GLOBAL MARKET OUTLOOK MID-YEAR 2017

Geopolitics

Globalization and Its Populist Discontents

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Optimistic supporters of globalization hope that 2017 might be seen as turning the tide against nationalist political movements, after France and the Netherlands avoided populist victories in the first half of the year. As investors, we are not so hopeful and believe policy uncertainty will remain elevated due to political shifts across the globe.

The same three forces we cited at the start of the year continue to dominate the geopolitical debate:

1. Protectionism & Weaker International Governance

The recovery in trade growth should not obscure the larger picture of a continued rise in protectionism. The death of trans-Atlantic and trans-Pacific (TTIP and TPP) free trade deals came as expected from the Trump administration, and risks remain over a potential escalation in trade wars. Yet the immediate concern is less about enacting substantial trade barriers and more about the erosion of global governance. Investors need to pay heightened attention to geopolitical shifts, especially in US–Chinese relations, as these developments may have more predictive power than existing international frameworks. Above all, in the event of economic or geopolitical shocks, there would likely be less international policy coordination than in the recent past. In plain English, it would be harder to restore market confidence as global rules are continually undermined. Economies most exposed to globalization thus have more to lose than relatively closed economies.

2. Populist Politics

European elections in the first half of 2017 provided a sigh of relief with their market-friendly outcomes. There has been a cyclical improvement in developed and emerging economies alike, yet we see little evidence that the underlying forces driving populism have abated. Populism in developed markets and the authoritarian concentration of power in emerging markets continue to cast a long shadow. In developed markets, anti-immigration and interventionist measures could undermine competitiveness or distort markets. In this context, the US administration is not really following the populist playbook and is instead lessening intervention by pursuing a deregulatory approach. Yet across developed markets, policy unpredictability characterizes the investment environment. In emerging markets, the increased politicization of business has investors worried, as do restrictions on information flows that can impede proper price discovery for assets. The quality of policymaking will be a greater differentiator among all markets going forward.

3. Fiscal Stimulus

One potential upside from populist pressure was the expectation of more fiscal stimulus — at least in infrastructure investment, where there is broad consensus of the need to spend more across the globe.

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However, as the Trump administration has become increasingly mired in controversy, the prospect of meaningful fiscal stimulus has receded further in the distance. The US is likely to concentrate fiscal stimulus now on tax cuts. If poorly designed, these would not translate effectively into higher growth. Most national politics will likely remain unconducive to larger fiscal reforms beyond short-term stimulus.

Main Economies Policy Overview

	Stance: Monetary	Stance: Fiscal	Key Reform Agenda & What to Watch	Chance of Progress
US	Tightening	Expansionary	**Tax Code** Reform of corporate and personal taxation. Repatriation of foreign profits of US corporations and their large cash balances abroad.	HIGH
			Infrastructure Public investment programs or private-sector incentive policies	MODERATE
Eurozone	Slightly Expansionary	Slightly Expansionary	**Capital Markets** European Commission to advance integration of continent's bond markets	MODERATE
			Banking Union Creation of European Deposit Insurance Scheme and completing single rule book	MODERATE
China	Tightening	Slightly Expansionary	**Capital Account** Continued gradual opening of capital account using special drawing rights (SDR) borrowing by state institutions and lowering entry barriers to foreign capital	MODERATE
			State-Owned Enterprises (SOE) Enabling more SOEs to operate according to market pricing, thus allowing for consolidation or increased competition	LOW
Japan	Slightly Expansionary	Slightly Expansionary	**Labor Market** Further reforms to boost wages, through incentives for private companies or changes to labor contracts	LOW

LOW HIGH CHANCE OF PROGRESS

Source: SSGA Research.

Projections are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Emerging Markets Policy Overview

For many emerging markets, the remainder of 2017 will be a challenge in coping with the gradual increase in interest rates in the US and a stronger dollar. Even countries without a pegged currency have found themselves forced to tighten monetary conditions in order to limit exchange rate depreciation and inflation. Aside from China, more emerging markets are likely to constrain fiscal spending than expand budgetary outlays, particularly among commodity producers still coping with low commodity prices. Regarding structural reforms, as mentioned above, policymaking in emerging markets has not suffered as much as in the developed world. Globalization has largely benefited those countries that have integrated into global markets, so there are fewer backlashes on that front. At the same time, weaker global growth lessens the incentives for difficult reforms ahead. Moreover, as we have seen with Brazil, political scandals can grind reforms to a halt.

Geopolitical Risks

Markets had exhibited a remarkable degree of complacency during the early part of 2017 before the renewed rise in US policy unpredictability. This was mainly due to benign outcomes in European elections and the perceived normalization of the Trump administration based on his foreign policy appointments and lack of adherence to major campaign promises. In addition, great power relations between the US, China and Russia now appear slightly more predictable than in January, though increased tension with North Korea remains a wild card. In our view, the geopolitical risk drivers we identified at the start of the year will remain in place for the rest of 2017 and next year.

Global

Despite Trump making the shift from campaigning to governing, US foreign policy could still be destabilizing as his multiple failures in domestic policy — for example, health care reform and the budget proposal — and intensifying investigations of his administration push him to look for initiatives abroad where he can act without legislative battles. The risks of misjudgement in the Trump administration or an international adversary remain considerable, which could lead to temporary asset price shocks.

North Korea

The regime in Pyongyang would have generated headlines under any US administration, but the risks of miscalculation across all actors (US, China, North Korea and South Korea) are higher than at any time since Kim Jong Un took over power in late 2011. Assuming no extreme event, even smaller tensions could repeatedly boost demand for “defensive” assets.

Europe

So far, 2017 has been the year when elections did not bring about negative surprises. The prevailing victories of centrist leaders in the Netherlands, France and Austria — along with the setback for the hard Brexit position in the UK general election — suggest that election worries will not re-appear until early 2018 when Italy goes to the polls. There, the election of an anti-EU government would lead to dramatic market reactions. This could already be felt in the second half of 2017 as the ECB begins to withdraw monetary support and the election date approaches. Despite major waves in headlines, Brexit negotiations will have limited impact until 2018 when the contours of a transitional and permanent agreement become clearer.

Middle East/Ukraine

Ongoing conflicts could see further escalation. Of particular concern remains the Syrian conflict, with related questions over stability in Turkey, which may fail to maintain the easing of refugee pressure or Western sanctions on Russia.

Venezuela

The political and economic impasse in Venezuela is reaching a boiling point. Although Latin America is generally exhibiting resilience, Venezuela still offers potential spillover effects depending on how the country navigates bankruptcy and political change. Sovereign defaults are rarely viewed entirely on their own, and since Venezuela is an oil producer, this could be relevant for both bond and commodity markets.

	Key Reform Agenda	What to Watch	Chance of Progress
Mexico	**Energy Reform**	Continuation of outsourcing of Pemex fields to private sector bidders and liberalization of gas prices	HIGH
Brazil	**Telecoms**	Liberalization and streamlining of telecoms industry	HIGH
	Entitlement Reform	Reform of entitlements, including raising retirement age and slowing costs of benefits by de-indexing from minimum wage	MODERATE
	Central Bank Independence	Formal independence compared to current status of operational autonomy	MODERATE
India	**Banking Sector Reform**	Consolidation and professionalization of state-owned banks	MODERATE
	Subsidy Reform	Reduction of wholesale fuel subsidies	MODERATE
	Labor Market	Simplification and relaxation of stringent labor regulations	LOW
Philippines	**FDI Opening**	Constitutional reform to allow for higher foreign ownership and opening new sectors to foreign direct investment	MODERATE
Indonesia	**FDI Opening**	Sector-by-sector relaxation of barriers to foreign direct investment	MODERATE
	Labor Market	Liberalization of labor regulations	LOW
Malaysia	**Fiscal Reform**	Broadening of tax base to boost revenue potential combined with tax cut for small and medium-sized enterprises (SMEs)	MODERATE
	Ethnic Subsidies	Malay-oriented set of rules to be reduced	LOW
South Africa	**Education Reform**	Increase accountability of teachers	LOW
	Labor Market	Changes to collective action clauses and ease of rules covering SMEs	LOW
Russia	**Business Climate**	Goal to move into top 20 of World Bank's Ease of Doing Business Index by 2018, requiring depoliticization of judiciary and cutting of red tape	LOW
	Pension Reform	One pressure point of low oil prices is public pay-as-you-go system, which will require higher retirement age	LOW
Turkey	**Labor Market**	Increase flexibility of labor contracts	LOW

LOW HIGH CHANCE OF PROGRESS

Source: SSGA Research; Eurasia Group

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Q4 2017
Thailand
Parliamentary Election
First election since new constitution was approved by referendum in 2016. Uncertain outcome.

2017 / 2018
Malaysia
Parliamentary Election
Potential snap elections on the backdrop of alleged scandals revolving around Prime Minister Najib Razak.

BY MAR 2018
Italy
Parliamentary Election
Possible success of Eurosceptic parties and their ability to coalesce with each other or mainstream parties.

JUN / JUL 2017
India
Presidential Election
Elected by electoral college, nonetheless a good barometer of PM Modi's political strength.

SEP 2017
Germany
Parliamentary Election
Stable coalition or hung parliament, performance of populist and Eurosceptic AfD party.

OCT 2017
Argentina
Parliamentary Election
Test of support for President Macri's reforms.

China
National Party Congress
Selection of new leadership from younger generation and prioritization of economic goals.

WHAT TO WATCH

Source: SSGA Research.

Key Political Dates

In 2017, notable elections with the potential to affect markets are in Europe and Asia. **Europe** faces the most significant challenges of the post-war era with weak economic growth, a refugee crisis, Brexit negotiations and the Ukraine conflict. The ultimate victory of mainstream parties in Austria's presidential, Dutch parliamentary and French presidential elections does not obviate the residual threat from challenger parties. Italy's upcoming election remains by far the most significant potential upset for markets, given the country's large debt stock and integral role in the European Union.

In **Asia,** none of the major elections are expected to bring about major policy reversals, but they could take place against a tense domestic political backdrop and therefore have market impact. For the rest of 2017, we expect relative quiet elsewhere among emerging markets, where only Iran and Argentina could deliver electoral surprises.

Glossary

Banking Union A plan for deeper European Union (EU) integration with the objective to strengthen and extend the regulation of the banking sector. Its four pillars are a single rule book for financial institutions, a Single Supervisory Mechanism (SSM), a harmonized system of deposit guarantee schemes (DGS) and a Single Resolution Mechanism.

Capital Account Reflects the net change in physical or financial asset ownership for a nation and, together with the current account, constitutes a nation's balance of payments. The capital account includes foreign direct investment (FDI), portfolio and other investments, plus changes in the reserve account. A capital account may also refer to an account showing the net worth of a business at a specific point in time.

Pegged Currency A currency with an exchange rate that is attached to the exchange rate of another country's currency.

State-Owned Enterprise (SOE) A legal entity created to partake in commercial activities on the government's behalf. It can be either wholly or partially owned by a government and is typically earmarked to participate in commercial activities.

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