The Investment Podcast

Episode 36: The Investment Podcast: The great global election cycle

23 February 2024

[music]

Speaker 1: *The Investment Podcast,* brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

Romil Patel: Hello, and welcome to *The Investment Podcast,* brought to you by M&G Investments. My name is Romil Patel and I'm delighted to be joined by an expert line-up for today's episode on the great global election cycle of 2024, as billions of people head to the polls in more than 50 countries. While some of these votes have already taken place across Indonesia, Bangladesh, and Taiwan to name a few, many more are yet to come, notably in the older democracies like the US and the UK, as well as India, the world's largest democracy.

Voting will also take place to elect members to the European Parliament, the world's only directly elected transnational assembly. On the mics today are:

- Anthony Balestrieri, Chief Investment Officer in the Americas;
- David Parsons, Head of the Fixed Income Investment Specialist Team;
- Maria Municchi, Multi-Asset Fund Manager; and
- Claudia Calich, Head of Emerging Markets Debt.

Welcome to you all. It's a huge pleasure to have you on *The Investment Podcast*.

David Parsons: Hello.

Maria Municchi: Hello.

David: Very glad to be here.

Anthony Balestrieri: Hi, how are you?

Romil: Very well, thanks. Which elections are you keeping an eye on and why? Maybe, David, I can come to you first.

David: Thank you. I think the obvious ones are going to be the two you alluded to in the older part of the world in terms of the democracies: the UK and the US elections. I think they will preoccupy certainly a lot of media time, a lot of speculation, and it's by no means clear-cut exactly what the result of the US elections will be, and I'm sure Tony will be able to comment a little more extensively on that. Taking the UK perspective, I think a change of government seems highly likely.

The government's policies seem to be somewhat in disarray at the moment, and the potential incoming administration will for sure make some changes. I think the difficulty is the extent to which financial considerations will restrict their ability to enact some of the changes they've previously suggested they were going to make around, for example, green spending, which we finance by borrowing, and their ability to deliver that over the course of the next parliament in the UK. I think the most likely outturn is they will have to scale back their ambitions, and that seems to be the direction of travel at the moment.

Overall, I think a lot of the countries where there are significant elections taking place are running significant deficits, and that in turn will constrain their ability to enact policy surprises. Nevertheless, I think in the US, the biggest wildcard is, of course, former President Trump, who's seeking to be president again. I think perhaps the bigger picture there around the impact that he would have on US foreign policy is something that we need to be considering as well.

It's not just the potential financial implications of changes of regime, but I think what it means for geopolitics as well. Tony, was there something that you perhaps felt was pertinent as well to the US presidential vote coming up?

Anthony: Yes, I think it's important to set the stage in terms of how close the election will be, and then even the election of both houses. If you look at the US, the House of Representatives, the Democrats would only need to pick up four seats to control the House – and all of those seats are up for election this year. The Republicans are defending 18 seats in Biden-won districts, and the Democrats are defending five seats. On the House side, just if you look at the odds, the potential for a Democratic pick-up in the House is a bit higher.

On the Senate side, the Republicans would only have to pick up two seats if Biden is re-elected, one seat if Trump is elected. There, Democrats are defending 23 seats, and Republicans are defending 10. Once again, on the Senate side, it tilts a little bit to the Republicans. Keep in mind, the margins on both houses are very, very tight; four and two. If you think of a split government and very small margins, it would make it very difficult for either party to push large legislative actions through. On the flip side, you have two candidates that are very unpopular with both of their underlying constituents.

Both Democrats and Republicans would prefer another candidate than the one they have. It looks like the US elections will shape up to be a very tight one. If you think about the 2016 election, Joe Biden won by 43,000 votes in the Electoral College – very, very tight. This election could be even closer than that. I think the ability for large-scale legislation to pass will be challenging, regardless of who wins. David, I think you're right, some of the more geopolitical issues where the candidates can use executive actions to affect some changes may be the bigger area to watch.

Maria: Very much agree with what David and Anthony highlighted. I think from an asset allocation perspective, what we're looking at very closely is obviously this outcome of [the] US election because of the influence that it'll have on fiscal policy at that level, monetary policy. We do know that the level of interest rates in the US really has a huge impact, not only on US assets, but really on a broad scale of assets across the globe. This will be something that I think assets allocators will be looking at very, very closely too.

Interestingly also in the UK, I'm very curious to see how things will evolve there because obviously, we've seen both the equity and bond markets suffer significantly in the past few years. Would the next government – whatever that will be or look like – be able to shake off this negative sentiment that is now really permeating UK assets given the circumstance that they will inherit, which is quite a complex economic situation that will come in the next terms?

Romil: How about you, Claudia, from an emerging markets perspective, what are you keeping an eye on?

Claudia Calich: Yes, I think it's interesting in emerging markets because one of the countries that was mentioned at the beginning was India. Sometimes when you have very large elections in terms of population, it doesn't necessarily mean that you're going to have a large investment opportunity. By that, I mean impact on asset prices. In fact, actually India, just because expectations that [the] BJP and the high popularity of [Prime Minister Narendra] Modi remains relatively high, that leads to potential status quo in terms of economic policies and so on.

From that perspective, we're actually not focusing as much as we are in a few other elections, where we could see then a change on economic policy or any other factors that could impact the economy or risk perception towards that country. I would highlight a couple that we're paying a little bit more attention [to]. One would be South Africa, where it is expected that the ANC is going to lose the majority in Parliament. Then the question begs: who do they build a coalition with?

That's going to have important implications, potentially on the fiscal side, if the coalition includes a party that may be a little bit more lax in terms of spending and so on, or not. We need to see, that one will be important. Mexico, again, there could be implications to the fiscal side of things, even though the front-running candidate, Claudia Sheinbaum, is very much ahead. Then finally, the other country that we may or may not have elections – and that's probably the one that would have the biggest amount of impact on asset prices – is Venezuela, which [Nicolás] Maduro has been obviously leading the country for many, many years.

Whether they will agree to elections that are deemed to be free and fair by international observers, that could easily have a 20%, 30% impact on prices – either positive impact or rally if that is the case or a negative impact, a major sell-off, if that does not happen.

Romil: Staying with the Americas, Tony, the economy is often top of mind for voters, and the US fared well last year, with inflation coming down faster than the UK and Europe. But for many voters, the bottom line is that the cost of living is a lot higher today than it was just a few years ago. How big an issue is this, and could it quickly become the issue in the US if we see a deceleration in the economy? From an investment perspective, which policies are investors watching most closely?

Anthony: I think it is the issue right now. If you take a survey of voters, that is the top issue for voters in the US: the state of the economy. While we as investors tend to look a lot at the rate of change, I think individuals that are actually sitting on the ground are looking at it at the actual level. If you take food, for example, it's 25% higher than it was pre-pandemic. If you look at rent, it's 20% higher. If you're renting an apartment or buying food, you're still feeling an impact.

If you look at real wages, they just turned positive in the second half of 2023. This is a problem in most Western democracies, where while there was wage growth, it lagged behind inflation for a number of years. Yes, the economy is the focus of most individuals, they are struggling to make ends meet. When you look at it at a high level, from an investment perspective, you look at inflation [which] has come down dramatically from the highs, which is certainly a positive. From an investment perspective, what I worry about is the fiscal stance.

The bad news there is that no matter which candidate wins, neither one has shown a lot of fiscal discipline. If you compare the Trump presidency to the Biden presidency, and look [at] who spent more, surprisingly, they spent about the same. The fiscal deficit has continued to deteriorate. If you look at interest expense as a percent of spending, and you look at the trajectory, CBO [Congressional Budget Office] estimates, interest expense will, by 2026, exceed what we spend on defense in the US, so I worry about crowding out, as the government has to borrow more and more, and that could be at the expense of corporate borrowing.

Once again, this is a problem I think affects all large Western economies. We've all overspent, we've all have large deficits, we didn't term out our debt, rates are higher and all of this debt will have to be refunded at a higher level, which I think puts pressure on the market broadly.

David: I think you're right there. The two big issues that people from outside the States looking in would think about are the debt servicing costs now, which I believe are at or approaching a trillion dollars a year but also the continuing propensity to borrow, to spend with no real sign of reining in that borrowing and any discipline being reattached to that. I think for the time being as the dollar remains the world's reserve currency, that can persist without causing any significant funding crisis for the US.

Over the very long-term, it's unhealthy. As we've seen with the example of many emerging market nations, you can only keep borrowing for so long before eventually the people are not willing to lend at anything like current market rates and want to build in a much more significant risk premium. I don't think the US is there yet but over the longer-term, there has to be some discipline reestablished to the level of borrowing in the States but it's hard to see how it's going to happen in the next five years under either candidate.

Romil: That's quite interesting because, in a certain sense, the US elections are both domestic and global in nature given what happens in Washington has global ramifications. Claudia, what are some of the top spillover effects of the US election results on emerging markets that investors will be keeping an eye on?

Claudia: Let me just speak on that earlier point on the fiscal. I think that is going to be very important because if on a long-term basis, the US curve is going to have to display higher levels of yield because investors would assign a higher, let's say, risk premia for US assets that clearly puts a floor on emerging market yields because a lot of countries and companies borrow in dollars so to the extent that is higher, that could be a very long-term negative impact.

Speaking a little bit more in the shorter-term in terms of the outcome of this particular election coming up, I would say it is mixed. For some countries, I think the impact is actually not going to be meaningful regardless of wins. I think Mexico, for example, we've seen the US-Mexico relations which is extremely important from a trade perspective, from migration and so on, from both a Trump presidency and Biden. Whether the US likes it or not, they need Mexico especially because the relations with China are very, very problematic to say the least.

I think from that perspective, the impact is not going to be as meaningful. The Trump administration did renew the Free Trade Agreement with Mexico, Canada and US back then so I think that is pretty much status quo for now. Relations with China, as I alluded to, I think they'll be problematic regardless of wins. I think the one that could potentially change, sadly for the worst, would be the relation or the foreign policy attention to some geopolitical pillars including Ukraine, the Russia-Ukraine war. I think from that perspective, there will be much less attention and funding.

We're already seeing quite a bit of problems passing funding for Ukraine currently in Congress. I think that would get potentially even more complicated if we were to see a Republican administration coming in.

Maria: I think the geopolitical consequences of some of those elections are very, very interesting also in the context of macroeconomic development, like inflation. How would inflation going forward be affected by some of those policies, some of this relationship between countries? How would this affect global trade? I think we've already seen a lot in the past few years on how quickly inflation can move so I think investors ought to look at these developments very, very closely and expect potentially some volatility which they will need to react to.

Romil: David, we're in an era where politics is more important to investors than ever before given the range of outcomes that can be produced. New governments can have a significant impact on financial markets, a near-immediate phenomenon that the UK witnessed with the Liz Truss administration, whose mini-budget had rather mega consequences. Given the sheer volume of this year's national elections around the world, to what extent have markets priced in the outcomes? Do you think that this could lead to mispricing opportunities?

David: I think that really is the crux, isn't it, of this incredible electoral cycle that we're seeing this year with almost half the world's population going to the polls, 7 out of the 10 most populous nations on the planet having general elections. I'm often reminded of a quote attributed to Niels Bohr, well-known Dane and Nobel laureate for physics, who is quoted as saying: "Prediction is very difficult, especially if it's about the future."

If you put that in the context of where we are today, with all of these elections, I think from an investment perspective, we've seen with the UK, for example, how markets can take badly to an ill thought through policy, something unexpected. It's not always the result of the election, it's what they do next, that can often be the trigger point. I think it is, I would suggest, difficult to position speculatively ahead of a lot of these elections.

Rather, I would say that from an investment perspective and learning from the Liz Truss experience as well, I think it illustrates perfectly the need to be in a position to respond to what happens rather than necessarily to predict, falling back on my Niels Bohr quote again. From a perspective of an investor, being able to be flexible, being able to move quickly to take advantage of opportunities that may arise as a consequence of many of these elections. Don't forget, the elections will have overlapping implications between countries as well.

Incredibly difficult to sit as an investor and try and make sense of it all ahead of time. I do think the response function is key to maintain in portfolios: liquidity, the flexibility to be able to move to take advantage of what occurs, rather than try to ahead of time, anticipate everything that could happen. I don't know whether perhaps you have anything further to add.

Maria: Yes, I think, picking up on your point – surprises really can come at any time, not just during elections. I think the Truss-Kwarteng mini-budget event has been particularly interesting. The way markets reacted in that phase, with UK gilts really shooting up more than 100 basis points in just a matter of days. It was an exceptional reaction to a piece of information that was released by the government.

I think in that situation, for example for us, it has been very interesting to note how this huge volatility was in a way inconsistent with the fundamentals at that time, but also mainly detected by the short-term focus on this key political event. As an example, this has been a great opportunity for multi-asset portfolios to move tactically around this event, adding exposure to the gilt markets, and then actually reducing this exposure very quickly after the yields reverted, again, in a matter of days really, to much lower levels and providing a very profitable trade for our funds. I absolutely agree that opportunity exists, not only around elections, but on an ongoing basis.

Claudia: David, I couldn't help with that quote I was chuckling a little bit because I remember hearing a quote from a former Brazilian finance minister, Pedro Malan, he said at one point: "In Brazil, even the past is uncertain".

Basically he was referring to a series of pension payments that happened many, many years before. Essentially, people thought maybe those payments were not big enough and they went to court and suddenly, they won that court battle. That basically presented and introduced a huge amount of contingent liabilities to the government, so anything is possible in emerging markets. Not only do we have to forecast the future, we have to try to forecast the past as well!

Romil: Turning our attention to a key global issue, Maria, in order to limit global warming to no more than 1.5 degrees Celsius, as called for in The Paris Agreement, emissions need to be reduced by 45% by 2030 and reach net zero by 2050. The next six years is quite a crucial window of opportunity to determining whether we live within planetary boundaries. We've also seen the climate being a political football. The US was originally a signatory to The Paris Agreement before pulling out and then rejoining. How much of an issue is this to investors? Is there a concern around the US leaving once again, if Trump wins the White House? In essence, where could we see global climate leadership coming from?

Maria: I think there's definitely a huge focus on what the next administration in the US will bring in terms of climate regulation. If we start with the good news, what we've observed in 2023 is that actually renewable energy capacity has grown very significantly – 50% more compared to 2022's growth. Actually, in this environment, China played a very, very central role. In fact, their installation of solar PV [photovoltaic] in 2023 increased by more than 100% compared to the previous year.

If we look at the current trajectory for renewable energy capacity growth, the International Energy Agency expectations are for continued growth that will lead to levels that should not be too far from the target that COP28 renewed just last year of increasing by three times the current capacity for renewable energy. However, we're still not there. Obviously, we need in the next few years to work in this direction. Also, there are areas where there is a potential need for improvement. In particular, policy. Policy remains absolutely crucial.

It's justified the type of focus that markets are having today in, what the next governments will be, and what they will do. The permits are a very important area as well. At the moment, it takes quite long to receive those permits. Slimming down on these practices will be very important. The grid infrastructure is another element that needs to be really upgraded. Again, governments will play a very important role in that. Then finally, financing to developing countries to continue to boost the growth in renewable energy capacity. We are on a trajectory, this growth hasn't stopped, it's continued to accelerate, but we do know that to achieve the targets by 2030, there will need to continue to be a lot of work being done.

There are two [technologies], in particular that will be key in achieving this. Those are clearly solar and wind power, given that the current economic terms, which are very favorable compared to other energy sources. This doesn't mask the fact that, sustainable investing has had some very tough times in the past couple of years.

There has been some important headwinds, starting from the high interest rates to challenges from a supply chain perspective that led to higher costs, for example, on the wind power side of things, but also higher inventories within solar. Valuations were very elevated after the 2021 rally. The starting point was also very, very challenging. I think today, we're starting to see better opportunities in this space. Yes, there is potential volatility that could still come, especially from the expectation of who is going to lead the US in the next term.

Some of it is potentially already priced in. We're seeing, for example, some of the reaction to earning news on some of the names that we invested in that suggests that there is quite a lot of bad news already discounted by these names. There is potential for further opportunities and volatility as we make our way towards the actual election later this year.

Romil: Just circling back to the point that you made around the trajectory, Maria, it was reported that the UK is the first major economy to halve its emissions, having cut them by 50% between 1990 and 2022, whilst also growing the economy. How much of an opportunity is there for the UK to take leadership in this area?

Maria: I think the UK has done some huge progresses, as many Western economies have actually done. I think the issue around climate change, [is that] it's really global. This is why both COP28 and the International Energy Agency are very, very keen on the need to continue financing for developing countries to make those changes as well. I think taking the leadership is important, but it can't be one country alone. It has to really be a global effort, and this is why it's so difficult, this is why every time COP28 feels like a little bit of a defeat, a little bit of a win. It's a long process.

Romil: Finally, before we go, what are you most excited about? Where do the best opportunities from an investment perspective? Claudia, perhaps I can come to you first.

Claudia: Yes, so basically, we find still quite a bit of value on the high yield portion of the emerging market at both sovereigns, but also corporates, and also local markets, both currency and/or selectivity rates, pockets of Latin America, and so on. The area that we find expensive and we're underweight is really the Investment Grade segment.

Maria: I think in the context of the political agendas and geopolitics, there is an expectation that we might see ongoing volatility this year ahead of these election results. We cannot position and we should not try to position ourselves for a specific outcome. Also, because we cannot really know even if one candidate or the other wins, how would the market actually respond? I think the latest Trump victory was interesting in this regard, where markets reacted in a way that maybe many investors found surprising.

What we know is that, this uncertainty around the outcome of the election and the anticipation of it tends to create misallocation of capital. We should be very watchful of this and trying to take advantage of some of the opportunities that might come along the way this year.

David: Picking up on those points, I would completely agree. I think it would be probably a little bit of a stretch to be positioning yourself ahead of a lot of these major events. Being able to respond to them is very important. The idea that we can always predict the outturn and the market response [is questionable]: I think you can use the 2016 Brexit referendum as an example – had you, coming into that, had perfect knowledge and foresight that the result was going to be to vote to leave the EU and positioned yourself as one would anticipate things would turn out, your market position would have been completely wrong, even though you knew the result in advance.

One has to be in a position that you can try to respond to these events and not try to always feel that you can anticipate. Even if you anticipate correctly, you may well find that your market positioning isn't as you would need it to be to benefit from that insight. Flexibility, being able to take advantage of opportunities as they arise is going to be, I think, a key success factor.

All I would say is that from a bond perspective, certainly, the global rate cycle seems aligned towards lower rates over the course of this year. As a bond investor, I think it could be a very interesting and potentially positive year for the markets. The electoral uncertainties, I think, will challenge us as ever.

Anthony: Yes, I agree. I think it's a safe bet that as you move into an election cycle in the US, there will be plenty of bouts of volatility as we approach the actual election. I think you have to let valuations be your guide. I do agree with David that we're probably near the end of the rate cycle. Selfishly, as a fixed-income investor, we're looking at levels that we haven't seen in over a decade. The asset class, to my mind, looks attractive. That being said, if you look at the underlying components on the spread side, those levels are less compelling.

There may be an opportunity later in the year to re-engage in some of those areas with the inherent volatility we'll see from the elections.

Romil: Unfortunately, that's all we have time for on today's episode of *The Investment Podcast*. Anthony, Claudia, Maria, David, it's been a real pleasure to sit down and discuss all of this with you for what is a seismic year both for the public and investors alike. Thanks indeed to you all for sharing your insights.

Maria: Thank you.

David: Thank you very much.

Claudia: Thank you.

Anthony: Thank you.

Romil: Thanks to you, our audience, as ever for tuning in. We look forward to seeing you next time, but it's goodbye for now.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will because prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

[00:27:24][END OF AUDIO]