The Rising Tide of Populism

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No country is immune. Populism is a growing, increasingly global phenomenon that isn’t confined to the United States in this current election season. The long-running consensus in favor of greater globalization is fraying in the face of growing anti-immigrant sentiment and protectionism the world over. Political polarization is increasing and democracy is waning. Brexit should be a wake-up call for investors – and a sign of the tectonic changes currently buffeting the global political economy. Compounded by demographics, debt, and deflation, this anti-establishment backlash against globalization is in full swing as economic growth has stagnated and income inequalities have increased. Economic and upward mobility expectations have been dashed. And as we all surprisingly found out in June, British voters said no mas.

Although one’s initial reaction may be one of abhorrence, not attempting to understand the root causes may only create more room for error in judging how best to cope with these larger changes. What we are witnessing highlights the frustrations felt by both developed- and developing-market constituents as technology and economics collide with politics. In many ways, it is a global revolt against metropolitan elites. But fragmentation is occurring among economic classes, generations, and peoples. While this phenomenon may be gradual, its existence injects even greater political – and thereby behavioral – influences into the investment management process.

Brexit may be a signal of the rising strength around the world of politicians seeking office based on anti-immigration, nativist, and protectionist positions. Still months away, the 2016 presidential election in the U.S. is already like no other in our recent history. In a campaign saturated with nationalist and populist themes, billionaire Trump received more votes in Republican primaries than anyone in history. Meanwhile, Senator Bernie Sanders, a self-described democratic socialist, actually competed seriously for the Democratic nomination, harvesting over 12 million votes in his primary challenge to establishment candidate Hillary Clinton.
This surge in populism is by no means unique to the United States. The global financial crisis that ended seven years ago created wounds worldwide that haven’t healed. Economic insecurities, stagnant wages, rising income inequality, decreasing productivity, corruption, loss of sovereignty, the threat of globalization, fear of immigrants arriving to take jobs and change the cultural landscape – the list of anxieties is a long one. Many are angry because they believe that only the elites and the richest have benefited from the recovery since the global financial crisis, while the average middle-income earner the world over can’t be blamed for thinking that there has been no recovery at all.

A substantial share of the electorate is extremely fractured and polarized in both developed and developing countries. They have come to believe that the establishment either doesn’t care about their problems, doesn’t have their nation’s best interest at heart, or have run out of ideas. The result is an environment that is ripe for populist movements that promise overly simplistic solutions to an array of complex problems. Witness the inconclusive election results and political paralysis in Spain, Ireland, Portugal, Australia, and Austria, as well as the election of strongmen in the developing world as in Turkey, Russia, and the Philippines. These are likely only a sign of the things to come.

IT CAN’T ONLY BE ABOUT MONETARY POLICY ANYMORE...

Ineffective or non-existent government action is not helping matters and global policy makers are sacrificing the future for the present. For the past few years, monetary policy was preeminent. It was initially effective as it sought to prevent financial calamity and prop up asset prices. Now it seems like it’s the only game in town and the juggling act is becoming more and more risky. Global investors aren’t listening anymore. Witness the emergence of negative interest rates. Global central bankers are attempting to jump-start inflation and bank lending and to get investors to take more economic risk – but it’s not really working. The risks of aggressive monetary policy are rising, leading to weakened banks, lower lending, and heightened income inequality. Weakness in the banking sector creates a risk feedback loop linking politics to economic growth. Monetary activism has permitted politicians to behave in fiscally irresponsible ways that have dire consequences for the long-term. The trade-off between growth and financial stability is becoming skewed and is consequently distorting markets. We are now nearing a point at which the efficacy of central bank quantitative easing is producing diminishing and even deleterious returns, as we noted in May 2016.

After the global financial crisis, global central banks immediately – and correctly – engaged and delivered a strong, coordinated policy response. On the other hand, however, politicians the world over, generally abstained and did not offer substantive policy prescriptions to deal with many of the structural issues. They relied solely on unelected central bankers to do the heavy lifting. It is interesting to note that policymakers have recently been getting the message. In the UK, the Bank of England (BOE) surprised the markets with a multi-pronged approach for greater stimulus, but rejected outright negative interest rates. And the Bank of Japan (BOJ) forced the government’s hand after an initial, some would argue desperate attempt as the currency markets revolted, at utilizing negative interest rates. The government of Prime Minster Shinzo Abe is returning to its three arrows approach and is specifically using targeted fiscal stimulus. Japan will likely utilize a combination of monetary and fiscal tools to fight deflation and stagnant growth going forward. Japan’s experience of targeted expansionary policies may be a lesson for others to follow.
THE STATUS QUO ESTABLISHMENT UNDER SIEGE AROUND THE WORLD

Political polarization is global. Even governments that have been successful in improving economic growth prospects for their citizens like Ireland, Australia, and Spain are feeling the wrath and have either lost power or are facing great change.

Let’s start with Europe where the anti-establishment nationalist right and the socialist left are flexing their political muscles. In Britain, the upstart UK Independence Party (UKIP) forced the Brexit referendum decision that now haunts Europe. It tapped into immigration fears, discontent with Britain’s membership in the European Union (EU), and a surging anti-establishment mood in Britain to grow its ranks. The rise of UKIP threatened the center-right Conservative Party. It caused Prime Minister David Cameron to gamble on holding a referendum on EU membership if the Conservatives formed a majority government in the 2015 election. The resultant Brexit victory, in which the older generation and the more deindustrialized north voted to leave, rocked the nation’s mainstream political parties: Cameron immediately announced his resignation as prime minister and even Labor Party leader Jeremy Corbyn overwhelmingly lost a no-confidence vote among his fellow lawmakers.

France is no different. A June 2016 survey by Le Monde shows that anti-migration and anti-EU National Front leader Marine Le Pen is favored by 28% of those surveyed, far ahead of President Francois Hollande, the Socialist party leader, and Nicholas Sarkozy, the likely Republican candidate. In December of last year, the National Front was blocked from taking a share of power in regional elections only because the Republicans and the Socialists banded together to oppose its candidates. Following the Brexit win, Le Pen celebrated the outcome and likened the destiny of an undemocratic European Union to that of the Soviet Union.

Even traditionally stable Germany is feeling the effects of populism. Recent polls in that country indicate that support for the right-wing Alternative for Germany (AfD) party has surged to 14% since the immigration crisis last year, threatening to take important votes from the center-right Christian Democratic Union in the 2017 federal election. Originally, the AfD were academics who grew disenchanted with bailing out Greece and the other weaker European countries during the European sovereign-debt crisis. Now staunchly anti-immigrant and comprised of Germans who feel left behind, AfD backs an election manifesto that says Islam is not compatible with the nation’s constitution and calls for a ban on minarets and the burqa. In addition, Germany’s anti-Islam Pegida movement has staged rallies in cities across Europe to protest the arrival of migrants from the Middle East and Africa.

Greece remains in turmoil. Vowing to end austerity measures imposed on Greece by creditors, the far-left Syriza party came to power in 2015 and nearly wiped out Pasok, the established Greek Socialist party. Despite electing a radical socialist government, the openly fascist Golden Dawn party won the support of 500,000 Greeks to finish in third place in the September 2015 election. Similarly in Spain and styling itself as the Iberian sister of Syriza, the radical left-wing Podemos party vaulted to prominence with an anti-austerity platform and a pledge to renegotiate the nation’s debt terms. Founded in 2014, the party’s goal is to unseat Spain’s essentially two-party system of the center-right Popular Party and center-left Socialists. Their rise in part caused the inconclusive elections we’ve witnessed in Spain during the past two years in spite of declining unemployment and relative economic growth in the country. While support for Podemos fell below expectations in the recent June 26 election, the party still gathered the third-most votes in the country. And the country remains, like Portugal, without an acting and strong government.
Speaking of weak governments, Italy’s Prime Minister Renzi is gingerly navigating the current political chaos in that country. He is desperately attempting to figure out a way to restructure the antiquated labor markets and to bail out the country’s weakest banks, which have high levels of non-performing loans, and by extension many of the local depositors and communities who are directly invested. In June, Italy’s anti-establishment and anti-globalization Five Star Movement (M5S), which narrowly lost in the last national elections due to the establishment parties banding together, won mayoral races in 19 out of 20 towns and cities in which its candidates stood for mayor, including Rome and Turin. In May, the Index Research poll showed 28.4% of Italians would now vote for M5S in a national election, compared with 28.0% for the governing Democratic Party.

And throughout the rest of Europe, populist parties are on the march especially after last year’s surge in migrants from the Middle East. In a sharp rebuke to their government and to the European establishment, Dutch voters overwhelmingly rejected a Ukraine-EU treaty in April that would have led to closer political and economic ties. The anti-immigrant nationalist Dutch Party for Freedom is the largest in the Netherlands, and leader Geert Wilders is calling for a referendum on Dutch membership in the EU. Over in Austria, the nation’s highest court ordered a rerun of the country’s presidential election, giving far-right, anti-immigrant candidate Norbert Hofer the chance to turn his narrow defeat in May into victory. In Hungary, the ultra far-right Jobbik party is encouraging the ruling conservative Fidesz party to pursue tough anti-immigration policies, which include building a 110-mile fence along its border to bar Middle Eastern migrants. Populist and nationalist parties in Finland, Denmark, and Sweden are now either the largest or the second-largest parties in their countries, while the populist Law and Justice party is already governing a divided Poland.

COMMON UNDERCURRENTS IN TODAY’S POPULISM

Public anxiety and frustration is being driven by several challenging and often-related developments, especially since the global financial crisis. A lack of trust and disillusionment in institutions seems to pervade across the entire political, cultural, economic, and strategic spectrum.

Stagnant Economies: The growth of global gross domestic product (GDP) has fallen from a high of 6% in the 1960s to 3% in 2015. The past half-century and the years leading up to the financial crisis were a time of widespread economic growth. According to the International Monetary Fund (IMF), world real GDP grew at an average annual rate of 4.2% from 1998 to 2007, with advanced economies rising at an annual rate of 3.2% and developing economies at 5.8%. However, the IMF estimates that world real GDP between 2008 and 2017 will grow at an average annual rate of 3.2% – a full percentage point less than pre-recession levels – with advanced economies increasing at an anemic annual rate of 1.1% and developing economies at 5.0%. The bottom line is that expectations for economic growth and upward social mobility have stagnated.

Inequality and Flattened Wage Growth: That the past decades have witnessed a sharp increase in income inequality worldwide is by now a widely acknowledged fact. It’s occurring globally to include more socialist leaning countries and in the emerging markets. In advanced economies, the distance between the rich and the poor is at its highest level in decades. A 2014 Pew Research Center survey found that the gap between the highest earners and average households is considered a major challenge by more than 60% of respondents worldwide.

Wage growth is flat and weak the world over. In the United States, middle-class wages stopped growing decades ago, a situation exacerbated by the financial crisis. A Pew Research survey in 2014 found that a substantial majority of Americans (65%) – say the economic system in this country unfairly favors
powerful interests. In Europe, high unemployment rates, especially among the young, are widening the income gap between the rich and everyone else, adding to the growing discontent of middle- and working-class households. Further, the pursuit of austerity policies in many European countries is often seen as a violation of the social compact that promised an ample safety net. The result is a growing sense of being left behind in a world that rewards elites.

**Demographics and Immigration:** The United States has long worried about the aging of its population and declining birthrates, but the trend has reached crisis levels in Europe. The share of the population aged 65 years and over is increasing in every EU member nation, while the working-age population is shrinking. By 2040, Europeans aged 65 and older will account for 26.9% of the EU’s population, up from 18.5% in 2014, according to Eurostat. The portion of the population comprised of persons 15 to 64 years old is projected to be 58.5% in 2040, down from 65.9% in 2014.

As a rule, rich countries need immigration to thrive. Immigrants increase economic vitality by addressing labor shortages in low- and high-skilled markets, filling holes left by the native labor market. However, immigration is now a hot button for populists in advanced economies. Interestingly, research cited in a recent *Wall Street Journal* article indicates that, while fears that immigrants will take the jobs of natives certainly matter, anti-immigrant sentiment is driven even more by worries about social, cultural, and linguistic cohesion. In addition, studies indicate that resistance to immigration is correlated with how fast the immigration population grows as much or more than it is with the actual size of the immigrant population. The news that net immigration to the UK hit a full-year record of 333,000 – the government sought to hold it below 100,000 – clearly hurt the Remain camp in June’s Brexit vote. In short, identity often trumps economics when it comes to immigration.

**Refugee and Migrant Crisis:** A part of the immigration issue, but worthy of consideration on its own, the migrant crisis is stirring strong populist and nationalist fervor in Europe. In 2015, more than a million migrants and refugees swept into a Europe that was still struggling to generate growth and that was hobbled by the years-long currency strife. EU members still haven’t reached agreement on a humane and comprehensive plan to deal with migrants and that addresses the concerns of citizens at the same time. The EU has seen borders opening and then closing, fences being built, and member nations openly quarreling over how many refugees each would take.

Fears of terrorism in advanced economies have increased with the influx of refugees and migrants, many of whom are Muslim. Attacks in France, Belgium, and now Germany have shaken the continent, and lone-wolf killings have elevated tension levels in the United States. While not terroristic, the mass robberies and assaults on German women on New Year’s Eve by men who appeared to be immigrants caused worries to soar. It is widely agreed that the bloc was woefully unprepared for the influx and has bungled its handling of refugees and migrants.

**The Twin Job Threats of Globalization and Technology:** Trade and the effects of technology are significant factors. Global trade appears to be slowing for the first time in generations. While trade has been a major source of global growth, globalization and technology are commonly viewed as hurting domestic workers and benefitting big business elites. The perceptions regarding globalization are the same no matter the country. Trade openness is believed to allow low-wage countries to steal good jobs and threaten a nation’s standard of living and economic future. Continuing economic integration in the EU and free-trade initiatives like the Trans Pacific Partnership are thus viewed with open hostility by wage earners who subscribe to this theory.

Over time, technology has created more jobs than it has destroyed and enabled workers to achieve higher standards of living. However, globalization results in near-term winners and losers and
workers with lower levels of education, especially older ones, find the adjustment threatening. Populist demands to raise the minimum wage for low-skilled jobs could worsen the situation if workers are easily replaced by automation. Anxieties caused by globalization and technology will continue to grow among workers and pressure the establishment.

NATIONALISM AND POPULISM: IT’S NOT JUST WESTERN DEVELOPED COUNTRIES

The rise of nationalism and populism is not limited to the advanced economies of the U.S. and Europe. For many countries, the surge in frustration is not the result of a popular movement per se but via official government nationalist policy. Autocrats rule in many parts of the world. In Russia, Vladimir Putin has long been taking the country down a stridently nationalist path with increasing emphasis on a collective Russian ethnic identity. Anti-government movements exist, but opposition is typically crushed. Similarly, Turkish Prime Minister Erdogan has increasingly become more and more autocratic. As the strongman Erdogan increases his power, the rest of Turkish society is becoming less engaged as the media and other cultural institutions lose power.

Anti-government movements are challenging the establishment in a number of other countries. In Brazil, widespread fury continues to be directed at leading politicians and business interests as the country struggles with a major corruption scandal and a recession. Protests against the government are commonplace in Venezuela, Thailand, and Turkey, and just recently Rodrigo Duterte – a tough-talking populist who has been likened to Trump – became president of the Philippines. In Mexico, mass protests are erupting as a result of disgust with government corruption and reaction to liberalizing reforms. Even Japan is striking a more active pose as Prime Minister Shinzo Abe is pursuing policies to beef up the nation’s military might and jump-start an economy beset by deflation and debt.

LESSONS LEARNED

Are there any conclusions that can be drawn in the midst of all this turmoil? Much remains to be settled, but there are some lessons we have learned already:

Anxieties and anger aren’t going away any time soon: Populist cycles generally last a decade. The tensions that are producing the surge in populism and nationalism show no signs of abating. A toxic mix of stagnant growth and diminishing expectations, rising income inequality and austerity, new technologies and a fast-changing digital world are all combining to increase frustration and anxiety. There are no easy fixes, and problems like the refugee and migrant crisis in Europe require a level of smart multinational coordination that has been absent to date.

Surprise: Populists have no magic bullets: For all their self-assuredness and simplistic solutions, populist parties that have won power haven’t exactly drenched themselves in glory. Syriza has failed to deliver on its promises to end the austerity regime demanded by creditors, and its popularity in Greece is now sinking. Brazil’s Workers Party implemented a number of populist policies during its long reign, but it is losing its grip on the country due to the aforementioned scandals and recession. Venezuela’s economy is collapsing after years of progressive populist governance that began with Hugo Chavez. In the wake of the Brexit vote, many voters in Spain lost their appetite for a risky populist adventure and pulled back from their support of Podemos. Even some Brexiteers are exhibiting buyer’s remorse as the awesome challenges of a UK outside the EU become clearer.

It’s time for politicians to take responsibility: Central banks around the world, including the U.S. Federal Reserve, the European Central Bank, the BOJ, and the BOE, have pursued extraordinarily accommodative and often unconventional monetary policies since the financial crisis. As we have lamented above and in past commentaries, they cannot do it alone. Monetary policy cannot solely bear the burden of addressing today’s challenges to economic growth. Politicians around the globe must enact pro-growth structural reforms and increase productivity. Countries with fiscal capacity can take advantage of low rates to make growth-enhancing investments to boost productivity and strengthen infrastructure. Structural reforms in product and labor markets can also help raise an economy’s prospects. Business suffers when it’s difficult to expand healthy firms or start new ones, and competition declines when product markets are protected. Both advanced and developing countries can do much more to rid themselves of growth-retarding policies.
Ironically, the mounting populist pressures around the globe may result in potential actions that will only further exasperate an already tenuous situation and negatively affect growth. Protectionism would raise import prices, lower standards of living, and only benefit those least efficient. And severe curbs on immigration would crush the long-term ability of an economy to grow and innovate.

THE WORLD POST-GLOBALIZATION

We are entering a post-globalization world. The repercussions from the global financial crisis are still being felt and may have long-term consequences. Brexit was likely a major blow to European integration – and by extension global integration. Other regions including the Association of Southeast Asian Nations are already re-thinking integration. Brexit represents an economic crisis for the UK, but a political one for Europe. On one hand, Brexit signified a triumph for democracy, liberty, and free markets. On the other, it represents a challenge to globalization. Most disconcerting, many younger voters especially in the U.S. have negative views about free markets and capitalism, which are inextricably linked to democracy and the ability to tackle the challenges of poverty and urbanization.

Global trade growth is slowing and has been in a structural decline since the crisis. Global central banks are overextended and have lost their credibility and ability to influence the economy. Political paralysis is not just local, but global. The question is where do we go from here?

Some would argue that the world is becoming even more decentralized due to communication and technology advancements leading to even greater globalization. Either way, we will likely see greater cooperation between monetary and fiscal policy makers as the effectiveness of monetary activism wanes. The BOJ’s possible retreat from its negative-interest-rate measure is the first sign of that trend. It will increase the likelihood of expansionary fiscal stimulus – or at least signal a greater burden sharing between monetary and fiscal policy makers. In spite of over-indebtedness particularly in the developed markets, this global shift away from austerity toward looser fiscal policy will occur sooner rather than later. Consequently, fiscal spending will likely get a boost everywhere. In the U.S., it is likely that whoever wins the presidency will increase spending on infrastructure. Trade agreements, if eventually successful, will be bilateral and likely include greater flexibility on labor and community issues. One of the biggest hurdles is how to increase ever-decreasing levels of productivity growth.

On the one hand, current trends will reinforce a multi-polar world and increase geopolitical risk. The danger for the global economy is that countries continue to turn inward. Political paralysis and fragmentation could lead to further crises. On a longer-term basis, economics trump politics. If Brexit teaches us anything, it’s that we can’t ignore political events. And investors ignore the signal from Brexit at their peril.

PORTFOLIO CONSIDERATIONS: HOW TO MANAGE POLITICAL RISK?

STICK TO YOUR KNITTING

Normally downplayed, political risk has implications for how investors approach their portfolios. Everything is ultimately interconnected. Diversification will become even more important. Brexit and its global progeny may mean higher volatility ahead for international investors. Thus, volatility will increase – in equity, fixed income, and especially currency markets. The election induced uncertainty has the potential to restrain business investment and consumer spending and further harming global economic prospects. This is not exactly an investing backdrop that most of us are accustomed to. Our international team is always expecting the best, but prepared for the worst. But we are steadfastly sticking to our process and our discipline as we have for the past 19 years. Process in the wake of political uncertainty is now more important than ever. Our top-down country allocation framework is focused on identifying the most compelling markets with the least amount of risk.

The current political and market environment highlights the importance of risk management. Political risk is exceedingly more difficult to analyze and plan for and we are not convinced that political risk is decreasing anytime soon. Aside from U.S. elections this fall, both Germany and France hold important, national elections next year. From an investment perspective, the environment will continue to be challenging, and the political and business establishment will be hard-pressed by a demanding and vocal
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public to produce solutions. There are few if any storylines of robust growth around the globe and financial markets are expected to experience high levels of volatility in the face of uncertainty. The road ahead may be bumpy, which places a premium on investing strategies that follow a time-tested and consistent philosophy and process that takes into account changing market conditions.

As previously mentioned, Europe is likely the biggest loser in the aftermath of Brexit. We are selectively moving some assets out of Europe and into Asia as a result. In addition, we are also gradually looking to add to the emerging markets. Emerging-market investors have traditionally discounted underdeveloped institutions. Now the developed markets may face the same scrutiny. Interestingly, the only region that seems to be headed in the right direction is Latin America, where more center-right parties have recently won elections promising market-oriented reforms. There is also a strong possibility that inflation makes a comeback – sooner rather than later. We will look for high-quality companies with pricing power and management teams with a clearly defined growth strategy.

It would be easy to equate the current environment with the 1970s or even 1930s and throw our hands up in despair. Inflation expectations, shocks, increased anxiety and underemployment, geopolitical concerns, companies less willing to invest, tighter financial regulations, declining trade, high debt, and lower growth are all similarities. But there have been plenty of crises the past century. The world is undergoing some fairly big changes as the emerging markets become developed, multi currencies compete, and it becomes more multi-polar. Rising populism, sectarianism, and tribalism are the reactions to low growth in an increasingly inter-connected world and 2016 may the year in which political risk trumps economics and corporate earnings. No pun intended.