Regime Change and The Risk-on/Risk-off Trade

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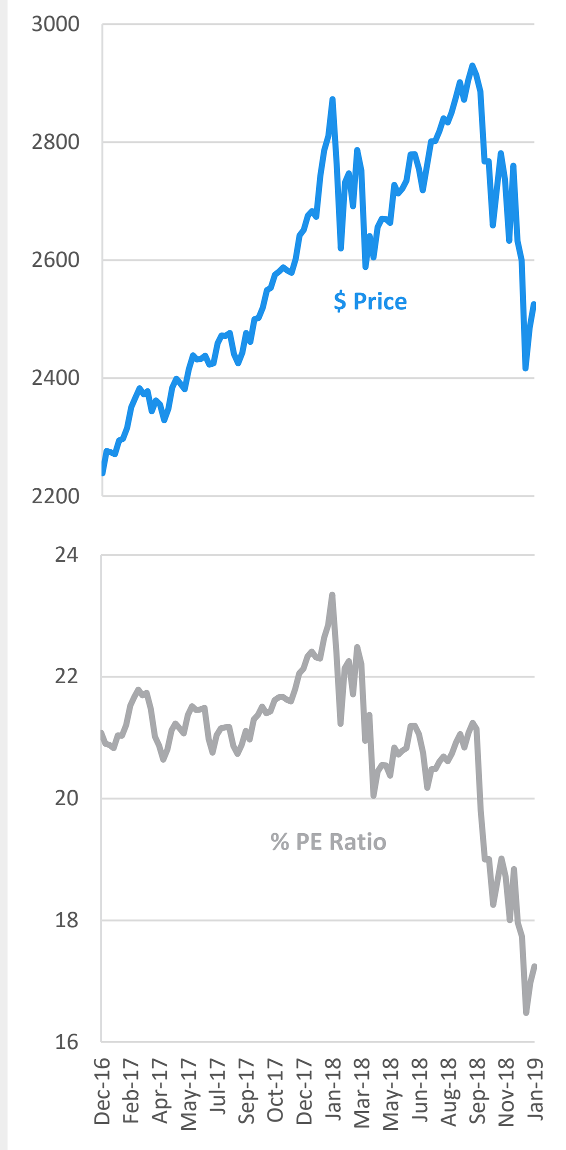
Relationships around the world are in flux. Risk markets are experiencing a heightened degree of uncertainty, and as a result, volatility. Concerns about economic growth and Fed policy are rising, as are fears about political risk in the US and abroad. These fears are legitimate. Challenges to democracy, and the rise of authoritarianism are challenges to the free flow of information, market efficiency, and the proper functioning of capital markets. When the rule of law breaks down, all institutions, including markets, are inevitably challenged. More political risk demands a higher risk premium – perhaps that is the message of markets in 2018. Investors are demanding cheaper valuations to compensate for rising political, geopolitical, and economic risks.

These rising risks, which we believe both create opportunities and underscore the need for greater diversification in portfolios, are occurring at an important inflection point in history. Harsh U.S. domestic politics, rising isolationism in the US, and challenges to a free trade economic order are all real threats to the multilateral economic and political order that the US built after World War Two. Rising authoritarianism abroad only increases the probability of destabilization whose sources are both political and military. If traditional democracy seems under threat around the world, there is a silver lining. New trends toward democratic capitalism are emerging that increasingly impact capital flows, how corporations are governed, and how companies interact with the people they serve. In short, investors may be riding to the rescue at a time when the world needs healing the most.

Risk Markets Experienced Heightened Volatility



Source: Bloomberg, S&P 500 as of 1/4/2019.

Across the world, investors are demanding greater voice and accountability through the ESG movement, proxy process, and the call to engage that has been sounded by the United Nations Principals of Responsible Investing (PRI). The PRI movement is gaining momentum and new institutions, organized by investors, are accelerating this movement. The Sustainability Accounting Standards Board (SASB) was founded just in 2011 and its efforts to promote disclosure standards on issues relating to governance, environmental impact, sustainability and social impact have gained the support of major pension funds and endowments around the world. These groups are now lobbying the U.S. Securities and Exchange Commission (SEC) to mandate standardized disclosures in these areas so that investors can change the world through their investments. **Is it possible that US support for a multilateral world order built on free trade, democracy, pro-growth regulation, are bolstered by new trends in investor democracy that drive positive change through capital flows?** Let's take a look at key regime changes that are both traditional and non-traditional in this bulletin.

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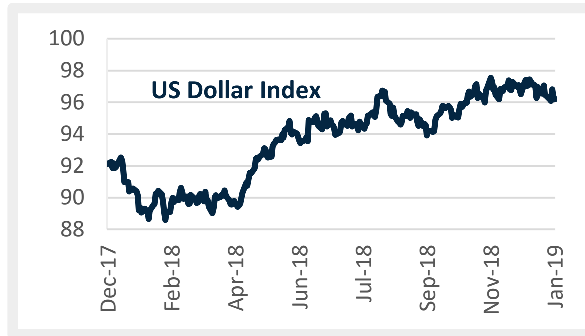
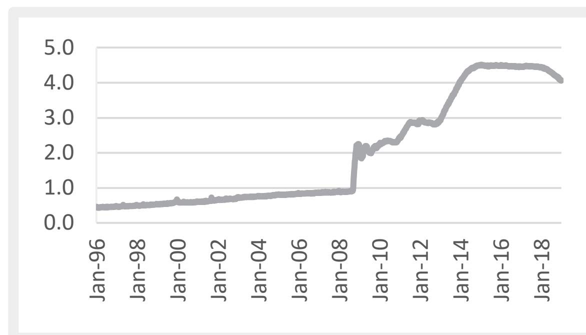
- For the past several years a strong US dollar has been a major investment theme. That is likely about to end as the Fed rate hike cycle decelerates, if not actually pauses. Foreign capital is attracted to the US dollar when US rates are higher than other markets, and when the spread between US rates and foreign rates is likely to expand. Not only is the US Dollar Index at a multi-year peak, but it has actually begun to roll over. The same is also true of the relationship between US rates and foreign rates. They have peaked and are now likely to contract. This is what we typically see at turning points in dollar bull and bear cycles. Importantly, a weaker dollar typically supports better exports, higher inflation, and rising commodity prices. These outcomes may seem unlikely given the dark clouds of December with risk markets under pressure, but the longer view supports the probability that we are approaching a trend reversal for the dollar and commodity prices.
- The Fed has just begun to reduce its balance sheet and as the charts on the right show, this is a major regime change in monetary policy. This shift in direction from Quantitative Easing and expanding the balance sheet to Quantitative Contraction and reducing the balance sheet has never before been accomplished in financial history. The uncertain outcome of balance sheet contraction is an important reason why the Fed will likely alter the course of its interest rate policy in 2019. The Fed has been rising rates and contracting its balance sheet. This has been too contractionary.
- Though we have seen the yield curve get flatter in the past few years, we are also likely close to a reversal of the flattening trend. As the Fed decelerates its rate hike plans, the curve will naturally steepen. This will be positive for credit, and the recent widening in credit spreads will likely be viewed later in 2019 as a good buying opportunity. While a steeper yield curve seems unlikely given the market response to the December Fed rate hike, the continued drop in inflation expectations as measured by the TIPS market highlights that if the Fed wants to achieve price stability and inflation securely above 2%, it is unlikely to raise rates meaningfully in 2019. We expect 2019 will prove to be a year to opportunistically add to credit exposures as spreads widen and likely peak. We believe this is a good time to develop approaches to add credit (both investment grade, high yield, and private lending) to portfolios.

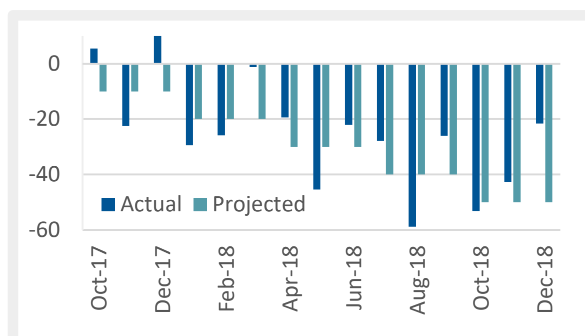
The US Dollar Rose Steadily Through 2018



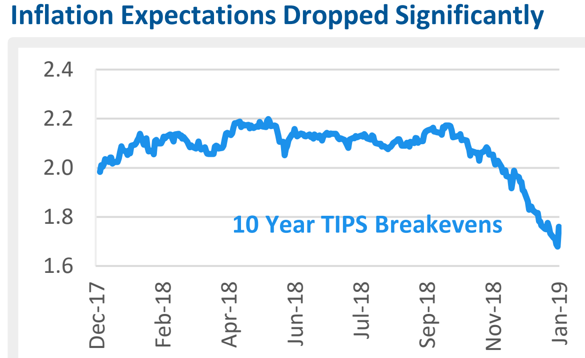
Federal Reserve Balance Sheet ($ Trillion)



Monthly Balance Sheet Reduction ($ Billion)



Inflation Expectations Dropped Significantly

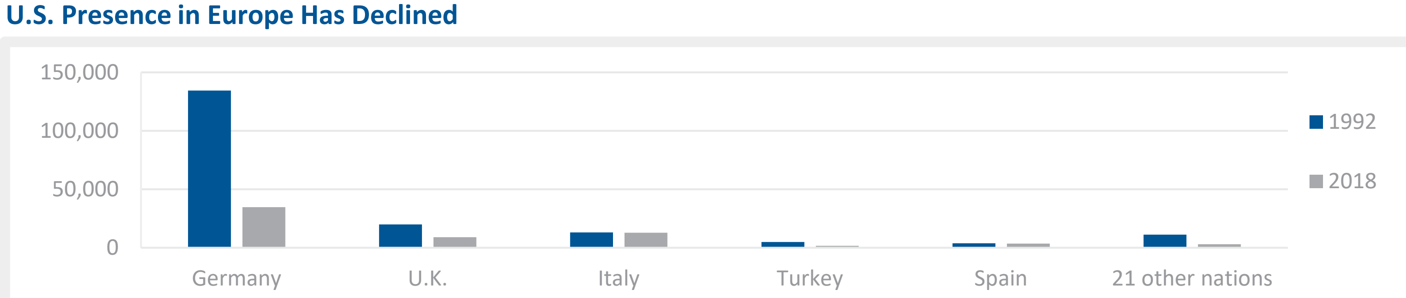


Source: Bloomberg as of 1/4/19.

- The United States is at risk of losing its moral authority as the champion of the multilateral world order that made possible the prosperity the world has known since the end of World War Two. The Heritage Foundation rates the nations of the world based on freedom: specifically, the degree to which they respect the rule of law, human rights and private property rights. The US has fallen far from the top in recent years. It now ranks 18th in the world and is now in a category called Mostly Free. As the US falls in its ranking, it is only natural that markets over time will evaluate it differently and assign an appropriate risk premium.
- The US has also fallen in the open expression of ideas as measured by the World Press Freedom Index. The US now ranks 45th in the world. Norway is number 1, Germany is 15, South Africa is 28, and China is 176.[1] The US is a society that rests on a foundation of a free flowing exchange of views. This free exchange of information is also critical to how our markets function – the efficient market hypothesis does require good information. The decline in the quality of the exchange of ideas and the freedom of the press, could likely prove a headwind to how democracy and markets in the US function. While investing based on long-term changes in the freedom of nations is an imperfect approach to investing, we believe it does suggest that US investors are considering allocating to nations with rising scores in economic and press freedoms in order to diversify their investment risks. At a time where the dollar may be peaking, this should help investors diversify internationally.
- While these changes loom, the US also faces a growing list of threats to vital US interests. The table below summarizes the range of threats the US faces today. Russia figures as an aggressive threat on this list, as do other nations one would typically expect: China, Iran, North Korea. Yet, US Forces deployed to the European theater have declined by 65% since 1992. The US defense budget has been falling as a percentage of GDP and so has the state of readiness of the US military. Expect the US defense budget to go up meaningfully in the years ahead, both because it is required, and because it serves as a form of military Keynesianism. For a nation that is approaching a full employment rate, this may help to stimulate the type of wage push inflation that has been long missing from the US recovery. Rising wages should help promote greater social stability in the US, which may moderate some of the harshness that has developed in the American political system.

	SEVERE	HIGH	ELEVATED	GUARDED	LOW
Threats to US Vital Interests	**HOSTILE**	**AGGRESSIVE**	**TESTING**	**ASSERTIVE**	**BENIGN**
Russia		X			
Iran		X			
Middle East Terrorism		X			
Af-Pak Terrorism			X		
China		X			
North Korea		X			
OVERALL		X			

U.S. Presence in Europe Has Declined



Source: 2019 Index of U.S Military Strength, Heritage Foundation accessed November 30, 2018.

- We expect falling oil prices to support regime transformation/liberalization in Russia, and throughout the Middle East. This will likely give the US breathing room to get its house in order geopolitically. Several years ago the journalist Thomas Friedman posited his First Law of Petropolitics. Oil rich dictatorships and repressive regimes, notably in the Middle East and Russia, finance their activities with oil revenue.[2]
  - When the price of oil is higher these regimes are financially healthy. They can export repression, and terrorism. They are more likely to act aggressively beyond their borders.
  - When the price of oil is lower these regimes are financially weaker and the forces of freedom and democracy are ascendant.
  - When the price of oil is low for a protracted period, these repressive regimes may become unstable, contributing to geopolitical uncertainty.

  If oil prices stay low for an extended time, we believe the US will get an unusual opportunity for a geopolitical restart and to regain the upperhand on the authoritarian regimes that seem to be on the march. If the US can use this opportunity as a way to reassert the multilateral, free trade world order that created prosperity, expect a great next decade for democracy, globalization, and risk markets.
- Over the past several years there has been a surge in shareholder proposals on ESG issues. Shareholder proposals and proxies are where capitalism and democracy intersect. In fact, for the first time ever, in 2017, the majority of shareholder proposals were on a range of ESG issues that seek to improve the environmental impact of corporations, their social impact, and improve governance. Shareholders are using the power of the proxy to improve corporate performance on a range of issues. In fact, while environmental issues received the largest share of shareholder resolutions filed, resolutions on political spending were in second place. Shareholders are demanding more information about how companies use money to support political candidates through their Political Action Committees. It may very well be that the political reform that has not occurred in Congress, may be driven by shareholders through how they influence the future behavior of corporations and their PACs. These shareholder initiatives have improved board diversity and focused renewed attention on good corporate governance. **Fiera Capital is a UN PRI signatory and we will be working in 2019 to integrate ESG factors thoughtfully into our teams' investment processes in a manner in keeping with each team's discipline.**
- Change has arrived at the United States Congress as well. The 2018 midterm elections have brought about the largest percentage of women in Congress in history. This surge in diversity, a Congress that is more representative of the nation, improves governance and democracy.

We will provide more updates about these topics throughout 2019. The skies may look dark at the start of 2019, but sunrise is coming.

Sources:

[1]2018 Freedom of the Press Index https://rsf.org/en/ranking

[2]Foreign Policy, October 16, 2009

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The Standard & Poor's 500, often abbreviated as the S&P 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ