Economic Insight

Big bang?

Financial markets and systemic political change

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Executive Summary

- There has been a noticeable increase in destabilizing political events in recent years. This begs the question whether we are dealing with an unfortunate accumulation of political accidents, or whether there is something systemic going on.
- Several underlying trends, such as global power shifts, weakening institutions, the move to hybrid conflicts and deepening economic and social divisions suggest the latter.
- Economists and investors might want to start preparing for a prolonged period of political instability. Politics might have to be given a more prominent place in economic and financial market forecasting.
- Even under more stable framework conditions, forecasting political risk is an art not a science. In a world of systemic change and growing interlinkages, the range of plausible scenarios becomes larger still. Complexity and uncertainty complicate the analysis of political risks and its economic and investment implications. Elaborate, data-intensive models might not be the best solution. We suggest some guidelines that might help to close the gap.

1. If it cannot be known, it cannot be priced

The world has enjoyed a period of extraordinary political stability since the end of the Cold War. This stable political and geopolitical framework provided the backdrop for hyper-globalization since the 1990s. International 'win-win' cooperation and the spread of pluralist democracy around the world seemed unstoppable.[1] Investors could take a political framework consisting of economic globalization, relatively stable international institutions and pluralist democracies in the West largely for granted.

In recent years, however, the world has been shaken by a number of destabilizing political events, including military conflicts in Ukraine, Syria and Yemen, the rise of populism in the West, the refugee crisis, the Brexit vote, the Trump presidency in the US and growing tensions over North Korea. Many analysts and investors seem to regard each of these events as idiosyncratic and contained, and hence focus on the question when things are going back to 'normal'. It is worthwhile asking, however, whether there are underlying trends of which these events are but symptoms.

[1] Francis Fukuyama famously caught the mood at the time by declaring "the end of history" and the "unabashed victory of economic and political liberalism".

Trends, not events

Taking a broader view, we see several trends that have the potential to fundamentally change the course of both domestic and international politics.

- It seems that globalization and technological change have created **deep divisions in Western societies**, both economically and in terms of values, that risk undermining the stability of pluralist democracies.
- Economic and military (perhaps also soft) **power is shifting** from West to East. History suggest that great power transitions are more often than not accompanied by political and military conflict.
- Global and regional **governance** frameworks are getting **weaker**, gridlocked and out of date, which will make it harder to manage power shifts and conflicts of interests between states.
- The **nature of interstate conflict** is changing, for example through state-sponsored cyber attacks, information warfare or the use of diasporas. The risk of escalation and miscalculation in such 'hybrid' conflicts is high.

Measures of conflict and instability, change 2008-2016

Source: Institute for Economics and Peace, Global Peace Index 2016.

These trends could mean that the world is not being shaken by a series of political accidents, but that the noticeable increase in political risk in recent years is the result of systemic change.

In a situation of systemic change,

- the general political risk level is higher, not least because the scope for political mistakes rises;
- the probability of tail risks goes up;
- the universe of possible consequences of any particular political action is growing.[2]

[2] Ian Bremer and Preston Keat, 'The Fat Tail: The Power of Political Knowledge for Strategic Investing', Oxford University Press, 2009. Lee Howell, 'Four principles for leadership in an uncertain world', The Agenda, January 3rd 2017.

In short, we will more often have to deal not with political risk but with political uncertainty (see box below).

What is political risk?

Definitions of political risk abound. For the purpose of this paper, political risk is defined as a the likelihood that a political action or event alters investors profits or return expectations.

The distinction between political risk and political uncertainty is important. A risk can be relatively clearly described and a probability can be attached to it materializing. In today's dynamic and interconnected political context, it is often more correct to speak of political uncertainty, since the probability of an event cannot be predicted using a normal distribution and the consequences of any given political event are almost impossible to describe with accuracy.

Rational inattention

Most of us struggle to question the prevailing narrative of 'stable geopolitics + pluralist democracies + win-win globalization'. There might be several reasons for this:

- systemic change in politics, such as the end of the Cold War, happens infrequently;[3]
- recent political shocks were not big enough or too sporadic;[4]
- there is still sufficient evidence to back up the business-as-usual narrative;
- many of the rising threats, such as great power competition and cyber war, are not tangible enough to lead to expectations adjustment.

For the time being, it is impossible to know whether we are moving from the post-war liberal paradigm to a new one, what this new world order might look like, and whether change will happen gradually and peacefully or abruptly and violently. Unlike a few years ago, however, a scenario of a more conflict-ridden and protectionist world now looks at least plausible.

Since the uncertainty surrounding systemic political change is so high, investors might exhibit "rational inattention" to long-term political trends.

Can this last? In the medium to long run, a world characterized by rising economic nationalism, hybrid conflict and growing geopolitical tensions would be bad for growth. In such a scenario, we would expect a gradual repricing of assets; or even a sudden reassessment, as a confluence of major political events puts the prevailing narrative into doubt.

If the world has entered a period of systemic political change, we should be prepared for higher levels of political risk and uncertainty going forward. This begs the question as to how.

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[3] It is arguable in how far even a momentous event like the collapse of the Soviet Union constituted a systemic shift in global politics. It spelt the end of the bipolar world order. But the former Communist countries subsequently integrated into the Western post-WWII liberal order, thus perpetuating this system.

[4] Expectations only change in response to shocks, whereby the size of the shock that is needed for people to adjust their expectations also depends on the circumstances; Eric Barthalon, 'Uncertainty, Expectations, and Financial Instability', University Press, 2014.

2. Qualitative analysis in a quant's world

Qualitative political risk analysis is available from a variety of political risk consultancies. Although many provide great insights and analysis, it is difficult to translate such political narratives into risk categories that economists and investors can work with. So political analysts and investors can find it difficult to communicate and cooperate.[5]

Therefore, considerable effort has been put into building *quantitative* indicators designed to capture political risk – albeit with mixed success.

Widely used country-based political risk indicators are often backward-looking and their updating frequency is low. Moreover, political risk ratings can be circular, as one organisation's risk ratings flow into another organisation's indicators.

A brief glance at some widely used country risk indicators illustrates the challenge:

- A sample of the most widely used country-risk indicators uniformly failed to predict the Arab Spring.[6]
- The Political Risk Index (PRI, a forward-looking aggregate of several business-relevant political variables) indicated particular low levels of political risk for Ukraine just before war broke out, and for the UK in the run-up to Brexit.[7]
- Often, political risk categories are rather crude. What, for example, do we gain from knowing that Spain has a similar political risk score as Russia?

Since we may be in a situation of higher systemic risk, and definitely in a situation of more complex interlinkages, the value of country-focused risk indicators may be declining.

Political Risk Map 2017

Source: Marsh

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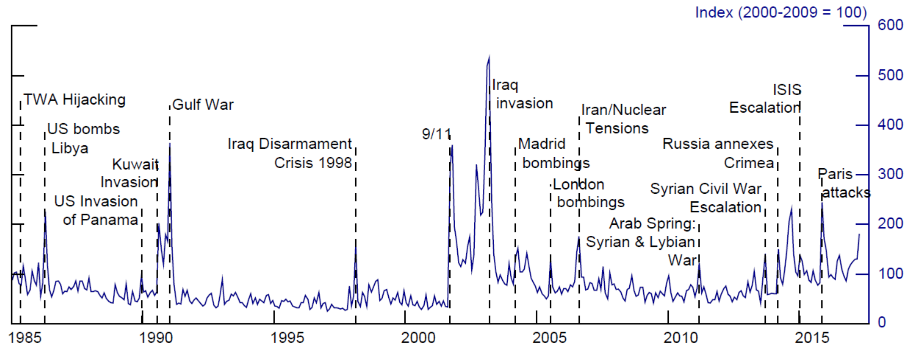
[5] It was somewhat similar for macro-economists until banks started placing them directly into investment management teams or onto their trading floors.
[6] Cecilia Sottilotta, 'Concept and Measurement of Political Risk: From Theory to Practice', PhD Thesis, 2013.
[7] https://www.prsgroup.com/category/risk-index

While it is difficult to construct country-specific political risk indicators, the challenge rises exponentially for more complex, system-wide indicators. Various attempts are being made to measure the general level of political risk based on the number of times certain terms appear in online media.[8] While these are a promising tool for monitoring and research, it is not yet clear whether such media-based indicators are a reliable measure of political instability and what their predictive quality is.

Media-based Global Geopolitical Risk Index



Source: Caldara & Iacoviello, 2016. The Geopolitical Risk (GPR) Index is constructed by counting in 11 international newspapers the share of articles mentioning phrases related to geopolitical tensions..

Political risk analysis will, by necessity, rely on qualitative judgement to some extent. This fact does not fit well into a world where analysis is increasingly based on big data, complex formulas and algorithms. This trend is also clearly visible in investments. Some USD4 trillion in assets is already managed through passive trading strategies / ETFs, and the shift continues apace. Actively managed funds are often managed through algorithms, too.[9] The growing use of complex models in investment decisions might lead to a tendency to focus primarily on quantifiable factors that can be fed into those models.

The past might not be a guide to the future

More research is yet needed on the impact of political events or political uncertainty on both economic outcomes and market performance. Even if such relationships can be established, though, human judgement will constantly be required to recalibrate models. Not even the best algorithm can as yet reframe the question it is programmed to answer.[10] Moreover, by definition, models are of limited use for predicting tail risks. A "naïve use of data-driven risk models" might hence create a false sense of certainty.[11]

3. Concluding thoughts

Crudely simplified, we see two contrasting views on the future of politics. One is that the recent rise in political risk and negative political events was an accumulation of unfortunate incidents. Global rules and institutions as well as domestic checks and balances will

[8] Dario Caldara & Matteo Iacoviello, 'Measuring Geopolitical Risk', Preliminary and incomplete draft, September 7th 2016. Google Jigsaw's GDELT database http://www.gdeltproject.org/.
[9] Quantitative hedge funds account for a bigger share of US stock trades than traditional asset managers and almost the same as retail investors. 'The Quants Run Wall Street Now', Wall Street Journal, May 22nd 2017.
[10] Martin Reeves and Daichi Ueda, 'Prediction in Uncertain Times', BCG Insights, March 23rd 2017.
[11] Thomas C Wilson, 'Risk Management in an Increasingly Complex and Interconnected World', Journal of Culture, Politics and Innovation, 2015.

be strong enough to limit policy uncertainty and prevent political turmoil. The world will go back to 'normal' eventually.

The second view is that the we are in s situation of systemic change. The tectonic plates of world politics are shifting and hence we should prepare for increased political instability in the years ahead, until the system eventually settles into a new equilibrium.

The first view suggests that investors would often do well to ignore political noise and look for buying opportunities when political events spook markets. In recent times, this strategy has often served investors well.

The second view implies a period of greater uncertainty and volatility, which suggests the need for more time-indifferent hedging, diversification and defensive positions as well as careful monitoring of political developments and market reactions to see whether market participants are beginning to re-assess the political environment in which they operate.

In this scenario, it is important to feed political risk more systemically into relevant analyses. Here are some preliminary ideas as to how this could be done:

- Acknowledge the **limitations of quantitative analysis** when it comes to political risk. Use data and models where possible, but do not allow them create a false sense of certainty.
- Do not apply to politics the **reversion-to-trend** techniques that are often employed in macro-economic forecasts. The assumption that past events are a good guide to the future has not worked well in recent years.
- More fundamentally, in politics, **stability can often be a sign of underlying fragility** (rigid systems can implode under pressure) while mild instability suggests that countries can adapt well to crises.[12] Extrapolation can point the wrong way.
- Work more with **scenarios** to explore the universe of plausible outcomes. Scenarios are not forecasts. But they force us to consider alternatives and become explicit about our assumptions.
- Be aware of your own biases and question your assumptions. It has been shown that **subjective perceptions** of political risk are as important for risk management as the objectively measured level of political risk.[13]
- Analyse trends and the big picture. Country-focused political analysis should be embedded in **a broader analytical framework** of global and regional trends.
- It appears that **small mixed teams** of, say, economists, political scientists and investment managers, could make better forecasts than both individual forecasters and homogenous teams.[14]
- Do not underestimating the possibility of discontinuous shocks and consider the possibility and implications of **systemic change**.

[12] Nassim Taleb and Gregory F. Treverton, 'The Calm Before the Storm: Why Volatility Signals Stability, and Vice Versa', Foreign Affairs January/February 2015. According to this logic, France would be considered more vulnerable to political instability than Italy, for example.
[13] Erasmo Giambona, John R. Graham, Campbell R. Harvey, 'The Management of Political Risk', Duke I&E Research Paper, 2016-32.
[14] Philip E. Tetlock and Dan Gardner, 'Superforecasting: The Art and Science of Prediction', Broadway Books, 2016.

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