Geopolitical risks in 2013

Earlier this month, we issued a paper focusing on developments in the eurozone. In this month’s second Market Update paper, we take a closer look at the geopolitical risks that capital markets face in 2013.

Identifying the risks

When we last wrote about geopolitical risks three months ago, we had identified six areas of significant risk and four areas of minor risk. Of the six major areas, two have now become low risk:

- The risk of Japanese political gridlock
- The Chinese leadership change

In addition, two more have either been reduced or have stalled:

- The eurozone crisis
- Island disputes between China and Japan

This leaves just two major risks that investors need to remain wary about:

- Political gridlock in the US over fiscal policy
- The escalation of Middle East tensions

The four minor risks that we had identified last October, i.e. labour unrest in South Africa, North Korea, Venezuela and Nigeria, remain as they were.

The outcome of the US fiscal policy discussions will be key for capital markets in the coming months.

US fiscal policy

The fiscal cliff agreement and vote on 1st/2nd January cancelled most of the tax increases that were due to come into effect in January, except for high income earners, while the payroll tax exemptions were not extended. In addition, the automatic cuts to public expenditure were delayed. The details of the deal are:
Tax rates on the wealthy were raised, payroll taxes expired and a higher medicare tax was implemented – all having an estimated annual impact of USD 181bn

2011 discretionary spending cuts of USD 60bn were enacted

Medicare fee cuts for doctors and the expiry of extended unemployment benefit were delayed for one year, meaning that USD 41bn of cuts did not take place

Individual and business tax breaks of USD 69bn were extended for one year

A sequester on public expenditure of USD 110bn was delayed until the end of February

The maintenance of middle class tax rates, estate duty, capital gains and dividend rates of USD 197bn was made permanent

The alternative minimum tax of USD 105bn was avoided

In summary, tax increases and cuts implemented were worth USD 241bn, cuts which were delayed totalled USD 220bn and tax increases of USD 302bn were permanently voided. At the end of February, the delayed public expenditure cuts of USD 110bn will have to be agreed on and the debt ceiling will have to be increased.

The central case scenario is that a proportion of these cuts will be implemented to achieve an agreement on the debt ceiling, but that the cuts will take place over one to two years. The outside risk (a 20% probability) is that the Republican House cannot agree with the Democrat Senate and therefore, in March, the US Treasury is increasingly constrained in paying suppliers, pensions and so on. A credit downgrade in these circumstances is inevitable.

Under the central case, fiscal policy at the Federal level will have a negative impact on real GDP growth in 2013 of close to 2% and in Q1 annualised growth could decelerate to around 1.5%, before improving in Q2 back to 2% and then 2.5% in H2 2013. Inevitably, market volatility will increase in February and, if there is agreement on cuts and the debt ceiling, the equity market advance should continue in Q2. However, in the event of no agreement on the debt ceiling, markets could reverse significantly in March until an agreement is reached. Having said that, the downside risk to markets is likely to be less than that of July/August 2011.

The escalation of Middle East tensions

By any criteria, the Syrian civil war has deteriorated, although so far there has been only a limited spill over into Turkey and Lebanon.

The central case scenario for Syria remains one of continued fighting, but with an informal partition of the country. Although the risk of spill over into Turkey is low, Northern Lebanon is at risk of being destabilised. The key “flashpoint” is the potential use of chemical weapons, in which case some form of NATO intervention would take place.

Iraq remains unstable, with tension points being the dispute over oil revenues between the Kurds and the Baghdad government and Iranian influence over the Shia dominated government. The central case here is that pockets of instability will persist but that oil production targets will be met.

The Israeli election in January will produce a shift to the Right. However, given military opposition, an outright attack on Iranian nuclear facilities remains unlikely given their dispersion around the country and the depth of the facilities. It would be safe to assume that covert and cyber attacks will intensify.

The Iranian economy remains under severe pressure with high inflation, a weak currency and sanctions resulting in shortages in key areas. Financing the Assad regime is becoming excessively expensive. The Iranian election at mid year might produce a slight move to a more moderate government and progress on the nuclear dispute.

Instability has increased in Egypt and Pakistan although not to an extent to lead to government change and/or have an impact on markets.

The probability of serious unrest in Eastern Saudi Arabia remains low and although unrest persists in Bahrain, Saudi potential intervention will support the government.

All of the above is discouraging, but Brent has continued to trade around USD 110 per barrel, with a modest uplift in WTI to USD 94 per barrel. The obvious question is to what extent Middle East tensions will lead to oil price spikes. The “flash points” are an Israeli attack on Iran, an Iranian attempt to close the Strait of Hormuz and significant unrest in Eastern Saudi Arabia. The central case remains that these are significant but outside risks with the natural hedge being to own oil companies with exposure primarily outside the region.

The eurozone crisis

Signs of reduced tension are the improvement in 10 year bond yields in Ireland, Portugal and Greece and, more importantly, in Italy and Spain. The EUR has recovered against the USD to back above 1.33. Bank deposits at the European Central Bank (ECB) have been reduced and interbank capital market liquidity has improved, with bank flows now partially increased across the eurozone.
The bail out programmes for Ireland and Portugal are largely on track. Countries with major trade/current account deficits have seen a major improvement in competitiveness and deficits are been cut back and, in certain countries, i.e. Italy and Ireland, trade surpluses are being generated.

Given private sector write-offs, the reduction in interest costs and the lengthening of repayments, Greece is funded for 2013 and the risk of Greece leaving the euro has been reduced significantly, at least for this year. However, eurozone real GDP growth will be negative for H1 2013 and a return to 1%+ growth will only occur in 2014. Having said that, growth should slowly pick up in Northern Europe in H2 2013 and Italy should emerge from recession.

Other negatives are uncertainty over the Italian election, with a probable move to the Centre Left, the risk of a referendum on Catalonia, the Cyprus bailout, the lack of growth in France and the challenge for the French government to reduce its deficit. Another concern is the continued slow progress in Greece achieving the targets in its bail out programme. Spain will also remain in recession in 2013, thereby constraining its ability to reduce its budget deficit.

Three months ago, the key risks in the eurozone were the default of a major bank, a bail out for Spain and Italy and pressure for countries to leave the euro, most notably Greece. All of these risk factors have now been largely reduced.

Island disputes between China and Japan

Although the Abe government is more nationalist, the focus of the new LDP government is, at least initially, on boosting the economy and pressurising the Bank of Japan (BoJ) into an easier monetary policy. Likewise, the Chinese government is focusing on the re-orientation of the economy, the need to boost growth back above 8% and on a smooth transition to the inauguration of the new leadership in March.

Consequently, outright confrontation over the Senkaku/Diaoyutai islands has been avoided. A significant factor for Japan is the loss of export market share in China and the damage to Japanese investment. While the probability of the dispute over these islands (and also over other island chains in Asia) will never be resolved, domestic economic interests will prevail and prevent an increase in confrontation.

Japanese gridlock

The LDP scored a decisive victory in December and in January the Abe government have announced a major easing of fiscal policy – equivalent to approximately USD 150bn or around 2.6% of GDP. The bulk of the funds will be spent on infrastructure. In addition, there is intense pressure on the BoJ to raise the inflation target to 2% and to weaken the JPY.

So far, the results of these announcements have been a reversal in the JPY to close to 90 against the USD, a rally in the Nikkei to nearly 11,000 (up 4% y-t-d) and a slight reversal in 10 year JGB yields to 0.8%.

Potential problem areas are the budget deficit, which is already at over 9% of GDP, debt to GDP at close to 230% of GDP and structural problems such as the regulation of the economy and the lack of economic openness to international competition. There is no certainty that the increase in public expenditure will boost the economy over the next two to three years, although the short term impact will be positive.

The investment conclusions are to remain short the JPY, to avoid the JGB market and to run tight stop losses on Nikkei long exposures.

The Chinese leadership change

As expected, the November Congress confirmed Xi Jinping as president and Li Keqiang as the replacement to Wen Jiabao. The formal change will take place in March.

The Bo case has successfully been pushed aside and the political in-fighting of last summer has now largely been dealt with. Although there are ongoing arguments about censorship and government control of the media, the level of unrest will be low, at least in the short to medium term.

The political focus is on boosting growth back to 8% by increasing domestic consumption (based on higher wages), by maintaining infrastructure spending, by focussing on regional and emerging market trade and by increasingly shifting the economy away from the coastal areas. The risk of political disruption leading to a Chinese “hard landing” is now low.

Minor risk areas

Labour unrest has continued in South Africa and, as forecast, has spread out of the mining sector. GDP growth should remain at a weak 2-2.5%. The current account deficit will remain above 5% of GDP and the currency will probably weaken to 8.6-8.8 against the USD.

North Korea has tested its rocket, but recent statements imply a new focus on the economy. In fact, Chinese pressure is intense to reform the economy along Chinese economic and political lines. The risk of a major confrontation with South Korea is low.

Chavez remains critically ill and could not attend his inauguration. Calls by the opposition for a new election have been resisted and although Maduro has been nominated as Chavez’s number two, political unrest will probably increase but not to the extent to impact the oil price.

In Nigeria, instability in the north of the country has continued and the problem in Mali could have a spill over effect. However, the risk to oil production remains low.
Conclusions/strategy

2012 was characterised by a significant increase in geopolitical risk with the potential to destabilise markets. Over the last three months, progress has been made in reducing these risks.

Notably risk/reward has improved in Asian markets, and China in particular, while although the eurozone is in recession, extreme event risk has been reduced.

The situation has deteriorated in the Middle East. However, oil prices have not responded and the risk of a major oil price spike remains low (with a number of caveats).

The initial fiscal cliff deal in the US led to positive market developments in early January and the central case is that the debt ceiling will be extended but market volatility could increase in February/March.

The overall theme is that the number of risk factors has been reduced, and this should support a policy of "risk managed" long positions in global equity markets.

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