GLOBAL PERSPECTIVE

From 2016 to 2017: a quantum leap?

Not surprisingly, the rise of populism in some of the world's most important economies has led to a lot of talk about a "return to the 1930s," particularly after the UK opted to leave the European Union and Donald Trump ascended to the Presidency of the US in 2016.

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We propose a return to the 1920s, however, not to draw analogies, but to draw inspiration from two concepts established during that decade: economist Frank Knight's differentiation of uncertainty and risk from 1921; and physicist Werner Heisenberg's Uncertainty Principle from 1927.

With mainstream thinking wrong-footed during 2016, often informed by what turned out to be "blind" polls, it feels as though uncertainty has made a big comeback and is here to stay. But the ideas of these two key thinkers on uncertainty might suggest a different conclusion – one directly relevant to investment strategy as we move from 2016 into 2017.

Particles and waves, uncertainties and risks

Heisenberg's Uncertainty Principle arises from the fact that, at the quantum level, matter exhibits the properties of both a particle and a wave. It says that if the position of a particle of matter is known precisely, there must be fundamental uncertainty about its momentum (and vice versa). One might say that the more precisely you think you know where you are going, the less precisely you know how fast you will get there.

Knight's insight was to draw out the distinction between what we call "uncertainty" (something whose probability is impossible to measure or quantify) and what we call "risk" (something whose probability we can measure or quantify). Imagine a bag that has 50 red balls and 50 non-red balls that may be all white or all black. If you are about to pick one, you can calculate the risk of picking a non-red ball (one-in-two), but the colour of that non-red ball is an uncertainty. Once you pick a non-red ball, of course, the uncertainty disappears and you are left with pure risk.

Yoke the two concepts together and we can see that uncertainty is not only different from risk, but to some extent its opposite. Remove uncertainty about the position of a particle of matter, and the risk around its momentum gets higher.

Risk "Trumps" uncertainty

Armed with that insight, let's come back up-to-date.

We saw this idea playing out in markets last year. Once they got over their worries about China going off the rails in the early part of 2016, the next six months were an oasis of relative calm. On the face of it this seems odd, given the political noise that erupted with the "Brexit" referendum and the gathering head of steam from the Trump campaign. With uncertainty engulfing decades-old economic and political orthodoxies, how could market-based risk measures be so low?

Heisenberg and Knight wouldn't have been surprised. Risk was low precisely because uncertainty was so high. When investors feel unable to form strong views because of uncertainty they position portfolios neutrally, and neutrally-positioned portfolios do not need to be radically changed until new information comes along to remove the uncertainty – the non-red ball coming out of the bag.

Trump's election was the non-red ball. From uncertainty about whether we would get more of the same in 2017, or a radical change in fiscal, trade and immigration policy in the world's leading economy, we moved to at least some certainty. And the markets moved: the S&P 500 Index soared to a record high; bond yields, which had started to edge up in July, continued their surge - by the end of the year the US 10-year rate had climbed by 108 basis points to end the year at 2.44%.[1]

With the election result in, the market has very quickly adopted a certainty: a fiscal stimulus is going to take over from eight years of unorthodox monetary stimulus, and it's going to be a "bazooka."

Other things have increased markets' certainty: Trump spoke a lot about changing fiscal, trade and immigration policies during the campaign; since the election he has barely mentioned immigration. That tells us something about his priorities, and markets have rightly picked up on it.

Some appointments have clarified things, too: Rex Tillerson as Secretary of State may be controversial for his links with Russia, but his attitude to globalisation and trade looks mainstream, pro-business Republican. A similar conclusion can be drawn from Trump's appointments to the Treasury, the Council of Economic Advisors and the SEC, for example.

Risks posed by fiscal foot-dragging, a US-China "trade tantrum"…

But now some certainty has been established, we are left with risk. And remember, the more certain markets become, the more risky things get. When things are "priced for perfection" against a view of some certainty, new information really can jog investors into sudden re-positioning, and that pushes volatility up.

So what are the risks?

On the fiscal side, Trump's programme for tax cuts, infrastructure spending and regulatory roll-back would almost certainly be stimulative, in aggregate. Moreover, we agree that the likelihood of some of this being realised is high.[2] The downside risk is that a lot of it proves difficult to get through Congress, or it simply takes longer than expected. None of this will be seen in 2017, so market positioning around fiscal policy this year will be all about expectations – which can change abruptly if the reality fails to live up to them. For bond markets, this could feed into disappointments from core inflation data, even as the headline number is pushed up by the oil price.

The upside risk, of course, is that Congress proves more amenable to the "Make America Great Again" mantra. With his deal-making hat on, one could imagine Trump using his high level of discretion over trade and immigration as a bargaining chip to get what he wants on fiscal policy.

On the trade side, there have been mixed signals. Trump's Commerce Secretary, Wilbur Ross, is pro-China, but he has also criticised what he describes as "dumb trade deals" and favours bilateral over regional agreements. Robert Lighthizer as Trade Secretary, by contrast, has been a fierce critic of China's trading practices for many years, not to mention the WTO, and comes with a track record of fighting back Japanese imports during the Reagan era.

On balance, there is clearly a more aggressive stance towards China and that raises the risk of a "global trade tantrum" from the world's two largest economies. If the aggressive tone persists in the first months of the new administration we can expect increased volatility around the otherwise bullish market positioning; if it dampens down a little the reassurance could push risk markets to even higher valuations.

[1] Source: US Department of the Treasury.
[2] See "Trump Testing" Our View of the World (November 2016).

… and Europe's populists

Have we made the same shift from uncertainty to risk in Europe? In some ways we have. Although the form that Brexit takes is subject to very high risk, it seems certain to happen at some stage. On the other hand, some might object that the populism story has a chapter or two to go on this side of the Atlantic. The Partij voor de Vrijheid (PVV) looks set to perform well in elections in The Netherlands in March, Marine Le Pen of the Front National will probably make the second round of voting in France's Presidential election in April, and Angela Merkel and the Unionsparteien (CDU/CSU) face a threat from the likes of Alternative für Deutschland (AfD).

However, it is important to note that binary, first-past-the-post outcomes such as Brexit or President Trump (the sort that carry great uncertainty) are much less likely in Europe's closer to proportional representation-based political systems. After Brexit and the Italian constitutional referendum in 2016, we think European politics now faces something more like "pure" risk. Rather than the uncertainty about whether populist parties can gain outright power, we face the risk that they influence the positioning of mainstream parties, or secure more seats in legislative assemblies.[3]

Higher volatility would reinforce our core investment views

We face a quantum leap, then, as we move from 2016 into 2017: from a world of high uncertainty to a world of higher risk and, consequently, more volatility. And yet we do not anticipate a quantum leap in our investment views. If anything, this regime shift reinforces many of them. For some time our key view in fixed income markets has been that liquidity is badly fractured, and duration no longer delivers its traditional benefits of stable returns, decent yield, and diversification against riskier assets. Our recommendation has been to trade less, buy-and-hold fundamental high-quality assets, and seek yield in a little more credit risk rather than a lot more interest-rate risk.

Should Trump's administration achieve the regulatory roll-back he has promised, investment banks may well return as important liquidity providers. However, that's a big "if" and an even bigger "when." The current situation will be with us for some years. Enforcement of Basel III and discussions for Basel IV could even make liquidity tighter, as it keeps banks' market-making capacity under stress.

Yields are clearly higher now than they were six months ago, but they remain historically low – especially outside the US. Even on the US curve, the move up to our new equilibrium leaves us with potential volatility as the risks around trade and the shape of fiscal policy rise: we believe the 10-year yield could easily consolidate at 3% or more, or head back to 2.2% on disappointment with policy or core inflation. Given that type of volatility, we still believe there is better compensation on offer from credit markets. Turning to US dollar dynamics, the outlook remains closely linked with changes in interest rate spreads, which will be driven by future growth and inflation developments, as well as the importance the Federal Reserve places on dollar strength.

In risk assets, this time last year we adopted a more positive view on emerging markets. Fundamentals continue to improve, but we acknowledge the need to monitor the US-China relationship and the general risks to trade and globalisation that come with the Trump administration. We tempered our optimism with caution in the last quarter of 2016, and see no reason to change that view, as yet: we continue to focus on underlying differentiation, based on fundamentals, within these markets.

To conclude, then, 2016 felt like a regime-change: from bond bull market to bond bear market, perhaps; from monetary to fiscal stimulus, probably; from low growth to higher growth, hopefully; from consensus politics to populist politics, certainly. Periods of transition such as these tend to lead to pronouncements about the arrival "a new age of uncertainty."

But, as Knight reminds us, uncertainty and risk are different concepts. As soon as the non-red ball comes out of the bag, uncertainty is over – we know the new parameters, and we are left with risk. For investors, 2016 was an age of uncertainty, for sure. But 2017 could well be a new age of risk. It might surprise many by being both more certain in politics and more volatile in markets.

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