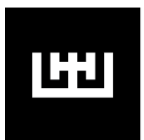

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CAPITAL

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FEATURE ARTICLE:

A SLEW OF GEOPOLITICAL RISKS

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CHINA – US RELATIONS

A SLEW OF GEOPOLITICAL RISKS

Whether we like it or not, geopolitical risk has come to dominate market sentiment again. President Trump continues to be wildly unpredictable - in one breath, claiming a big step forward in world peace through his mid-June summit with North Korean leader Kim Jong-un - in the next, implementing sweeping tariffs on imports from both close allies and archrivals. The escalating imposition of tariffs may potentially trigger an all-out trade war threatening traditional trading relationships and alliances. There is also sustained unrest in the Middle East and lingering populism in Europe – the latter of which is starting to emerge in Latin America.

This month's feature article provides an update on the current sources of geopolitical risk at the forefront of the world's attention and its effects on financial market sentiment and behaviour. We start with the risks that are both most concerning and likely to severely impact the economy and financial markets - chief among them ongoing trade tensions.

We then discuss ongoing geopolitical risks across Europe and the Middle East. Finally, we address the Trump administration's first major political test – the US mid-term elections in November.

CHINA – US RELATIONS

Status: Among the most concerning risks given the recent escalation of tensions, and the two countries' footprint in the global economy.

Background

China has obviously been the subject of most of Trump's scorn over the past few months as it relates to trade, with the bulk of the tariffs implemented to date imposed on Chinese imports. Following the announcement of the steel and aluminium tariffs on 1 March, he announced sweeping tariffs on Chinese imports, worth at least US$50 billion.

The Trump administration claimed that the tariffs were in response to a report conducted by an American trade official that quantified the volume of the Chinese theft of American intellectual property (IP). A series of threats of tariffs of up to US$100 billion followed from both the US and China. In early July, the Trump administration imposed a fresh wave of tariffs totalling US$34 billion worth of Chinese goods. Tit-for-tat retaliatory tariffs have since ensued.

China and the US have had a tumultuous relationship over the past several decades, but President Bill Clinton helped thaw a relatively icy relationship when he signed the US-China Relations Act of 2000 which granted China a permanent trading relationship with the US. This also served as the first step in allowing China to join the World Trade Organisation in 2001. Since then, there have been several issues that have proven to be points of contention between these two nations.

Trade Deficit

Since the opening of trade between the two countries, the US has amassed a significant trade deficit with China (approximately US$400 billion in 2017). This is predominantly because China can produce goods at a much lower cost than the US, and thus Chinese goods imported into the US are cheaper than equivalent American-made goods.

Additionally, China produces goods that America does not make, so America ends up importing a significant amount of such Chinese-made goods.

Trump does not approve of the trade deficit that America has with China (nor any of its other trading partners). Trade deficits are financed by debt as the country is spending more on its imports that it is receiving on the sale of its exports. To finance this spending habit, the US borrows from its trading partners. While this is fine at the moment because its trading partners continue to lend to the US, it could become an issue if they ever decided to stop lending and asked the US to repay its debt instead.

However, the likely thornier issue for Trump is the message that such sizeable trade deficits send regarding the competitiveness of the US economy. When American consumers opt to buy goods that are foreign-made even though they are also being domestically made, with price being the deciding factor, if it occurs over a long enough period, American manufacturers are likely to be less competitive and fall behind. This is because they are no longer profitable enough to invest and innovate and shuttering their factories may be the only reasonable option left for them.

Excess Steel Capacity

For years, the Chinese government has produced far too much steel than the volume of steel that the government needs, with the excess steel often sold in the American market at cheaper prices. The lower cost of imported steel has caused domestic steel prices to decrease as well. The Chinese government has promised for years to reduce its excess steel capacity, but it has faced a great deal of domestic resistance because of the impact that this would have on the Chinese economy, particularly for jobs in the steel and aluminium industry. Trump hopes that the tariffs will cause the Chinese government to expedite the rate at which it reduces its excess capacity

North Korea

Over the past year and a half, as tensions between the US and North Korea have escalated and since tapered, the United States has repeatedly called on China to place more pressure on North Korea to try to get it to disband its nuclear program. China is North Korea's main trading partner and one of its few allies. The North Korean regime would be in serious trouble if its relationship with China soured. As a result, China has an incredible amount of influence and leverage over North Korea. The US understands the extent of the bargaining power that China has with North Korea and has issued a great deal of scorn towards China for not being tougher on North Korea. It is expected that Trump has used his tough talk on trade with China as a way to manipulate China into acting tougher towards North Korea.

South China Sea

Several different countries have tried to lay claim to the South China Sea, a dispute which is often regarded as Asia's most dangerous point of conflict. Both China and Taiwan have claimed the entirety of the body of water to themselves while almost every other country in the region has claimed some part of it. China has even created artificial islands in the region. Per satellite imagery, China has been placing military equipment on these artificial islands, despite the government's claim that the islands have only been constructed for civilian purposes.

The US has formed alliances with other countries in the region against China, arguing that any militarisation of the South China Sea is completely unnecessary. Meanwhile, China berates the US for its unnecessary involvement in the region, claiming that the US is intentionally putting itself in the way of Chinese supremacy in the region. Both sides of the party have repeatedly attempted to display their military might in these waters.

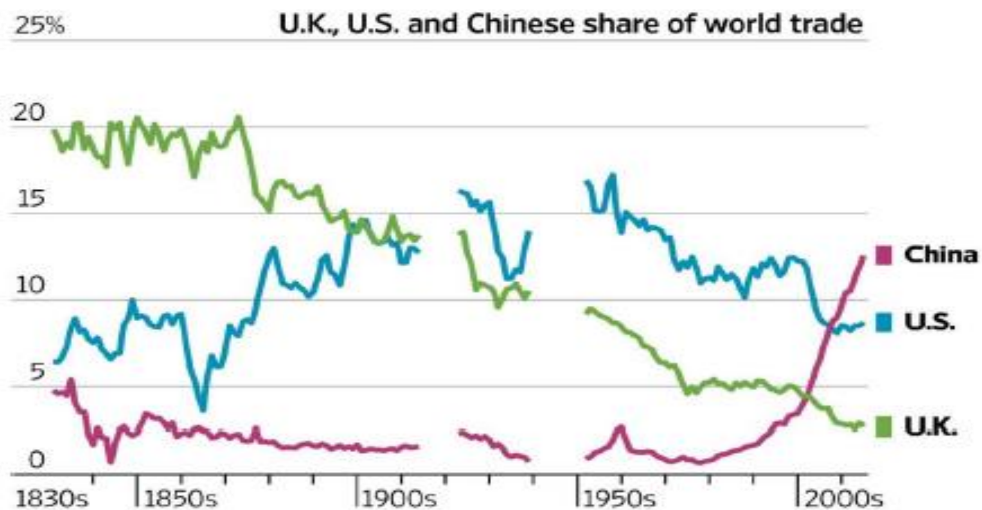
While this has been an ongoing point of contention between the US and China, it has certainly not dissipated since Trump was elected. This could further raise the stakes in one of the world's most volatile regions.

Threat of Economic Supremacy

Combined, China and the US account for almost 40% of the global economy. Historically, the US economy has been far larger and more dominant than the Chinese one, but the gap between the two has been decreasing rapidly over the past few decades. In 2005, the US economy was almost six times the size of China's, however in 2017, the US economy was only one and a half times the size. It has been projected that in a decade from now, China could be the world's largest economy, complementing its title as the world's largest trader, as shown in Chart 1.

China does not plan to slow down its quest for economic supremacy. The government has pledged to increase spending on corporate research and development such that it accounts for 2.5% of GDP by 2020, which would equate to a 70% rise in absolute terms since 2015. This coincides with 'Made in China 2025', which is a strategic plan announcement by the government in 2015, with the goal of moving the country's manufacturing up the value chain. For example, the country wants to increase the domestic production of core materials to 70% by 2025. The focus is primarily on technological goods, which if successful, could upset America's top position on the technology innovation food chain.

Chart 1: Share of World Trade, 1830 - Present Countries -2015



Source: The Wall Street Journal
Note: Data not available for 1914-20 and 1939-49; China includes Hong Kong and Taiwan.

Economic Impact

To understand the impact of tariffs on domestic and foreign economies, consider the implications of tariffs implemented against Canadian steel and aluminium. The tariffs are good news for American steel and aluminium producers because a tax on imports makes their products relatively cheaper. But it is bad news for American steel and aluminium-consuming industries. If such industries rely heavily on foreign imports, their cost of production suddenly goes up, unless they can find a reasonable domestic alternative (although adjusting supply chains is typically a protracted process). They can either choose to swallow the increased costs or pass them on to consumers. If the companies are 'price-takers' in that they do not have the market power to significantly increase prices and expect to retain their current level of business, the companies will have to swallow the costs, putting jobs in such industries on the line. Ultimately, tariffs usually create wealth for a small slice of a particular industry, and destroy it for a much larger part.

Tariffs also have direct implications on consumers. Tariffs make both domestically produced and foreign imported goods more expensive. Everyday consumers will see increased costs on a plethora of essential items. While wage growth has picked up moderately so far in 2018, it is certainly not high enough to offset the inflationary pressures and higher costs that could come from the unintended consequences of tariffs.

Higher prices with little to no change in incomes will cause spending power to decrease. For those who may be affected by spikes in tariff-induced unemployment, this issue may be even more acute. It is important to note that such economic implications would be expected to play out in all countries that are involved in facing and implementing tariffs.

Australia

The steel and aluminium tariffs on their own are unlikely to have significant implications in Australia, although an escalation to a broader trade war would likely have consequences for Australian exporters. The consequences would likely be most felt in terms of commodities, because commodity prices and volume of exports are inextricably tied to global growth, particularly Chinese growth. In the short term, a tariff-induced slowdown in Chinese growth would cause their demand for Australian commodities to fall sharply, likely also resulting in a weaker Australian dollar. This could prove difficult for the RBA to manage given that interest rates are already so low, and so it has minimal flexibility to spur the economy by slashing cash rates. Over the longer term, the Chinese government may start to try to stimulate economic growth through infrastructure investment for example. This would cause commodity prices to rebound.

Market Impact

Over the past year and a half, we have finally seen an emergence of synchronised global growth. The trade wars that the world seems to be on the brink of have the potential to seriously disrupt this optimism.

Share markets grappling with the uncertainty of what Trump's tariffs will bring has been a predominant theme since they were first announced. History has shown us that trade wars are not good for markets. In our recent article on trade wars (refer to March 2018's The Art of the Trade Deal), we discussed the few reasonable precedents that we have for share market implications during periods of trade wars. These include the Smoot Hawley tariffs during the Great Depression and those that George W. Bush implemented on steel in 2002. In the more recent example, in the months following the implementation of the tariffs, global share markets fell by a total of between 30-45% before making a recovery. The recovery was supported by the WTO's ruling that the tariffs were ultimately illegal.

Chinese companies that are being directly targeted by the Trump tariffs will likely come under pressure given that their export volumes would fall as American consumers opt for the cheaper American-made equivalent products. The same is true for the American companies that export goods to China that have been targeted by China's retaliatory tariffs.

Companies with complicated supply chains embedded in China will also feel the pinch given that they will either have to pay more for the Chinese goods that they use in their production, or they will have to fundamentally change their supply chains to replace Chinese suppliers with domestic suppliers, which could be both expensive and drawn-out.

Investors are understandably worried about the potential impact of an all-out trade war between the globe's two largest economies. They are worried about the impact of escalating trade tensions on global economic growth, inflation and corporate earnings. Cyclical sectors, or those that are most exposed to economic swings, will be the most susceptible. Furthermore, companies that have invested a great deal in cross-border supply chains may need to write them off, another source of concern for financial markets.

Trump's tariffs have thrown a spanner in the works for the Federal Reserve, because it was just starting to tighten its monetary policy in reflection of the stronger growth, tight labour market and emerging signs of inflation. With the tariffs expected to reduce growth and raise inflation, the US government yield curve has reacted accordingly. The yield curve is currently the flattest it has been since 2007. Short-term rates have moved higher because of the continued expectation that the Fed will raise rates, while long-term rates have remained relatively flat given the longer-term risks to economic growth brought about by escalating trade tensions.

We would likely be revisiting the investment strategy with a view of lowering equity allocations in the event of a full trade war coming into reality.

Impact So Far

Given the precedent of previous trade wars, share markets have been rightfully skirmish so far this year. The S&P 500 index has had a far more volatile year so far in 2018 than it did in all of 2017. February and March saw particularly notable sell-offs. February's was brought about because of robust economic data in both North America and Europe, in terms of both global economic growth and tightening labour markets, which spurred fears that inflation could be on the rise sooner than previously expected. Trump's announcement of tariffs in early March caused further sell-offs. Share markets have been jittery in early July as Trump and China are going head to head with their retaliatory tariffs.

A SLEW OF GEOPOLITICAL RISKS

EUROPEAN FRAGMENTATION / RISE IN POPULISM

EUROPEAN FRAGMENTATION / RISE IN POPULISM

Status: The headline countries survived a populist push in 2017, however populist risks remain for several smaller European countries.

Background

The fractious political landscape in Europe is not a new story. The all-important elections in the Netherlands, Germany and France in 2017 saw populist candidates attempt to pull off the same surprising outcome that Trump did in the American election in 2016. Markets breathed a sigh of relief when none of them managed to get through. Those outcomes did not mean however that populism, Euroscepticism and anti-establishment sentiment met its match across Europe. Rather, these feelings are still very much alive and well.

In a feature article we wrote last year we discussed the severe economic and financial market implications that could come with a populist, anti-EU uprising in one of the most prominent EU countries (France), given the uncertainty that would be expected if another key European nation opted to leave the EU. While the political landscape in some of the prominent European countries has turned moderately more placid, there continue to be flashpoints concerning the EU's future.

Poland

A shift towards a populist Poland has been occurring since the start of the decade. The right-wing populist Law & Justice Party (LJP) increased its popularity dramatically between the 2011 parliamentary election and the 2015 election in which the party took power.

The party had primarily campaigned on protecting the nation's Catholic upbringing, prioritising family values and getting rid of the liberal elite. The election was seen as ordinary Poles voting for change, particularly because of their distaste with the very uneven wealth distribution between them and the political elite.

Since the election in 2015, the LJP has made some sweeping and controversial changes, as promised. It has purged much of the public administration and has introduced legislation in an attempt to control the media. It has also made it harder to get an abortion and has taken on an extreme anti-refugee stance. However, the issue that has garnered the most attention and has worried the EU the most is the country's attempt to revamp its political system such that newly implemented legislation threatens the independence of the courts. The justice system, including the courts, can now be stacked with political appointees. This is particularly worrying given that the courts ultimately decide upon the validity of election results.

The EU gives Poland more money than any other member country and given its disdain with the overhaul that the Polish government is enacting, the EU has decided to step in. The EU has threatened to limit access to funds to any country that appears to be disrespecting the democratic rule of law.

Despite the obvious differences of opinions between Poland and the EU, most people in Poland do not want to leave the EU (in a recent poll, a third of Poles indicated their desire to leave the EU). Even the more moderate faction of the right wing would rather stay in the EU, albeit provided some sweeping changes are made to the governing body.

Economic and Financial Market Implications

Poland's economic performance has been relatively robust, with 26 consecutive years of economic growth, a track record that rivals Australia's. Joining the EU in 2004 has only continued to support reasonably strong growth. Poland was the only country in the EU to withstand the financial crisis without entering a recession. However, continued uncertainty in Poland's political landscape and its ongoing spat with the EU could cause a blip on the radar. The Polish zloty has been one of the best performing emerging market currencies, but it has proven to be vulnerable when the tension has escalated. For example, when there were street protests in July 2017, the currency faltered, as it has when there have been concerns about Poland's sovereign ratings.

In April 2018, rating agency S&P surprisingly updated Poland's outlook on its BBB+ rating to positive despite the ongoing turmoil, citing the country's solid fiscal and economic performance. That said, further criticism from the EU could call Poland's status as a relatively safe emerging market investment into question.

Italy

A general election took place in Italy in early March of this year. The outcome was a hung parliament, which did not come as a surprise given it mirrored opinion polling leading up to the election. The Eurosceptic, direct-democracy Five-Star Movement won 32% of the seats, with its leader, Luigi Di Maio, flagging that the party was open to negotiation about ruling the country via coalition. A coalition of Eurosceptic centre-right parties, including Silvio Berlusconi's Forza Italia party, together won 37% of the seats.

The best-performing of the coalition was the right-wing Lega Nord, which has previously campaigned for northern Italian secession. Meanwhile, the governing centre-left Democratic party performed poorly, triggering the resignation of former Prime Minster Matteo Renzi.

The process of forming government was a rather long and protracted process. The Five-Star Movement and the Lega Nord worked together to try to form a coalition government, however, Italian President Sergio Mattarella pushed back on many of the coalition's proposals, including for reforms to remuneration for politicians, particularly bloated pensions.

Furthermore, Mattarella disapproved of a proposal that included a highly Eurosceptic finance minister, Paolo Savona. Finally, in early June, Mattarella approved the coalition between the two parties. The uneasy coalition begs many questions about the nation's political and economic future – both are anti-EU and anti-establishment, and they have conflicting economic goals. Furthermore, Italy's new Prime Minister Giuseppe Conte is a law professor with no political experience and the coalition only has a very slim majority in parliament. It looks as though political uncertainty will persist for a while yet, which is a feeling that Italians have grown accustomed to. Italy has had 90 different governments in the past 116 years, including 23 different Prime Ministers since 1980.

Economic and Financial Market Implications

The economic viability of some of the coalition's proposed policies have already been questioned, despite only just over a month in office. For example, the coalition has proposed an overhaul to the tax system and a universal basic income, which together is expected to cost an eyewatering €65 billion per year, or 5% of GDP. It is important to note that the Italian economy is in a much better place now than it was in the lead up to and amidst the European debt crisis in 2011 and 2012. The country has reduced its fiscal deficit and the country now has a trade surplus rather than a deficit. Economic growth continues to be somewhat meagre, but it has been more robust than it was immediately following the debt crisis. The country's debt-to-GDP ratio remains fairly high at 130%, but the country's banks are in a seemingly more stable spot than they were at this time last year.

That said, Italian share markets have had a wild ride amid the uncertainty that persisted while the two political parties were attempting to form government. Volatility is likely to persist with this government in office, given the uncertainty of its fiscal spending and EU membership plans. However, the government, while populist, right-wing and anti-EU, did not campaign on exiting the EU, so the likelihood of Italy pulling itself out of the EU is small.

Italian government bond yields increased significantly during the rocky formation of government in May, particularly so after President Mattarella disapproved of the coalition's first proposal. With the prospect of further instability for a heavily indebted nation that has the world's fourth largest bond market, Italian government bond yields surged (and prices plummeted) as investors sold off Italian holdings and tilted into safer issuers such as US Treasuries and German bunds, both of which saw yields fall (and prices rise). However, the associated panic was short-lived, as yields decreased when the Italian president accepted the amended proposal.

Political jitters may ultimately trigger ratings downgrades for Italian debt, with Fitch warning that fiscal loosening from the new coalition may push its Italian sovereign rating below BBB. A bond is considered investment grade if its credit rating is BBB- or higher by S&P, so Italian government debt could be at risk of falling out of global developed market bond indices with further rating downgrades. Moody's, meanwhile, put the nation's ratings on review for a downgrade.

A SLEW OF GEOPOLITICAL RISKS

PERSIAN GULF TENSIONS

PERSIAN GULF TENSIONS

Status: Moderate level of risk of sudden escalation given the ongoing jostling for regional domination using a brute force approach.

Background

The Middle East versus Qatar

In June 2017, a contingent of four countries in the Middle East, comprised of Saudi Arabia, United Arab Emirates (UAE), Egypt and Bahrain, decided to unanimously ostracise neighbouring Qatar. The contingent cut all land, sea and air links and required Qatari citizens living elsewhere in the Middle East to move home. The ongoing tension between these countries is the most significant since the Gulf Cooperation Council (GCC), which is comprised of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE and was established in 1981.

The predominant source of enmity towards Qatar is what its neighbours consider to be its rogue and activist foreign policy, including Qatar's alleged sponsorship of terrorism activities, its state-funded media outlet Al Jazeera and its softer stance on Iran. Saudi Arabia is arguably the loudest voice of the four countries that have isolated Qatar, and the Saudi Arabian government believes that by cutting Qatar off, Qatar will have to make serious concessions as they relate to the nation's foreign policy. Ultimately, most countries in the Middle East are posturing for regional dominance, and alliances are being formed to strengthen the likelihood of dominance.

However, this battle is proving harder than expected. Qatar is a relatively wealthy nation, with only 300,000 citizens and very profitable oil and natural gas reserves, and so far has been able to resist capitulation to Saudi-led demands. Nevertheless, this has caused the period of uncertainty and political games to continue without an end in sight.

Iran Has Few Friends

Iran has long been the black sheep of the Middle East as it is not part of the GCC, nor an ally of any of the predominant Middle Eastern countries. Saudi Arabia and Iran have been engaged in a long conflict concerning regional dominance, and the conflict is only exacerbated by religious differences. While both countries follow Islam, Saudi Arabia is largely Sunni Muslim while Iran is largely Shia Muslim.

Iran has also been a longstanding foe of the US. The tumultuous relationship between the two nations dates back to the Iranian Revolution of 1979, which included the Iranian hostage crisis involving 52 American citizens being held hostage in Tehran for several months. In 2002, President George W. Bush denounced Iran as part of an 'axis of evil' alongside Iraq and North Korea, a comment which enraged much of Iran. Since then, Iran's development of in-house nuclear capabilities has drawn a great deal of disdain from the American government.

The UN implemented several rounds of sanctions on Iran between 2006 and 2010 over the nuclear issue, and the US and EU also imposed sanctions on Iran, including sanctions on the financial sector in 2012. The sanctions were varied in nature, but largely they involved limiting or ceasing all trade with Iran. The sanctions crippled the Iranian economy because of their effect on Iran's ability to export oil. It has been estimated that the country lost more than US$160 billion in oil revenue between 2012 and 2016 on account of the sanctions.

In 2015, Iran agreed to a long-term deal with the P5+1 group of world powers (P5 is the UN Security Council's five permanent members: China, France, Russia, the UK and the US, and the +1 signifies Germany's inclusion in this deal), which involved Iran curbing its nuclear programme and allowing international inspectors to regularly investigate their nuclear programs in exchange for the lifting of the crippling economic sanctions. As a result of the deal, Iran was able to resume selling oil to international markets, access global financial markets for trade and access more than US$100 billion in assets frozen overseas.

Trump has been an overt opponent of the Iran nuclear deal, referring to it as 'the worst deal ever' on a few occasions (although he has been known to use this phrase very liberally). He pledged to exit the deal throughout his campaign and he followed through on his promise in May 2018. The US's withdrawal from the deal is considered a setback in the American-led effort to contain the development of nuclear weapons, and it also undoes a significant piece of legislation that President Obama championed. The withdrawal means that the US-imposed sanctions come back into effect, with one of the most significant implications being a reduction in Iran's production of oil.

Trump's withdrawal from the deal has several ramifications, with one of them being a continuation of political uncertainty in the Middle East. Trump's withdrawal aligns the US with Saudi Arabia, UAE and Israel, three nations that were strong proponents of the deal because the lifting of economic sanctions allowed Iran to grow its regional dominance. Furthermore, it could encourage Iran to restart its nuclear programme, and what it will do with its nuclear programme is not yet clear.

Market Impact

When the oil price collapsed in late 2015 and into early 2016, it was largely driven by supply-side factors. In the years leading up to the collapse, Iran's oil production had been severely suppressed by the international sanctions that the US and the UN had imposed dating back as far as 1979. The sanctions initially targeted investments in oil, gas and petroleum, among other industries. Lower levels of supply supported the oil price to remain higher. However, with the negotiation and signing of the Iran nuclear deal, most of the sanctions were officially lifted in January 2016, and Iran was able to sell its oil in international markets again.

Iran's return to the oil market was one of the contributors to the oil supply glut that caused prices to tumble. The oil price has increased since 2016, however it is nowhere near its greater than US$100 per barrel highs that were seen in 2014.

The price of a barrel of oil has been hovering between US$60-70 per barrel since the start of the year, supported by the curbs to production that OPEC implemented amid the oil price collapse in 2016. The resumption of the international sanctions on Iran means that Iran's ability to sell oil on the international markets will again be dramatically reduced, sending oil prices higher.

It is not just the international sanctions facing Iran that could send oil prices higher. Middle Eastern countries are among the world's largest oil exporters, so continued threats to regional stability could lead to supply disruptions.

Given the ongoing tensions, both verbal and physical, in the Middle East, it is not inconceivable to see a noted disruption to supply. Reduced supply will cause the price of oil to go up, which would have knock-on implications for global inflation given the global importance of oil. Inflationary pressures have already been building in many developed countries, and higher oil prices would add a bit of fuel to this slow burning fire.

Chart 2: Oil Price, US$ per Barrel, 2014 - 2018

Source: Bloomberg, Whitehelm Capital

A SLEW OF GEOPOLITICAL RISKS

AMERICAN MID-TERM ELECTIONS

AMERICAN MID-TERM ELECTIONS

Status: Emerging, could lead to more political uncertainty in the world's largest economy.

Background

The 2018 mid-term elections will mostly be held on 6 November 2018, which is the mid-point of President Donald Trump's first term in office. All 435 seats of the House of Representatives and 35 of the 100 seats in the Senate will be contested. Additionally, elections will be held for various governorships, as well as numerous other state and local elections. Currently, the Republican Party holds majorities in both houses.

Mid-term elections are often considered to be a performance check of the sitting president halfway through his first term. Of the 35 seats of the Senate that will be contested, 26 are currently held by Democrats, with 10 being in states that Trump won in the 2016 presidential election, five of which he won very convincingly.

This puts the Democratic Party on the defensive, as it wants to ensure that it retains these seats. If the Democratic Party is able to pull off a few wins of Senate seats that are currently held by Republicans, the Democratic Party could secure a small majority in the Senate. The current composition of the Senate is 51 Republicans, 47 Democrats and two independents.

As for the House of Representatives, this is a likely path for the Democratic Party to make some headway in chipping away at the Republican majority in Congress (which is the combination of the Senate and the House of Representatives). Opinion polls currently suggest that Democrats could carve out a small majority in the House of Representatives, although we know that opinion poll results do not always (or rarely) predict the actual outcome of elections.

Mid-term elections have often resulted in a swing away from the president's political party and this year is expected to be no different. The Democratic voter base is particularly energised given Trump's polarising nature, and the seats that are up for grabs present an opportunity for the Democrats to sweep up the necessary number of seats to swing the majority.

Market Impact

The Democrats winning a majority in Congress poses a serious threat to the Trump administration. Trump would suddenly be faced with the significant challenge of pushing legislation through Congress with a flip in the majority party, particularly issues related to the budget, immigration, trade and infrastructure. He has already had enough trouble passing through proposed policies, such as repealing Obamacare, despite having small majorities in both houses.

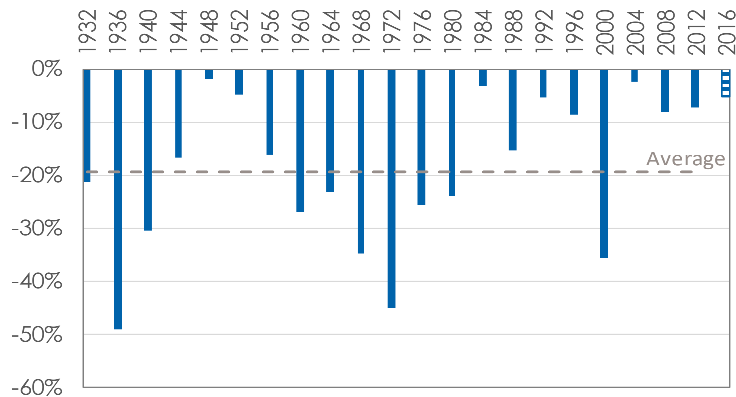
Furthermore, with a majority, the Democratic Party would be able to set up committees that could target the president directly. These committees could be tasked with pursuing investigations against the president, which could result in a renewed push for impeachment given that there is strong support amongst the Democratic base for impeachment charges to be laid against Trump.

Impeachment does not mean instant removal from office, rather it means that a motion will be put to the Senate, on which two thirds of the Senate needs to approve the motion for impeachment to take effect. Given that even if the Democrats do gain a majority in the Senate, it is expected to be by a slim margin, so there may not be enough support for this outcome to be considered likely.

The mid-term elections are likely to impact markets whichever way they shake out. Share markets in particular do not like uncertainty, and the mid-terms are dripping in it. Pre-election polls are the only available indicator of how the elections may shake out, and we know that these polls have not proven to be overly useful in the past few years.

In Chart 3, we show the difference between the maximum of the Dow Jones Industrial Average in the year following an election and the minimum in the year of the mid-term elections (two years after the election year). The average drop in the index is 19.4% from the high in one year to the low in the next. There are of course other factors at play in these examples than just the mid-term elections. For example, in the year of the 2002 mid-term elections, George W. Bush had implemented tariffs on steel imports, which caused share markets to sell off.

Chart 3: Difference in Dow Jones Index Between Maximum in Year Following Election and Minimum in Mid-Term Election Year



Source: Bloomberg, Whitehelm Advisers
Note: The year on the horizontal axis denotes the election year. The 2016 figure denotes the difference between the 2017 index high and the index low in 2018 year-to-date (as of 12 July).

Equity markets have already been much softer so far in 2018, as compared to the post-election euphoria that gripped markets in 2017. The Dow Jones index has risen by just 0.4%, after an astounding 24% return in 2017. We expect further share market weakness, and certainly volatility until well after the mid-term elections are over.

Conclusion

Geopolitical risk has always had a place in determining market conditions. When new risks emerge, investors typically worry about the likely implications and react accordingly. Unexpected outcomes in elections, physical conflict between countries and trade wars can all lead to investors preferring to make investment decisions that are considered safe. More often than not, this can trigger a flight to safety in which investors choose to divest from riskier investments, such as equities and high yield bonds, and move into cash, government debt and safe haven currencies.

So far, 2018 has proven to be a breeding ground for several different geopolitical risks. In the months following Trump's announcement of tariffs, there seemed to be a case to be made that the trade tensions could dissipate to be nothing more than just threats. Over the past month or so, the risk has very much re-emerged, with the world seemingly on the brink of trade wars. The China-US relationship appears to become more fractured with every passing day (and tweet), which is worrisome given their mutual goal of economic supremacy. It is not just about the US however. Political uncertainty in Europe continues to wreak havoc, as does the ongoing tension in the Middle East. We live in an unpredictable world, and financial markets have the difficult job of digesting and understanding what this means for them.

This feature article is a condensed version of a more in-depth article. If you are interested in accessing the longer-form version, contact Nicole McMillan at Nicole.McMillan@WhitehelmCapital.com.

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