Elections Have Consequences But May Provide Opportunities

KEY TAKEAWAYS

The divergent returns in 2018 from Brazil and Mexico, two of the larger emerging market countries, further underline the growing impact of political changes on equity market trends. Brazilian equities rebounded following the elections, while Mexican markets declined in the aftermath of the July elections.

As you are reading this, a remarkable spectacle in electoral democracy is being staged in India. In the largest democratic elections in history, nearly 900 million people can vote to elect the country's next government. The logistics of this event is so humungous that it is being staged over several weeks and the final verdict will be known only by the third week of May. As can be expected, the Indian elections have attracted much media attention, but should international investors pay attention?

Until recently, many seasoned developed market investors might have argued that elections don't meaningfully change the growth trajectories of mature economies and are hence not very significant for long-term investors. There used to be broad economic policy consensus among the political parties in the developed world and large parts of economic management are vested with independent central banks. The 2016 U.S. presidential elections upended many of these market notions. Over the last two years, the Trump administration has unleashed the most significant U.S. tax law changes in decades and an unprecedented challenge on the hitherto well-accepted global trade system. Even the critics cannot deny that these are transformative changes that could have lasting effects for the global economy and investors everywhere. Despite all the political noise and distractions, U.S. domestic equity returns have been robust over this period.

THE TALE OF THREE 2018 ELECTIONS

The divergent returns in 2018 from Brazil and Mexico, two of the larger emerging market countries, further underline the growing impact of political changes on equity market trends. Foreign investors shunned Brazil during the second quarter of 2018 as corruption allegations swirled and the political environment looked fragile ahead of presidential elections. To make matters worse, Brazil's economy was crawling out of a deep recession that has lasted over two years. Meanwhile, investors were warming up to Mexico on optimism about the renegotiated NAFTA deal.

Then came the elections. In July, Mexicans decided that it was time for a change and elected the left-leaning Lopez Obrador as their next president. The new administration's first major move was to cancel the airport project in Mexico City, though billions of dollars had already been spent. This was followed by promises to limit bank service fees and other measures to aid consumers. Alarmed investors wasted no time and rushed to the exits, sending Mexican asset prices lower.

In Brazil, equity prices got a tailwind from poll results that suggested that Jair Bolsonaro, the most business-friendly among the presidential candidates, was steadily building a lead. Bolsonaro, now called the 'Trump of the Tropics', won the elections and Brazilian equities outperformed even as most other markets tumbled during the last quarter of 2018.

The most shocking election result of 2018 happened earlier, in May, when Malaysians elected a 92-year old as their leader. Few believed that the political coalition led by Mahatir Mohammad, a former prime minister whose looks and energy belie his age, had a chance. Investors did not like the surprise result or the inherent contractions of Mahatir's opportunistic coalition. Malaysian equities sold off and have yet to recover.

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The optimism surrounding last month's national election in military-dominated Thailand seems misplaced as the results are still being awaited and foreign investors have become more cautious. On the other hand, the people of neighboring Indonesia reelected their popular leader Joko Widodo who is expected to continue his investor-friendly economic policies.

THE TALE OF TWO LATIN AMERICAN ELECTIONS IN 2018

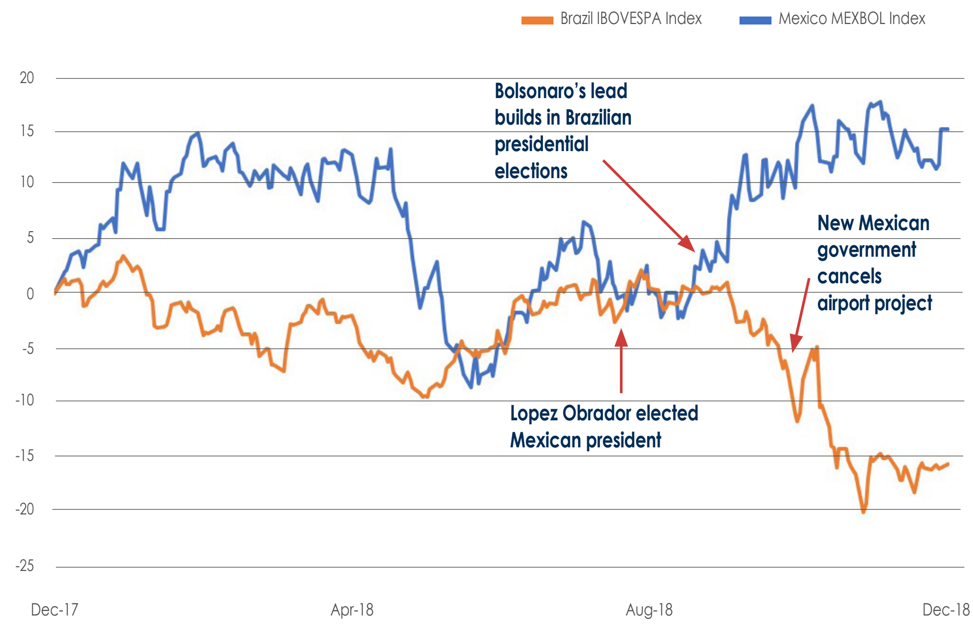

Chart shows percentage change in local currency. Data Source: Bloomberg

ELECTIONS INVESTORS SHOULD WATCH OUT FOR IN 2019

Last month's national election in Thailand was expected to mark the country's transition from a military-dominated past to a more mature democracy. Such optimism seems to have been premature as the country still awaits the results and foreign investors have become more cautious.

More recently, the people of neighboring Indonesia reelected their popular leader. President Joko Widodo is expected to continue the economic policies that have made Indonesia one of the favored destinations for foreign investors in South East Asia over the last decade.

INDONESIA HAS LED AND MALAYSIA HAS LAGGED OVER THE LAST DECADE IN ASIA

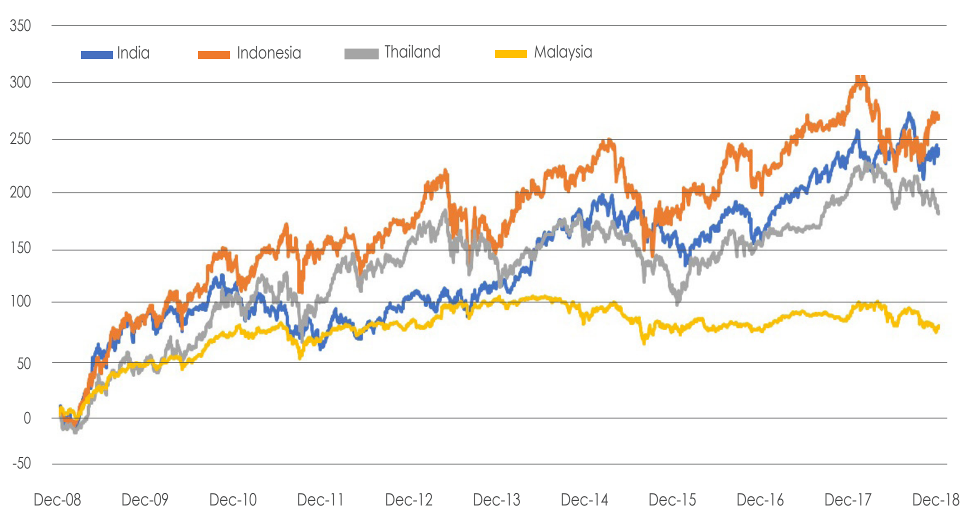

Chart shows percentage change in local currency for the MSCI India, MSCI Indonesia, MSCI Thailand and MSCI Malaysia indices. Data Source: Bloomberg

There are a number of important upcoming elections that we are closely following across the world.

European Parliament: Though more than 700 representatives will be elected from across the continent by the end of May, the rest of the world has largely ignored this event so far. The perception is that the European Parliament is not very relevant and nothing much happens there. However, a likely surge in the number of populist parliamentarians could dramatically change the policy debates. It is quite possible that they will demand more aggressive fiscal policy interventions – such as lower taxes and higher public spending – to revive the moribund economy. Markets would likely respond positively to such policies, especially given Europe's significant underperformance for the last several years. If U.K. voters do end up participating in this election, the results should show if British public opinion about Brexit has changed.

India: Equity indices in India have surged after opinion polls showed that the current government of Prime Minister Modi is likely to be re-elected. Though his track record on managing the economy has fallen short of his early promises, investors would generally prefer the stability of a continuation of the Modi government rather than have a fragmented opposition coalition take charge. However, it appears that investor optimism about Modi's prospects largely ignores the widespread discontent among voters about the lack of jobs and stagnant income growth in rural areas. It is probable that Modi's coalition will only have a thin majority in the next parliament and markets could be disappointed. On the positive side, a diminished political mandate would likely force the government to bring more effective policies and avoid some of its past mistakes.

Though Prime Minister Modi's track record in managing India's economy has fallen short of his early promises, investors would generally prefer the stability of a continuation of the Modi government rather than have a fragmented opposition coalition take charge. In South Africa, a new political mandate should help President Ramaphosa to fight corruption and introduce much needed economic policy reforms.

South Africa: After promising much when it emerged from the dark days of apartheid, the country has disappointed most foreign investors. Rampant corruption and ineffective leadership has held back economic growth. Cyril Ramaphosa was appointed president last year after his predecessor was forced to resign. Though he is very much a part of South Africa's ruling establishment, and not an outsider, a new political mandate should help President Ramaphosa to fight corruption and introduce much needed economic policy reforms.

Argentina: The newest entrant to the MSCI EM Index will elect its next president in October this year even as it struggles with a recession and hyper-inflation. Though President Macri, who has led the country since 2015, has seen his popularity diminish as the economy weakened, he is still favored to win another term. Victory for the populist former president Cristina Kirchner, who is generally believed to be responsible for the country's economic ills, would likely worry most investors and international lenders.

Canada: Given the controversies that have made the Trudeau government unpopular, the ruling Liberal party could struggle to retain its parliamentary majority in October's national election. Markets would not be expected to react positively to a 'hung parliament', with no clear majority for either of the major parties, but may see some upside on signs of the Conservative party gaining ground.

United Kingdom: Though the British people appear even more confused about the Brexit shamble than the rest of the world, the final decision to remain or leave will have a profound impact on the economic future of Europe. Markets are still optimistic about a negotiated Brexit by October this year, but realignments among U.K. political parties could lead to another referendum or force another general election. Most investors would likely prefer any result that keeps the U.K. economy close to that of the European Union. Few would desire a chaotic Brexit followed by a general election that brings a Labour government, though the prospect of a major parliamentary shift cannot be discounted completely.

To conclude, elections do matter for equity market investors even if an unexpected victor like Donald Trump does not emerge each time and shock everyone. Though the short-term impact on markets often depends on the economic context, level of investor optimism, and the extent of result surprises, investors can no longer ignore major elections in an increasingly volatile world.

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