FIXED INCOME

# Putting Geopolitical Tensions into Perspective

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When world leaders talk, markets react. And with social media becoming mainstream, politicians have a new way of getting their message to the masses. John Beck, Franklin Templeton Fixed Income Group senior vice president and director of fixed income, London, recently recorded a podcast where he discusses geopolitical tensions and the impact of social media. Looking across the globe, he outlines some market challenges within today's highly charged landscape as well as the potential investment opportunities.

*Listen to the full "Talking Markets" podcast and hear more from John Beck as he discusses putting geopolitical tensions into perspective.*


Talking Markets w. Franklin Templeton Investments

SOUNDCLOUD

Putting Geopolitical Tensions In Perspec...

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**Here are some highlights from Beck:**

- Regarding the tensions in Northeast Asia, North Korea, Japan, United States and China, the worst binary outcome is so unthinkable that no one can really plan for it.
- Inevitably, when you see a political headline, markets react in the short term. Whether they do in the long term, I think, is driven by far more fundamental types of patterns.
- The combination of political dissatisfaction, greater emphasis upon fiscal spending and a reduction of central bank bond buying is beginning to add to a degree of caution, in particular in the risk-free bond markets.
- We have reasonably strong global economies. Economists talk about something called the flattening of the Phillips Curve, where we have low rates of unemployment, but people's wages have not gone up. That means what we have is a lot of people who are feeling that they are not getting their stake in society. People may feel we need a bit more pressure now on the fiscal side, more government spending.
- To some degree, I think Poland could reflect what the European yield curve might look like if the European Central Bank wasn't buying quite as many bonds and with emergency interest rates. But I think in regard to the general structure of the traditional fixed income markets, there is no denying we are at relatively rich levels so we proceed with some caution.

**The full transcript of the podcast follows.**

**Richard Banks:** John, let's start the discussion in an area that is generating headlines at the moment—North Korea and the volatility there. How do you view the situation as an investor, and how do you see the markets responding?

**John Beck:** The tensions in Northeast Asia, North Korea, Japan, US, China, I think you really cannot plan because the worst binary outcome is so unthinkable that one can't really plan for it. So you do see the knee-jerk reaction, which is a ballistic missile is fired over the Sea of Japan, over Hokkaido, Japanese yen rallies. When [Japan's Prime Minister Shinzo] Abe says, "well, we are not going to shoot down a missile that we know is not going to land on us and we'd already projected that it was going to overfly Japan," yes it ratchets up geopolitical tensions.

**Richard Banks:** I recently caught up with a colleague of yours, Carlos Hardenberg, senior vice president and managing director, Templeton Emerging Markets Group. He gave some perspective from our resources in the region. Let's take a listen.

**Carlos Hardenberg:** What our local colleagues are telling us, they do not expect this situation to get out of control…of course no one has any certainty at this point in time. But the Koreans themselves believe that there is a lot room to negotiate and there's a lot of room to get all of the parties involved to settle at some solution which is certainly not a military conflict. If you were to assume the worst-case scenario there, and a conflict between the involved countries, I think the whole world will be impacted by it.

**Richard Banks:** Carlos' thoughts, John, seem to be very similar to yours, and while everyone is concerned, you also try to be optimistic.

**John Beck:** I don't think you have that catalyst of crisis point. So what have we seen? I mean, again, I think it's interesting to look at the development for example of 10-year Treasuries year-to-date. When we were at the height of North Korean tension, 10-year Treasuries were close to 2% in yield. If you took a month-end close of 10-year Treasuries this year, with the exception of the end of August when we did have that height of geopolitical tension, you would struggle really to say that a whole lot had gone on because we [Treasuries] have been largely range bound, so I think one has to be aware that there is a degree of political tension and maybe that is the reason the Japanese yen is trading at the level it's trading at.

Whereas we think from an interest-rate perspective, it [Japanese yen] probably should be trading a little bit weaker. So you have to factor some of those things into your investment process, but I think you have to keep your eye very much on the medium-term growth factors because you simply cannot plan for the impossible and the unknown.

**Richard Banks:** Talking of Japan, obviously the snap election announced by Abe. How does that affect your thinking about that part of the world?

**John Beck:** I don't think, fundamentally, it's going to change a whole lot. I think the context in which the election was called was probably to extend Prime Minister [Shinzo] Abe's period of office, if he can. Clearly, to the degree that he is more, if one uses the kind of hawked-up type of phrase with respect to Japan's constitution, which again is well known for being a pacifist constitution. The fact that North Korean and Northeast Asian tensions are there makes it an opportune moment for him on that hawkish side to say, "look, I'm the candidate that you should re-elect so we can project a slightly more outgoing stance with respect to how we might respond to those geopolitical tensions."

**Richard Banks:** Investors are beset on all sides by headlines about politics around the world, whether it's elections, or referendums or even Twitter spats between leaders. How do markets tend to react to that kind of news and those kinds of developments?

**John Beck:** First observation in terms of Twitter spats, I believe now we are going to have more characters that we can include in Twitter spats. So possibly they will become more, rather than less. So I suppose my immediate answer is that inevitably when you see a political headline, markets react in the short term. Whether they do then in the long term, I think, is driven by far more fundamental types of patterns. And I think really what I mean by that, in Europe, again, we have seen three elections this year, which I think on the face of it are very much status-quo outcomes. They were the concerns that we had at the beginning of the year with the Dutch election in January/February, then we had the French presidential election in the middle of the year and the German election has just taken place.

And actually, in all cases where we were concerned that there might be a rise of populism and what the impact of that might be, on the face of it, we have seen the status quo parties winning, so that would tend to indicate that everything is going on as normal before. But, I think underlying that when you sort of analyse the data, so here we are in early October and the Dutch have only just now formed a coalition government. And again, the most immediate outcome, for example the German election, I think is Angela Merkel and the CDU [Christian Democratic Union] have won, she has won with a weakened majority.

The former coalition partner, the SPD [Social Democratic Party] has decided to go into opposition. We have the Greens who have won a significant number of votes and the FDP [Free Democratic Party], which is a party that actually wasn’t even in the parliament of the last election. They have been a traditional coalition partner, but you have the Greens who are on the left side of the political spectrum, you have the FDP on the right hand side of the political spectrum, and that’s going to be quite a complicated coalition to put together. But I think that really reflects that underlying sort of slight dissatisfaction that people have with the political status quo. And of course, we are seeing a lot of that in the UK at the moment and there’s a lot of that going on in the [United] States that we saw last year with the presidential election. We have presidential elections coming up in Mexico where there is a surge of populism for the current, or the former Mexico City mayor and dissatisfaction with the incumbent president. We have political elections, a snap election called in Japan. So, there is a lot of, kind of, underlying political anxiety I think going on.

**Richard Banks:** So as you say, on the face of it a status quo, but actually what’s going on underneath the surface is perhaps a little bit more interesting. What lessons can you learn as an investor?

**John Beck:** Well I think as a bond investor, we tend to focus on the macro type of things and I suppose the types of things that people might talk about is the absence of inflation. On the one hand, we have got reasonably strong global economies. Economists talk about something called the Flattening of the Phillips Curve, what they mean by that is actually that we got low rates of unemployment, but actually we are not really seeing people’s wages go up and of course what that means is that we know we have got a lot of people who are feeling that they are not getting their stake in society. And so equally, I think by extrapolation, what people feel a little bit is that maybe we need a little bit more pressure now on the fiscal side of that macroeconomic adjustment, more government spending. And therefore, those are the sorts of concerns, clearly as bond investors we have to have in the back of our mind because while we’re still very much supported by central banks continuing to buy government bonds, the Fed [US Federal Reserve] has announced that it is beginning now to not only end the taper, that ended some time ago, they are potentially selling bonds back into the market.

And we have the ECB [European Central Bank], again, likely to tell us what their plans are and not for selling bonds back into the market, I think not at this stage for changing their interest rate policy, but again, slowing the rates of purchase of bonds. So I think the combination of kind of political dissatisfaction, greater emphasis upon fiscal spend, a reduction of the central banks buying bonds is beginning to add to that degree of caution, in particular in the sort of the risk-free bond markets. The US Treasuries, the [German] bunds, the JGBs [Japanese government Bonds], the [British] gilts, that are at relatively, or generationally, low on yield levels and where that imbalance shifts between reduced purchasing, so reduced demand and increased supply, then an Economics 101 model says the price changes and the price will change lower and the yield will change higher.

**Richard Banks:** The geopolitical developments that we see and the announcements like the ECB [European Central Bank] made and the announcement that the [US] Fed made, how quickly do markets respond to that and how sustained are those reactions?

**John Beck:** Some of the time you see an immediate reaction, so when the Fed announced that it was buying, we saw a sharp decline in bonds. And no one can say that they don't know that the Fed is about to start reducing the size of its balance sheet. And yes, actually the market reaction has really been quite muted and I don't know whether this partly reflects the new economic norm, you know the flattening of the Phillips Curve, disruptive change, lower inflation the Fed talked about at the Jackson Hole Summit last year, something called Our Star which is going to lower long-term rate of equilibrium interest rates. So there are lots of those long-term factors, demographics, aging population, global competition that mean that long-term interest rates may not rise at the same level, but one can't help but feel that we have seen six, seven years and in some cases, 10 years now post global financial crisis of near-zero interest rates and it's just, I suspect, there are a lot of market practitioners who have gotten used to that idea and haven't really gotten their heads around the fact that we are still seeing Fed governors suggesting we have got one more rate increase this year and potentially two or three coming out next year.

And so, there is this big dichotomy I think between what the Fed governors are forecasting in terms of their so-called "dot plot," where they think interest rates are going to be and where the market is again, saying well, actually we know better, bond yields are always going to stay low. And that's not only in the US, that's in Europe in particular, certainly in the UK, and it's difficult I think to have a certainty around it but I think our bias is that bonds are on the expensive side at the moment and we are generally in most developed markets running shy of benchmark duration positions.

**Richard Banks:** Have we ever seen a situation before where the market just doesn't believe what central banks are saying and essentially what you are alluding to there?

**John Beck:** I am sure we have but I can't bring back any kind of the historical comparison. I mean, I think my thought process around this is a little bit that you need to have a long period of dissatisfaction over whatever set of circumstances it is before you actually see a really dramatic reaction to it. In terms, I think of inflation and bond markets, it took six, seven, eight, maybe 10 years of high inflation in the 1970s before you had Paul Volcker brought in to say "enough is enough," and then again whether it's led by American monetary policy but similar moves in Europe, obviously in the UK, a significant tightening of monetary policy because people got fed up with inflation and I don't think that we are kind of yet at the point where real wages have been suppressed so much by that irritation that inflation is always running ahead, life is becoming more expensive, so we need the central bank radically to change their policy. So I think there is an element of "low for longer" and we will stay with lower-than-expected bond yields. But I think we are beginning to get into that kind of turning process where there are those broader issues, those that have tended to have assets, be they salaried pension holders or those that own property or other real assets, have tended to do better than the millennial generation and I think that we are seeing that in some elements of political protest.

I think universally, so again, whether that is addressed by central banks changing their policy gradually, which I think will be part of the solution. But I think equally it is going to be part of the solution, that politicians always feel the need to do something now. And to do something now is going to be spending some more money.

Now some of that is going to be inevitable, the need to rebuild after a hurricane in Florida, or potentially in Puerto Rico, some of it is going to be we need to build more houses because our young people haven't got anywhere to live. But there are those types of patterns I think that are likely to weigh upon issuance of government debt that will add I think to the supply and therefore cause some eventual adjustment in price.

**Richard Banks:** That's a really interesting point, this politics of protest you have alluded to here and in the past. How geared up are bond markets in particular to that and how would you expect them to respond?

**John Beck:** I don't think they're sufficiently geared up, I mean that's not just my view, I think that is broadly a view held across many of the fixed income groups within Franklin Templeton. What we have seen actually is a significant lengthening of duration, which is the interest rate sensitivity of bond markets over the last 10 years or so. And that's two fold, that's one because coupons have fallen and so there's a mathematical impact that interest-rate sensitivity rises because what does that mean? It means interest-rate sensitivity duration is how much of your money do you get up front and you used to get a lot more of your money up front with a 5% coupon than you do with a close to zero percent coupon. So inevitably those relative interest-rate risks have increased. But some of it has been because governments have issued long dated debt. Now that's great news, if you like, for the taxpayer, possibly not such good news for the investor. So the average duration of the UK gilt market is now 12 years. Austria issued a 100-year bond very recently. A lot of people are pretty sanguine about it. They say "you know, well the duration of a 100-year bond is not really that much more than the duration of a 50-year bond." Both of which are true. The question is really have we got our head around what the duration of a 50-year bond is, because it is a lot longer.

To begin with, we weren't issuing, you know, 50-year bonds 20 years ago, 30-year bonds were pretty radical then. So it's not only longer than the bonds we were issuing then but the argument, "well, it's not really that much longer than this bond is," is perhaps that extrapolation that makes me a little bit nervous, that there is too much complacency. And I suspect that as short-term interest rates do gradually rise that that complacency will be shifted. I mean, I feel a little bit, as a sort of bond-market investor 101, you always used to have something called a term premium. In other words, you would be paid more for lending out money long because you were tying your money up. Now there are times that the yield curve is inverted because we are predicting a slowdown in the economy but I don't think, you know, here we are into the eighth year of economic expansion, ninth maybe, and it doesn't really seem to be any particular reason that that economic expansion is going to die any time soon, so the traditional inverted yield curve "we're about to go into recession" I don't see. And therefore, I am a little bit concerned that the absence of term premium at the long end of the market is the market's myopia over the current low level of short-term interest rates.

**Richard Banks:** So how does that play out longer term, and how do you adjust for that?

**John Beck:** We try to find markets where we think they're better priced, some of them can be fairly straightforward. You know Mexico's seen interest rates rise for local reasons, defending the currency in the last political you know, stuff going through in 2016. So, its interest-rate level is at a much higher interest-rate level than the US. Polish interest rates again is another example compared with European interest rates. The National Bank of Poland has short-term interest rates of 1.5% and hasn't changed its interest rates for a long time. To some degree, I think one can almost look at Poland as a structure of a yield curve that would be what the European yield curve might look like if the ECB weren't buying quite as many bonds and with emergency interest rates. So you can try to invest in markets that offer a little bit more protection around that. But I think the general structure of the traditional fixed income markets, there is no denying we are at relatively rich levels so we proceed with some caution.

**Richard Banks:** In the UK, on Brexit, what should we be looking out for as the negotiations unfold?

**John Beck:** This is to quote [Former US Secretary of Defense] Donald Rumsfeld, "an unknown unknown." I think we are beginning to see some element of economic uncertainty come into the GDP [gross domestic product] numbers that we see now in the UK. Although again I think that some of this would actually be broader long-term factors over productivity, which again comes back to that argument that I said about fiscal policy. So on the face of it, you can see the rating agencies downgrade the UK on the basis of greater economic uncertainty, lower growth prospects. Is that ultimately going to have a long-term impact on a country that issues debt in its own currency? Probably not. Will the economic uncertainty again put more pressure on body politic to do something for those people that are feeling the impact most acutely of that weaker growth prospect? So again whether that's simply weaker growth equals less money in the exchequer's coffers and therefore a bigger deficit to finance—whether that is more pressure for well, "this isn't going very well… so we better now distract by building an infrastructure project here, or doing something else." I am not sure that one can kind of forecast that sort of immediate impact upon the Brexit negotiations, there's still lots of uncertainties.

I tend to take a medium—by which one's probably looking at a five- to 10-year view—and that is that I think both sides if one wants to put it inside arguments are incentivised to have a positive outcome. So I think that we will see a broader growth dip, which probably will impact upon the UK more than it will impact upon Europe because we are at the heart of it. And Europe is a bigger body of GDP. But thereafter, I think these things will probably iron themselves out.

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