HEALTH WEALTH CAREER

POLITICAL RISK: "BIG THINGS" LIE AHEAD

SEPTEMBER 2018

MAKE TOMORROW, TODAY

MERCER

INTRODUCTION

Since the seismic events of 2016 – the EU referendum and the election of Donald Trump – many UK pension schemes have discussed and debated the potential risks they pose, but it has been very difficult to know what to do about it.

To the surprise of many political and economic commentators markets have been unexpectedly calm. Sterling initially fell, then recovered, and remains well above its post-referendum lows. The UK equity market has followed a similar pattern. Volatility in the gilt market has been remarkably low. In the US, the impact of Trump's policies, particularly the large scale tax cuts, has led to continued strength in the economy, and despite a moderate correction in February, the equity market is now sitting around all-time highs. The dollar was weak for a time; but is now rising. The US Federal Reserve has continued to raise rates and unwind QE, and while US Treasury yields have risen the once-feared bond market meltdown has not materialised.

So, what's the problem? Should pension schemes really be worried about political risk? Is there anything they can do about it anyway?

By focussing on Brexit and Trump, and the relentless media coverage of every twist and tweet, there is risk we are all missing something really big – the unwinding of decades of internationalism, deregulation and trade liberalisation. Arguably both Brexit and Trump are the products of the same seismic wave of discontent that has swept the world since the Arab Spring. The so-called "Washington Consensus", or neoliberalism, that started with Reagan and Thatcher and has dominated Western political thinking for nearly four decades may have run its course. The wealth generating and peace-promoting benefits of neoliberalism are there for all to see. But what many people see is that their own lives have not gotten as better as some, and in some cases, they have gotten worse.

Until this problem of those that feel "left behind" is solved, if it can be solved, political risk should be high on the agenda of all investors, but especially pension funds with funding challenges, or uncertain sponsor covenants.

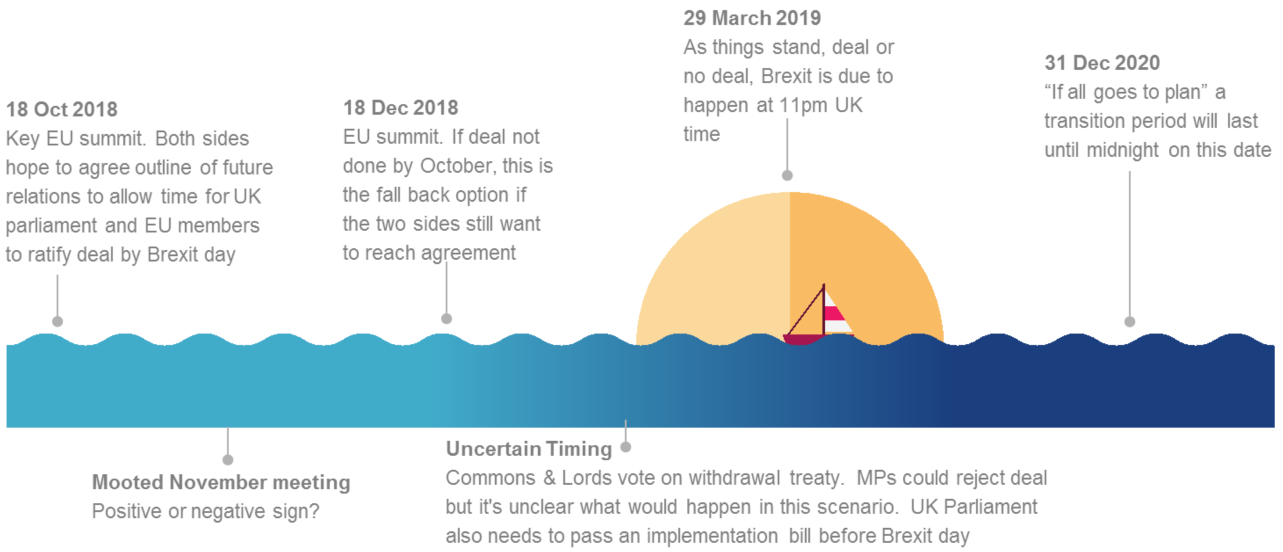
As we sit here in early September 2018, we find ourselves at a critical juncture with regard to both Brexit and the Trump Presidency. But we also need to be aware of other events linked to the same root cause - from Turkey and Eastern Europe, to Italy and Germany, not to mention Sweden. The shape of the distribution of possible outcomes for Brexit and Trump has become clearer but such clarity is not independent of "big things" happening elsewhere. If the outcome for Brexit is trade based WTO rules, the uncertainty will remain if the WTO rules themselves are under threat, or reformed. Seeking a free trade agreement with other countries will not happen, if they too turn their backs on free trade. Regardless of how much longer Trump is in the White House, his personal fate will not matter if his election has changed the political landscape of America for a generation. If "America First" replaces the Washington Consensus, or if China under Xi seizes the leadership void left by an isolationist America, the world will be a very different place long before most UK pension schemes have paid out their last pension.

In this paper, we focus on the immediate political risks which pension schemes need to consider – Brexit and Trump. But we should all be aware that Brexit and Trump might not be just "blips", after which everything will go back to normal. "Populism", as it has been condescendingly termed, could also be called "democracy" or "people power". Such people power may shape politics, economies and financial markets for decades to come, just as the neoliberalism championed by Reagan and Thatcher has shaped the past four decades.

BREXIT MEANS…BREXIT?

More than two years after the vote to leave the EU, and with only 6 months until we are due to do so, the UK finds itself in a situation where almost nothing material has been agreed (even in principle) and where the Prime Minister is championing her so-called "Chequers" deal, despite it being unacceptable both to the EU and to the majority of politicians on both sides of the debate. The October EU meeting - which was to be the watershed for reaching a deal - is rumoured now to be followed by a November meeting. With the Government releasing papers on contingency plans for a "no deal" scenario, and the Bank of England Governor warning the Cabinet of the dire short-term consequences of "no deal", it is difficult to discern what is fact, what is posturing, and what is simply negotiating tactics.

Figure 1 – Key Brexit Dates



What we know with reasonable confidence is that the parliamentary arithmetic with regard to Brexit is challenging for the Government. After surrendering her slender majority in the 2017 election, the Prime Minister is in a situation where it is unclear whether any Withdrawal Agreement can pass through Parliament. The risk of a constitutional and political crisis poses almost as much political risk as a "no deal" or "cliff edge" Brexit.

MARSH & McLENNAN COMPANIES

There are two separate aspects of our future relationship with the EU that bring about Brexit-related political risk. The first is the immediate question of the shape of the economic and political situation on "day one". The second is the ultimate form of our relationship with the EU where any differential impact, positive or negative, is likely to be felt only over the medium to long term.

When considering political risk as a "left tail" event, what should concern Trustees is the immediate need to agree a Withdrawal Agreement ("WA"). The WA (a Treaty) would be the agreement between the UK and EU under Article 50 of the Lisbon Treaty. In relation to future relations between the UK and the EU, it is intended that the WA will make a *non-binding* declaration of what the economic arrangements will look like. It has also been agreed that the WA will allow for a "Transition Period" from 29 March 2019 to 31 December 2020, during which trade will continue as now, but with the UK no longer providing input on the rules.

Notably, the EU and the UK agreed in December 2017 that the WA would also contain a legally binding backstop provision to ensure that under no scenario would there be a hard border between Northern Ireland and the Republic of Ireland. This backstop would kick in if the subsequent negotiation of the future relationship (post March 2019) failed to reach an agreement that would prevent a hard border.

It is likely that the long term nature of the relationship between the UK and the EU will not become clear for some time after withdrawal on 29 March 2019, and many commentators are sceptical that a deal can be reached by the end of 2020. Nonetheless, something tangible must happen in the next few months, and the implications may be material.

Below we set out what we view as the potential outcomes *as we see them today*, and the risks and implications inherent in each. Please note the percentages applied to these scenarios are purely indicative, and it is not possible to have any real conviction in these given the complexity of the situation.

Negotiated Deal (c.60% likelihood)

The Transition Period could begin on 30 March 2019 with a broad framework agreed by the UK and EU for the terms of a future trade deal (but, notably, not necessarily a huge amount of detail) that would then be worked on during the period to 31 December 2020. As noted above, this would require a legally binding backstop to be agreed with regard to Northern Ireland. This has essentially been "Plan A" for the UK since the "Lancaster House" speech in January 2017, where membership of the Single Market and Customs Union was effectively ruled out by Theresa May, although the UK was hoping for a deeper partnership than is currently in place with Canada (which now appears to be what would be on offer, at least in the short term).

The Chequers deal - in particular, the proposal to stay aligned with the Single Market for goods but not for services - is considered untenable by many commentators both because it violates the integrity of the Single Market, the maintenance of which is the single highest priority of the EU, and also because it appears unlikely to enjoy parliamentary support. Indeed, the pro-Brexit European Research Group believe as many as 80 Conservative MPs would vote against it.

With the rhetoric from the EU having softened over recent weeks, it would seem, however, that an agreement of some kind is the most likely outcome. If this can be kept sufficiently broad (i.e. if it manages to kick some of the most divisive "cans" further down the road) it might lead to another uneasy truce, of the kind we have experienced at various points in the process so far. While the DUP (whose votes the Conservatives currently rely on in Parliament) would be vehemently opposed to any outcome that resulted in Northern Ireland remaining in a Customs Union with the EU, they might take the pragmatic view that the risk of a UK Government led by Jeremy Corbyn, who has supported a united Ireland throughout his political life, together with the economic implications of "no deal" on Northern Ireland, are greater evils.

No Deal ("Carney's Carnage" or "Negotiated") (c. 20% likelihood)

The risk of no agreement whatsoever before 29 March (i.e. no WA, no contingency agreements in place and no extension of the Article 50 deadline) has the potential to be the ultimate "Doomsday" scenario (e.g. legal contracts voided, airplanes grounded). In this case, the economic impact would be immediate and profound. Such an outcome has been termed "Carney's Carnage" by the media, following the Governors' leaked testimony to the Cabinet. It is very difficult to conceive this happening intentionally because of the implications for all sides, but it seems plausible that this could happen inadvertently - the product of inept brinkmanship at the eleventh hour. This would likely open the door for a Prime Ministerial challenge, vote of no confidence in the government, and/or a snap election.

However, the other "no deal" alternative is that agreement could be reached that no comprehensive trade deal is achievable in the short term, as there is too much difference between the two sides (i.e. the government might employ the familiar maxim that "no deal is better than a bad deal"). Since WTO rules apply only in the absence of a framework of rules that govern the relationship between trading partners, both sides could agree a series of mini-agreements to keep the critical current trade arrangements going (replacing, in effect, the "status quo" of a Transition Period). This would mean the impact on the economy would be one of disruption rather than catastrophe. Such an approach is favoured by many Leave campaigners.

However, in this scenario, the UK might refuse to make the "divorce payment" of c. £40bn (given there would be no trade deal) which the EU would see as the UK defaulting on payments it is legally obliged to make. It is therefore highly likely that while the EU would agree to some mini-agreements (e.g. to keep planes in the air) they would be motivated only to negotiate deals that were unambiguously beneficial to member states/EU businesses, rather than the more comprehensive set of agreements that the UK would seek. Depending on what is actually agreed, this scenario could still result in sharp economic disruption and, as noted above, a prime ministerial challenge, a vote of no confidence in the government, and/or a snap election.

Extension of Article 50 (c. 20% likelihood)

It is highly unlikely that Theresa May would get to a position where she asked the EU for an extension to Article 50, for this would (in essence) be accepting that her Government have failed to take preparing to leave the EU sufficiently seriously, or alternatively that their negotiating tactics had been particularly weak. There would most likely be a leadership challenge, on the basis that Brexiteers would be able to deliver Brexit in the agreed timeframe, whatever the implications.

However, it is entirely possible that if there is "regime change" in the UK before 29 March then the new Government (regardless of which party they come from) may ask the EU to extend Article 50 to give them more time for negotiations. Given the EU does not want a "no deal" scenario, and the formation of a new Government in the UK might imply an eventual relationship that is closer than currently looks likely, the EU would probably accept this. If Article 50 was extended (e.g. by a year) then any Transition Period would also be extended, and therefore any change to the current trade relationship would be pushed back further.

Remain (??%)

There is a cross-party campaign underway to stop Brexit by holding a second referendum – a "People's Vote" on the final deal with an option to Remain. It seems likely that the Labour Party will agree at its upcoming conference to making a referendum on the final deal with the EU official policy, but it is not clear that "Remain" will be an option at the time of writing.

We assign no probability to Remain, as it would only be possible through "regime change" under one of the options already provided (Theresa May has explicitly ruled this out). It would also likely require an extension of Article 50 given the timescales involved.

Although markets may be supportive, a second referendum that resulted in the UK remaining in the EU introduces risks of its own, particularly the perceived implications for democracy if the result of the first referendum is not honoured. This is a low probability event both because of the low likelihood of a second referendum taking place, and also the fact it is also unclear that it would yield a different result. Although polls in 2018 have suggested a consistent, small majority for Remain, this is not large enough to have any real predictive power given the uncertainty of how the (repeat) referendum campaign would unfold in practice.

The extent and severity of the impact of Brexit-related political risk for UK pension scheme will obviously depend on which scenario ultimately plays out in practice, as well as the scheme's investment strategy, funding position and, most importantly of all, sponsor covenant. But whatever the outcome is, things will not remain the same – the economy will be affected, sterling, gilt yields and UK equity prices will move. Any sponsor which has direct or indirect linkages with EU countries will be affected in some way.

BREXIT MEANS…CORBYN?

Any of the scenarios discussed above could result in the collapse of the current government, at any time between now and the end of March. While this is a political risk in itself given the potential for it to jeopardise the overall Brexit timetable (and, say, make a "Carney's Carnage" scenario more likely), the consequences also depend on who steps into the void:

Boris Johnson / Jacob Rees-Mogg – This would make a no deal scenario of some variety highly likely, with the associated economic implications.

Phillip Hammond / Amber Rudd – If Remain backing Tories are able to win the support of Parliament for a "soft" Brexit (e.g. EEA), or even a second referendum (neither of which are consistent with the policy of the May Government), this could mitigate most of the negative economic outcomes from Brexit.

Jeremy Corbyn – An immediate election that resulted in a victory for Corbyn and Labour would, regardless of the circumstances, introduce a different set of risks over the resulting Parliament and beyond. In addition, given Corbyn's historical distrust for the EU, it is unclear to what extent if any the probable outcomes would be affected (although the Parliamentary Labour Party would seek to use their influence to guide towards the EEA or a second referendum).

The fact that Corbyn managed to successfully overcome the attempted coup by Owen Smith and Labour moderates in 2016 has faded in the minds of political commentators. But the implications are profound. For the foreseeable future, the battle for the heart of the Labour Party has been won by a faction that would have been considered as Far-Left extremists during the New Labour period.

The UK therefore faces the very real prospect of a genuinely socialist Labour Government taking power for the first time since 1945. It is unclear to what extent the checks and balances built into the UK political system would act to moderate the legislative agenda of a Corbyn Government, but even the Shadow Chancellor John McDonnell has been forthright about what Labour would expect the immediate market impact to be: the flight of capital from the UK and a run on sterling.

Clearly, any immediate rise in corporate or personal taxation would hurt the competitiveness of the UK economy at a time when the strength of London as a financial centre remains a bulwark against some of the negative impact of Brexit. The impact of a move to re-nationalise certain industries such as rail and water would clearly be less immediate, although it would increase direct and indirect covenant risk to many UK schemes.

More broadly, given the disarray in the Conservative Party if the current government collapses, and the fact they will would be forced to "own" any Brexit related upheaval, any election victory for Labour could result in a lengthy tenure (first by Corbyn and then a far left successor given the power of Momentum) which would have the potential to fundamentally change the nature of the economic and political direction of the UK, in the opposite direction to the Thatcher government in the 1980s.

THE ELEPHANT IN THE SITUATION ROOM

Donald Trump was not a conventional candidate and he is not a conventional President. But the mistake many commentators have made is to muddle up their views on the personal morality and unpredictability of the President, with the actual impact of the policies he champions, and has in some cases implemented.

Trump has courted controversy with his rhetoric on issues such as immigration, international relations and Islam, and many have argued his presence in the White House has damaged the office of President and America's standing in the world. But these issues are cultural not economic, and do not pose the same risks to investors as they do to the neo-liberal institutions of the free press. Indeed, with regard to issues of taxation and regulation, Trump has followed a traditional Republican pro-business agenda, which has almost unarguably helped to support the US equity market and risk assets more broadly.

However, from an economic perspective it has been argued by many that the fiscal stimulus (tax cuts) package came at precisely the wrong point in the economic cycle, and will only increase the severity of the inevitable recession that will come at the end of this period of economic expansion. In addition, one area where there has been understandable concern around Trump's agenda is on trade, and in particular, the actions he has taken based on his view that international trade is a zero sum game, and a large trade deficit (e.g. with China or the European Union) means that America is "losing" from the relationship.

Trump, with his slogan of "America First", has been consistent in his disdain for multi-lateral trade deals, calling NAFTA the "worst trade deal ever" and withdrawing from the Trans-Pacific Partnership. Part of his attraction as a candidate to those in the "rust belt" states that were critical to his election was the fact he sought to defend those who had lost their jobs as a result of the march of globalisation.

Despite Trump being Trump, many conservatives have been surprised by the extent to which he has been willing to use tariffs to provoke America's trade partners into taking action to correct the imbalances he believes to exist, hurting the economic interests of all involved. In 2018, Trump has slapped tariffs on billions of dollars' of goods from China, the EU, Canada and Mexico (who have largely responded in kind). It may be this is purely presentational, and he has gained some headlines from apparent "wins" through paper concessions and the desire to move to a "fairer" relationship (e.g. from Jean-Claude Juncker), but he does truly appear to believe that America is treated deeply unfairly by its trading partners. While Trump has a point about intellectual property theft, his central complaint that the US's large trade deficit is evidence that China is taking advantage of the US is false. A country's current account deficit/surplus is the result of a country's savings and investment imbalance and is not due to tariffs or other impediments to trade. China's overall current account surplus has come down sharply over recent years, and some expect China to be in overall balance in a few years.

The probability of an all-out trade war (e.g. punitive tariffs on 100% of goods traded between America and China) is difficult to assess, but clearly this would have a negative impact on the world economy. It may already be weighing on emerging market countries that have benefited from trade liberalisation. One defence against a full trade war is that no-one around the President appears to believe it would be good for the American people; although he can act unilaterally at times, he does rely on the input of those around him with more technical expertise. In addition, the negative impact of tariffs being implemented (e.g. on consumer goods such as iPhones) would be felt by American consumers swiftly, which would likely hurt public support for his policies and lower his approval ratings further.

Of course, the key issue is whether Trump will serve his full term. It is not a great position to be in for a President when reputable news sources are genuinely debating whether he has the ability to pardon himself, and whether he is therefore “above the law”. Unfortunately for Trump, while the founding fathers were very keen to ensure independence of the Executive from the Legislature, there are built in checks and balances that mean there is a chance he is removed as President.

The on-going special counsel investigation headed by Robert Mueller on potential Russian interference in the 2016 election has taken some interesting turns, but none more intriguing than the indictment of Trump’s former lawyer Michael Cohen for charges related to the payment of “hush money” to women with whom Trump allegedly had affairs. If it is proven that these payments were made at the direction of Trump, there is precedent to suggest this can be interpreted as an illegal campaign payment which would be a violation of federal law. Such lawbreaking – compared with, say, committing murder or treason – may not be sufficient to warrant impeachment or removal, but could cause a constitutional crisis (Trump, unlike Nixon, is unlikely to “jump” before he is “pushed”).

In terms of the mechanics, impeachment of a sitting President requires a simple majority in the House of Representatives but a two-thirds majority in the Senate. While the Republicans currently hold the House, it is widely expected that they could lose control in the mid-term elections in November, and if this occurs such impeachment proceedings are virtually guaranteed to be bought to the House at some point. While it still seems very unlikely that enough Republicans would turn against Trump for a two-thirds majority in the Senate, the scenario where Trump is held responsible for losses in the mid-term elections and an escalating trade war begins to affect the economy is not implausible. The recent “Op-Ed” scandal, where it is alleged that a member of the cabinet wrote an anonymous article for the New York Times suggesting that discussions were being held regarding invoking the 25th Amendment to the Constitution, under which Trump would be deemed “unfit to serve”, might be appealing both to Mr Pence and the Cabinet at times, but it would undoubtedly spark a political and constitutional crisis. One could also imagine mass protests from Mr Trump’s base.

While the future of the President is of interest to many, it is not clear what the economic or market impact might be. Mike Pence is ultra-conservative on social and most economic issues, but his congressional track record suggests he is in favour of free trade. So, with Trump gone, would the prospect of a trade war evaporate? Or, would Pence continue with Trump’s policies to secure Trump’s core vote, in order to propel him into a second term?

The real political risk of the Trump presidency is that the US continues down the path of isolationism, which is what “America First” is really about. History teaches us that American politics lurches between isolationism and globalism on multi-decadal cycles. It would be ironic if China became the champion of multilateralism and free trade, but this is a possibility if “Trumpism” persists after Trump, as Reaganism long-outlived the former president.

For UK pension schemes, the risk of escalating trade wars is why the Trump saga is relevant. The shift to America First likely scuppers the hope of beneficial trade deals with the US, or other countries, after Brexit. As the Economist magazine has frequently pointed in various articles over the course of 2018, by bending the rules of the WTO (i.e. invoking “national security”), rejecting multilateralism, and ranting against all the institutions that have underpinned the Washington Consensus and neo-liberalism, Trump might leave an economic legacy which will be felt for decades after he is gone. Pence, if he follows his long held beliefs, could avert this outcome.

WHAT CAN WE DO?

Whatever unfolds over the remainder of 2018 and beyond, the key point about political risk is that “big things” lie ahead. Just as politics in the UK and Europe have been changed by Brexit, and the surge in support for so-called “populist” movements, the Trump presidency has changed politics in the birthplace of the Washington Consensus and neo-liberalism. It might not be too late for this trend to reverse, but such a reversal needs to happen soon. Momentum in political thinking is a powerful thing, irrespective of whether the “elites” think it is sensible or not.

In a world of rising tariffs, other beggar-thy-neighbour policies, more restrictive immigration and unilateralism, we all get poorer. This is not speculation: history teaches us that trade and free movement of resources produces stronger growth, and rising wealth. The reverse does the opposite. More importantly, in a global financial system more complex than it has ever been, policies which restrict economic flows will ultimately have profound and potentially rapid effects on financial flows. This has not happened yet; but then neither has Brexit or a full-blown trade war.

Many Trustees and sponsors dedicated time in 2016 to considering the potential impact of Brexit and the US election on funding and investment strategy, both before and after the events took place. However, the fact is that in 2016 we could only guess at what would happen, whereas now we have a clearer view of the potential outcomes and their implications, make this more urgent. “Contingency plans” may need to become “actions” in the short-term, let alone the medium term.

At a minimum, we would recommend that Trustees seek to undertake or revisit scenario analysis and stress testing of their portfolios, in light of the most up to date information. This is especially relevant for those running material market risk (e.g. with large equity portfolios), or with particular concentrations to the UK and US markets.

Perhaps more importantly, we recommend that Trustees consider the viability of their sponsor covenant under different scenarios, particularly for schemes where there could possibly be a high correlation between demands on the covenant (i.e. risks of higher deficits) and weakness of the sponsoring employer. It is likely that most sponsors are already undertaking detailed assessments of the impact of Brexit on their business and making contingency plans. Trustees should be seeking access to such assessments and plans. Failing that, the analysis which has been produced on the Brexit impact on different sectors is publicly available, and the (somewhat rudimentary) papers on the impact and potential mitigations under a “no deal” scenario are currently being issued by the government.

Important Notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualised investment advice.

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For the most recent approved ratings of an investment strategy, and a fuller explanation of their meanings, refer to your Mercer representative and/or for MercerInsight subscribers, see www.mercerinsight.com, as appropriate.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest