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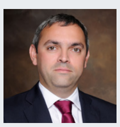
POLICY INSIGHTS

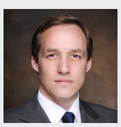
January 2018

The view from our global fixed income portfolio managers.

Will Political Risk Dominate Fixed Income Markets in 2018?

GLOBAL INVESTMENT TEAM


Arif Husain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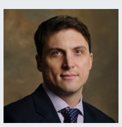
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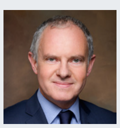
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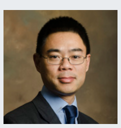
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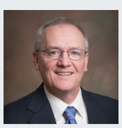

Steven Huber

Once a month, our fixed income portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This monthly article series examines one of the predominant themes highlighted during their discussions.

An unpredictable political environment in the U.S., ongoing geopolitical tensions, and elections in Italy as well as in a number of emerging market countries are among numerous political risks facing markets this year. The question is: how should fixed income investors price in these risks, if at all? This was a key discussion point during our latest investment policy meetings.

Political risk didn't matter in 2017—bad news came and went without causing much alarm in markets and efforts to hedge portfolios against event risks generally did not pay off. Buying protection on the South Korean won, for example, did not benefit investors despite an escalation in tensions over North Korea; similarly, underweighting Spanish government bonds did not reap rewards as there was minimal fallout from Catalonia's unofficial independence referendum in Spain.

The lack of volatility around political events in 2017 has led some participants to question whether a more relaxed approach should be taken to bond market risk this year. But this is something that Arif Husain, portfolio manager and head of International Fixed Income, strongly disagrees with. "I always prefer to err on the side of caution," he said. "With hindsight, given the repeated missile launches by North Korea in 2017, I would have probably spent the same amount of money on insurance against a potential geopolitical crisis."

With this in mind, the Global Investment team took a deep dive into the political risk events on the horizon for this year. For emerging markets, it's all about elections: Russia, Colombia, Indonesia, Mexico, Malaysia, Brazil and Thailand—which together represent more than a 50% weighting in JP Morgan's emerging market bond indices—are all scheduled to hold presidential, general or local elections in 2018. The build-up to such elections often leads to price distortion and opportunities for medium-term investors.

> "Fixed income markets can overreact ahead of elections."
>
> **–Arif Husain, portfolio manager and head of International Fixed Income**

"Fixed income markets can overreact ahead of elections," said Mr. Husain. "This was the case in South Africa last year before the African National Congress leadership contest. Ultimately, market volatility gave us the opportunity to re-enter the local bond market at a more attractive level."

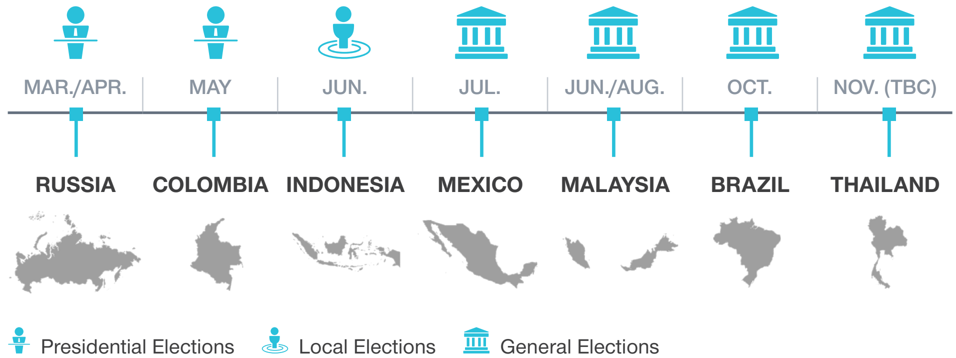
Currencies can also be affected by political risk. A current example is

“All this makes for a highly interesting political environment that will offer opportunities, but where we will have to react quickly.”

–Arif Husain, portfolio manager and head of International Fixed Income

FIGURE 1: A Number of Emerging Market Countries Will Face Elections in 2018

As of January 10, 2018



Source: T. Rowe Price.

the Mexican peso: not only is Mexico bracing itself for the possibility of leftist presidential candidate Andrés Manuel López Obrador winning July’s presidential election, but it is also facing the nearer-term threat of the U.S. withdrawing from the North American Free Trade Agreement (NAFTA). “This backdrop leaves Mexican assets vulnerable to further political headline risk in the short term,” said Mr. Husain.

Political risk will not be confined to just emerging market countries in 2018, however—it will also be a major theme in developed markets. In the U.S., the possibility of federal government shutdown continues to loom amid ongoing battles over key pieces of legislation in Congress. At the same time, uncertainty persists over whether the Trump administration can deliver on its pre-election promises—while tax reform has been delivered, actual fiscal stimulus and healthcare reform continue to be pushed back. On the international stage, the U.S. administration will enter challenging NAFTA renegotiations with Canada and Mexico, a prospect that seems to have weighed down on the U.S. dollar recently. Lastly, concerns over rising populist forces in Europe have receded, but risks remain with elections due in Italy on March 4, and noise surrounding the UK’s exit from the European Union likely to continue throughout 2018.

“All this makes for a highly interesting political environment that will offer opportunities, but where we will have to react quickly,” said Mr. Husain. “Short-term price dislocation should only be exploited if the medium-term fundamental investment thesis remains solid,” concluded Mr. Husain.

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