respect to climate change that will fundamentally alter economic structures and sector and firm viability;
- the risk of instability created by cybersecurity;
- the new battle for economic and political supremacy between the United States and China that has the potential for tension and potentially conflict (Taiwan) or key market disruption (Hong Kong); and
- the loss of strong political leadership at the head of the Eurozone.

In this environment deep knowledge of the issues and how they are likely to play out will be critical. Effective stock selection through active management will be key to managing the risks and identifying new opportunities that arise. Geopolitics often opens major investment opportunities as well as providing periodic grounds for anxiety for investors. There is little doubt that a global economic consensus that has supported and sustained asset values for around four decades is now undergoing fundamental erosion and revision. The investable assets which will emerge in a position of advantage, and those which will be penalized by transformed economic drivers, are identifiable in advance through our processes of highly-active engagement and analysis.

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