How Long Can Markets Ignore Political Risks?

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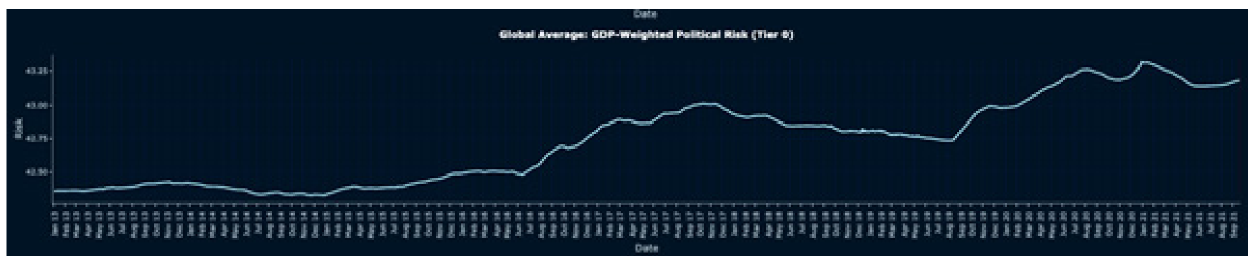
In short, the large and thus-far unrealized "build up" of global political risk since the 2008/9 financial crisis – especially in developed markets – is the most important trend in the global economy that policymakers are not paying attention to, and that the U.S. president would be well advised to follow every day.

On the surface, global political risks are hardly ignored. Every year, a cottage industry of political risk consultancies, investment strategists, executive surveys, and armchair futurists highlight a cacophony of potential geopolitical and country risks in "year ahead" forecasts, while both public sector and private sector intelligence and security outfits live and breathe political risk daily. There is no shortage of pundits highlighting the potential economic significance of recent events like Brexit; the 2016 and 2020 U.S. elections; the advent of a new "cold war" between the U.S. and China; growing authoritarianism and militarism in Russia; the decline of global democracy; and so on.

Yet pundits and policymakers alike largely ignore a simple fact of global political economy: absent a few ephemeral shocks, global markets have continued to record highs and the global economy (pre-pandemic) has continued to expand at more-or-less the same rate despite this expansion of political risk. On a systemic basis, the post financial crisis build-up of global political risk has yet to be realized in global market outcomes. What's more, history tells us that it almost certainly will. We ignore this trend at our peril.

Courtesy of GeoQuant, we can make this reality more explicit (and even provide key data for the U.S. president!). The graph below presents our Global Political Risk indicator — a GDP-weighted average of top-line Political Risk scores for the 127 countries in our system — from 1 Jan 2013 to present, the current span of our daily time series. Note that this is an extremely broad-based measure, aggregating 21 fundamental political risk indicators across 127 countries into one global average, weighted by country GDP. Nonetheless, it clearly captures the trend described above: a more-or-less steady, day-on-day increase in Global Political Risk.

Figure 1: Global Average: GDP-Weighted Political Risk (Tier 0)



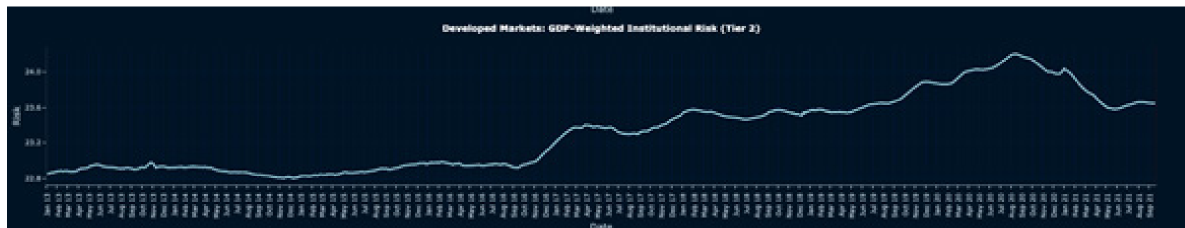
Strikingly, this indicator is correlated at 0.87 with the S&P 500 day-on-day, meaning that there is a strong positive relationship between Global Political Risk

and the S&P 500 in this time period. Counter-intuitively (at least for a political economist…), the more political risk there is in the world, the better returns for the world's benchmark stock market index.

Figure 2: Asset Value: SPX:IND

Though a bit weaker, this relationship holds up for the benchmark European (0.55), Japanese (0.83), and Emerging Market stock market indices. Meanwhile, even taking into account the Covid-19 pandemic, we see a similar pattern when it comes to net assessments of global growth and global trade.

Figure 3: Developed Markets: GDP-Weighted Institutional Risk (Tier 2)



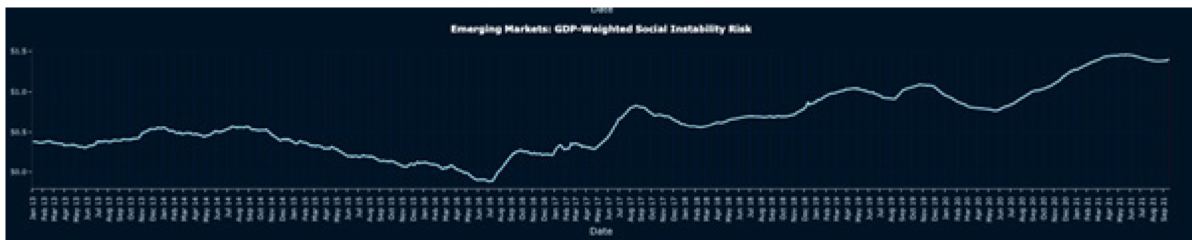
For a variety of reasons, this global "equilibrium" of high global political risk and increasing market/economic returns is unlikely to last. First and foremost, it is largely contingent on the massive expansion of monetary (and in the context of Covid-19, fiscal) stimulus provided by the Fed, the European Central Bank (ECB) and other large economy central banks since the financial crisis—a level of support for the global financial system that is most likely to decline in the near-to-medium term. Second, while developed market central banks have been flooding the global economy with money, political institutions in these countries have weakened substantially. To wit, our aggregate measure of Institutional Risk in developed markets since 1 Jan 2013 looks quite (frighteningly) similar to that for Global Political Risk presented above.

From the U.S. to the U.K. to the E.U. to East Asia, previous robust domestic and multilateral norms in developed markets increasingly fall victim to the political expediency of winning and holding power. And while the rule of law is still comparatively robust in these polities, it is clearly under threat from increased corruption and democratic backsliding. If the political economy literature tells us one thing, it is that strong democratic institutions are ultimately critical to the stability and growth of financial markets and economies, the thus-far-exceptional growth of autocratic China notwithstanding. Coupled with the likely

wind down of developed market stimulus, the increase in political instability and policy uncertainty generated by higher institutional risk are chickens that will come home to roost for global investors and policymakers.

Finally (but non-exhaustively!), GeoQuant echoes the findings of our colleagues at the Economic Intelligence Unit that Covid-19 will continue to generate much larger and more sustained economic costs for emerging markets—where vaccine access and health infrastructure is more limited—than the developed markets discussed above. These costs will be aggravated by the rising social and political instability risks embedded in our data (see below), making the realization of building political risks in global markets that much more likely.

Figure 4: Emerging Markets: GDP-Weighted Social Instability Risk



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