DO POLITICS MATTER?

Gerald Smith, Investment Manager. Third Quarter 2018

BAILLIE GIFFORD

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Cover Image: The results of the US Presidential elections at Westminster, London.

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DO POLITICS MATTER?

It matters a lot to politicians and to journalists, but how much does politics matter to economy as a whole, and to what happens in financial markets in particular?

This may seem a daft question. Surely the markets are moved by the breaking news of major events, and what could be more significant than the election of Donald Trump, the Brexit referendum or Angela Merkel's struggle to hold onto power, to name but three political surprises of recent years?

In *Forecast: What Physics, Meteorology and the Natural Sciences can teach us about Economics,* Mark Buchanan references studies of large price movements that have attempted to link the movements to significant pieces of news or other identifiable external triggers. The studies showed that, in the case of the majority of large price movements, there is nothing of this sort to which they can be attributed[1]. Most big moves just happen without anything external to cause them and once these have been eliminated from enquiries we have to conclude that the cause lies within the financial markets themselves. It's a bit like the way traffic suddenly slows down and then suddenly speeds up again on a multi-lane road without there being an obvious reason such as a lane closure. We may resort to talking about events that make the news (and this includes headline-grabbing political events) in an attempt to explain market movements but on critical examination this turns out to be about as soundly based as explaining thunder by saying that the gods are angry.

If markets largely do their own thing in the short term with little or no regard to headlines, whether these are political stories or not, it still seems hard to believe that the decisions that politicians take are completely irrelevant. This would amount to saying that wars, taxes and government spending decisions don't have any consequences for investors. Some things do matter, but even some of these apparently big decisions probably matter rather less than we are inclined to think.

Former British Prime Minister Margaret Thatcher famously said "there is no such thing as society – there are individual men and women and there are families". She might equally have said that there is no such thing as 'the economy'. There are individuals who are consumers and workers and organisations, such as companies and government agencies, who interact with each other in numerous ways. What we like to call 'the economy' is the outcome of complicated interactions involving individuals, firms and other actors. These economic actors are not like billiard balls bouncing off each other governed by the immutable laws of physics, instead they learn and adapt their behaviour based on previous interactions and on the information available to them at the time. Because of this, it is now common to hear the economy described as a 'complex adaptive system'.

1. For example David Culter, James M. Poterba and Lawrence H. Summers, "What Moves Stock Prices?" *Journal of Portfolio Management* (Spring 1989) and Ray Fair, "Events That Shook the Market", *Journal of Business* 75 no. 4 (October 2002). Both are quoted in Mark Buchanan, Forecast: *What Physics, Meterology and the Natural Sciences Can Teach US About Economics,* Bloomsbury 2013.

Former British Prime Minister Margaret Thatcher, 1989.
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LESSONS FROM NATURE

Other examples of complex adaptive systems can be found in the natural world and many of the techniques that are now being applied in an effort to understand how economies work are derived from the study of natural eco-systems. The ability of complex adaptive systems to adjust and evolve has both good and bad sides. For example, life on Earth was not extinguished by the meteorite impact that is widely believed to have resulted in the extinction of the dinosaurs but this same adaptability makes it hard to eliminate diseases. When we turn to the domains of economics and financial markets we can observe something similar happening. The economy has a tendency to fight back like the jungle reclaiming the cities of the Maya. Individuals and organisations change their behaviour in response to changes in legislation, taxation and regulation and the consequences are frequently not what those making the changes anticipated. Margaret Thatcher also said, "you can't buck the markets" and this is one reason why.

This does not mean that today's politicians are no more able to change the course of events than Canute with the water lapping around his ankles in the eleventh century. Despite everything said up to now, there is evidence from history that sometimes political choices matter a lot, even if the consequences are often very different to those intended by the politicians who made them. The behaviour of complex systems is, as the name suggests, complicated, but they can be tripped from oscillating around one set of values to another, sometimes by relatively minor shocks. I think this is a helpful framework in which to think about how political decisions taken today may affect returns from financial assets on timescales that are relevant to long-term investors.

Panoramic view of rainforest and top of mayan temples at Tikal National Park, Guatemala.

A view of Amsterdam by Charles Euphrasie Kuwasseg.
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UNINTENDED CONSEQUENCES

To find examples of decisions that turned out to have long-lasting consequences we naturally have to go reasonably far back in history in order to be sure that the effects were indeed long lasting rather than transient. One such is example is provided by the change in the relative importance of Amsterdam and London as centres for trade and finance. Prior to the Revolutionary and Napoleonic Wars of the late eighteenth and early nineteenth centuries Amsterdam was the dominant centre for both in Europe. London's financial markets had benefited from an infusion of Dutch capital and expertise following the Glorious Revolution in 1688, but London remained of secondary importance when compared to the longer-established trade and financial hub in Amsterdam. This was changed by Napoleon's decision to close the markets of his conquered European territories to trade with the outside world. This forced all such activity offshore to London. He was defeated not long after and trade between continental Europe and the rest of the world, including the United Kingdom, quickly resumed, but ever since then London instead of Amsterdam has been the main centre for international trade and finance in Europe[2].

2. David Cannadine *Victorious Century, Penguin History of Britain volume VIII*, 2017, p.121. It will be interesting to see whether Brexit will cause a similar shift back in favour of a continental financial centre, but unless a single clear winner emerges among the competing the European cities it is going to be difficult to replicate the powerful network effects that support the position of London as the main global financial centre in the European time zones.

HEADLINES DON'T MATTER

The challenge that faces us as investors in bringing political considerations into our analysis is two-fold. One is working out what is actually likely to make any difference and the other is working out what that difference is, bearing in mind that the intentions behind political decisions are a frequently a poor guide to outcomes. A good rule of thumb is that almost everything that makes the headlines will turn out to be irrelevant, but assuming that everything that occurs in the political domain can be safely ignored is also unwise. As the Nobel Prize winning economist Joseph Stiglitz put it, "economics and politics cannot be separated – as much as some economists would like them to be".

Some academics, including Daron Acemoglu and James Robinson in *Why Nations Fail: The Origins of Power Prosperity and Poverty,* have advanced arguments that link the political institutions of a country with its economic success. It is not necessary to fully embrace these theories to recognise that governments that have to rely on either a majority or a sizable minority of their people for support are more likely to adopt policies that are aimed at improving the lot of the many rather than those that favour a small number of key supporters at the expense of the commonweal. That said, democratically-elected politicians can still make economically-damaging policy choices for rational political reasons, so one can push these arguments too far, but an analysis of the institutional framework of a country and the constraints imposed on policymakers by domestic and international politics form an important part of any investment research.

The tension between economic logic and political possibility is at the heart of European debate and even some of those who regard themselves as enthusiastic supporters of the European project are concerned about its future as a result.

DELVING DEEPER

Maybe it always feels like this at the time but, at the moment, it feels like we are approaching what could be a number of potential tipping points all at once. China now has a President for life and we have a US President who is determined to fight and win a trade war. In Europe there are serious challenges to the framework put in place by the Maastricht Treaty of 1992 with the rise of Eurosceptic and populist parties; and Brexit is only adding to these tensions.

Former US Treasury Secretaries Henry Paulson and Timothy Geithner, and former Federal Reserve Chair Ben Bernanke, spoke in the run up to the tenth anniversary of the 2008 financial crisis. They contrasted the speed with which they were able to craft the US response with that of their slower-moving European counterparts struggling to iron out a European-wide response. This was not a one-off. The US Federal Reserve also moved much more rapidly to implement quantitative easing than the European Central Bank (ECB). It is the more fragmented nature of the Eurozone political system that makes dealing with financial crises more difficult.

Talk of the institutional weakness of the European Union is at least as old as the European Union itself, however, it has proved to be not only complex but also adaptive enough to re-order its institutional arrangements in order to ensure its survival. The ECB under the leadership of Mario Draghi has been particularly innovative, but progress on creating a banking union across the Eurozone has been slow.

There is now a European Single Resolution Board in charge of a European Single Resolution Mechanism backed up by a Single Resolution Fund; but the fund is not very big and growing relatively slowly while the rules governing when the Single Resolution Mechanism rather than national government rules should be applied seem subject to alternative interpretations. Based on current plans it will be many years before the burden of bailing out failing banks will be fully lifted from national governments.

Efforts to centralise control of the financial system and create an effective framework for fiscal transfers within the Eurozone face a serious headwind from the simultaneous rise of nationalist parties, such as the Alliance for Germany. This puts pressure on even the most Europhile European political leaders to push back against these efforts for domestic political reasons. The tension between economic logic and political possibility is at the heart of European debate and even some of those who regard themselves as enthusiastic supporters of the European project are concerned about its future as a result.

There is nothing inevitable about the outcome being ‘more Europe’. The proportion of the population who have direct experience of the Europe of warring nations that provided the impetus for the move to ‘ever closer union’ is falling. As a result there may be what we might call a ‘British Rail’ effect whereby discontent with a current unsatisfactory state of affairs leads to demands for an alternative that few with experience of it in the past would want to see again. The European Union may therefore have to adapt in the direction of giving greater autonomy to its constituent nations in order to survive.

IN THE LIMELIGHT

The United States has a long-established institutional framework and separation of powers between the President, Congress and the Supreme Court meant to constrain the President of the United States from acting unilaterally. It does not, however, make the country immune from the same political backlash against globalisation and the domestic political establishment that we see in both continental Europe and the United Kingdom and so there are votes in being the 'Disrupter in Chief'.

Donald Trump seems to have embraced Facebook founder Mark Zuckerberg's approach of 'move fast and break things' and is applying it to the business of government; in the process testing to their limits the constraints devised by the architects of constitution. It is, however, wrong to cast him as an unpredictable force. He is clearly intent on doing what he said he would do as President when on the campaign trail, whether that is moving the United States Embassy in Israel to Jerusalem or putting tariffs on Chinese imports. We know what he wants to achieve, even if we may debate whether that is either desirable or achievable. Our challenge is working out the consequences of his efforts to achieve it.

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Donald Trump speaking at a fund-raising luncheon in October, 2016.
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POLITICS MATTER

As my colleague Sally Greig noted in her recent paper *From Brexit to Brazil,* “The past few years have not been the UK’s finest, especially when it comes to politics.” Through that time, the now ex-Foreign Secretary Boris Johnson has been the headline writer’s dream, even arranging a photo shoot of himself signing his own resignation letter. The folly of trying to extrapolate what matters for the long term from a single news story or event is apparent even in his House of Commons resignation speech. Johnson referenced Prime Minister May’s 2017 Lancaster House speech in which she laid out her Brexit plan, claiming that the pound had “soared” following it: a journalist from the Press Association was quick to point out that any jump was short-lived, less than a day in fact. And for all the talk of political crisis in the immediate aftermath of his resignation, little appears to have altered. Boris Johnson continues to garner headlines from the back benches, and a very soft form of Brexit remains the most likely outcome of the political upheavals, just as it was prior to his exit stage left.

These are just a few examples of the importance of incorporating political analysis into the decisions we make about whether we are being over or under compensated for the risks attached to a particular investment. The headlines are symptoms of the forces that can move markets rather than the things that move markets themselves. We believe that focusing on the underlying forces that trigger the headlines is much more useful than the headlines themselves as these are mainly noise.

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