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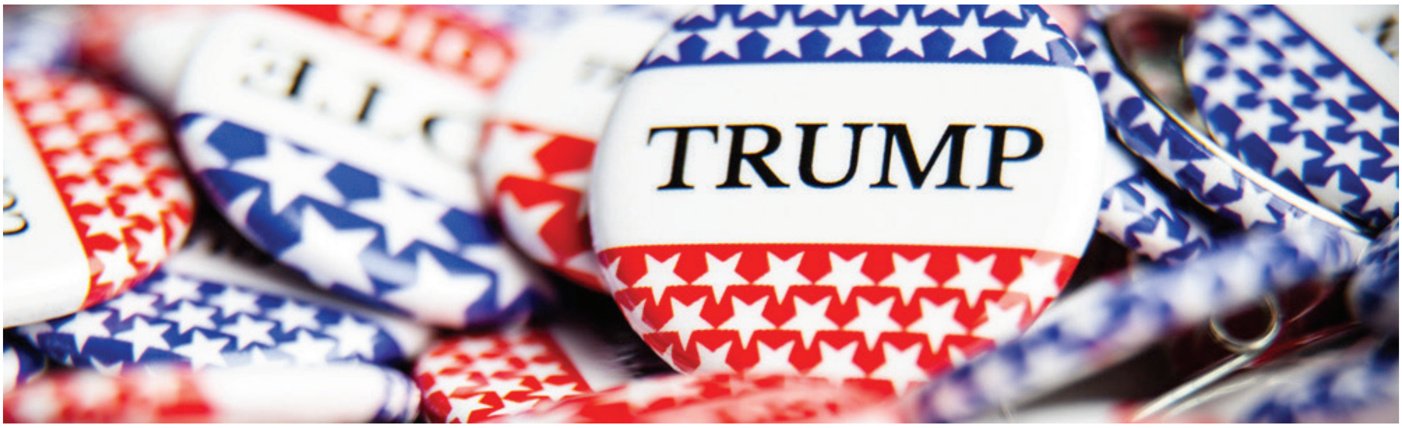

9 November 2016

Investing when populism trumps policy

Once again, markets and pollsters have been caught out by a major shift in the direction of popular opinion. Initially regarded as a joke, the election of Donald Trump as the 45th president of the United States of America, has become a reality. Trump has proved to be enormously successful in rallying undecided and recalcitrant Republicans. Against this, Hillary Clinton has failed to secure the same level of support as president Barack Obama did, with many voters concerned about her past. Despite Trump's gaffes and 'non-politically correct' utterances, the Americans have chosen, via their electoral college system, the radical and untested promises of his presidency over more of the same from the Democrats.

This unexpected outcome has triggered a knee-jerk reaction in the markets. Huge uncertainty is driving markets into a 'risk-off' mode. Trump has not campaigned on a firm set of realistic policies; his campaign focused instead on winning over the 'missing middle', those voters who feel ignored by the incumbents in Washington. 'Make America Great Again' is a wonderful slogan that has resonated strongly with the population, but is not easily translatable into real actions. A perfectly political outcome.

Many of Trump's more outrageous pledges, like building a wall across the 2 000 mile (3 200 km) southern border with Mexico, deporting illegal immigrants en masse and screening/profiling specific racial and cultural groups, are either impossible to implement from a practical perspective or illegal under the US constitution or international laws. Similarly, international trade agreements cannot be torn up unilaterally, and any attempt to do so would result in significant global censure and potential trade wars. It is important to bear in mind that the US is a mature democracy with a system of government that is far bigger than one individual. The US Congress and Senate are made up of directly-elected officials who are experienced career politicians and answerable to their constituents whose views vary across the country. Additionally, the Republican establishment is generally considered to be pro-business, versus the more interventionist and regulation-prone Democrats. The previous Bush presidency introduced many policies that were friendly to businesses and investors. In truth, the market reaction would have been very different if any other Republican candidate were elected. We believe the US political system will prove to be more robust and functional than investors are currently fearing.

It is also worth noting that with the Republicans having retained control of both Houses of Congress, the US has the same party in charge of the main spheres of government for the first time since the first two years of Obama's first term as president (2008 - 2010). With Republicans generally doing well in mid-term elections given the weaker turnout among Democrat voters, there is a reasonable prospect of four years of undivided government (the next mid-terms are in 2018). Given how much gridlock there has been in Washington over the last six years, there is a reasonable chance of major reforms being enacted under this Republican administration. This would not have happened during a Clinton presidency, who would have almost certainly faced pushback in Congress on any major policy proposals.

As the second major poll (after Brexit) falls the way of the populist vote, it does raise the risk of similar outcomes across Europe. Populist outcomes are now more likely in the Italian referendum on a constitutional overhaul in December and elections in France and Germany next year. The stakes are even higher, given the lack of political union in Europe and the risk this holds for the European currency union (euro). The break-up of the European Union would be a very high-risk event, with major implications for investments. The key takeaway from the rise of populism is general unhappiness with fiscal restraint (austerity) and the likelihood that some form of greater fiscal expansion needs to take place. This will have a significant impact on a number of asset classes.

So, what will a Trump presidency mean for our investment outlook?

Impact on our South African portfolios

We take great care to construct diversified portfolios that reduce specific risk. Our focus is on the long-term valuations of investments, not the outcome of closely-run polls that are impossible to forecast. Accordingly, nothing has changed following the US election. We remain invested mainly in equities and property, which we believe can deliver inflation-beating returns over time. We are still very underweight local and global government bonds as government debt levels are high and yields unattractive. Again, a Trump presidency will not change this outlook. In fact, the most likely shift in policy is towards more fiscal expansion (to appease voters), which will be positive for equities and negative for bonds.

We don't believe the holdings in our South African portfolios are directly impacted by the outcome of the US elections. As a small open economy, South Africa will, however, be affected by the direction of global growth and how this will eventually be influenced by US trade policies. It is too early to identify if there will be significant changes that would impact here. The global holdings in our SA portfolios are broad and diversified. While some companies are listed in the US, a large part of their earnings are typically earned abroad. We do not expect any material impact on their valuations under the new administration.

Impact on our Emerging Markets strategy

As with all our strategies, the Coronation Global Emerging Markets strategy was not positioned for or against any particular outcome in the US presidential election. We expect the immediate impact of Trump's victory to be negative due to the short-term market reaction. Over the longer term, however, we expect the impact of this event to be limited in our portfolios both in absolute terms and relative to the benchmark based on current exposures. The strategy has very little exposure to Mexico (1.3%), a result of our view that valuations in Mexico are simply too high. Mexico is likely to be the most negatively impacted by a Trump presidency given his hostility to free trade, and the North American Free Trade Agreement in particular. Our exposure to the Indian IT services providers TCS and Cognizant (in total, 3.5% of portfolio) may be impacted. An anti-trade, anti-immigration Trump administration would likely curtail the offshoring industry due to the business model of outsourcing work to India and other low-cost labour destinations.

It is important to note that the vast majority of the strategy is made up of domestically-focused businesses, which offer attractive valuations, across the various emerging markets.

Domestically-focused businesses by their nature are less exposed to global political developments. Our portfolios have little exposure to export-oriented businesses that are likely to be negatively affected by new trade barriers. The developed market exposure of the strategy (20%) is spread across a variety of mainly defensive global businesses, with at least 40% exposure to emerging markets, in the brewing, FMCG, tobacco, athletic wear and other industries. We expect the long-term impact of the election result on these stocks to also be limited.

The current developments offer an opportunity for investors to take stock of the perceived risk of emerging markets relative to developed markets. While the perception is that emerging markets are risky, unpredictable places to invest, it is now clear that political risk in developed markets has, to date, been underpriced by market participants. With Brexit and the Trump election victory followed by critical elections in France and Germany in the next two years, it is hard to rule out further surprises that may puncture the perceived safe haven status of developed markets.

Impact on our Global Equity strategy

The strategy is overweight the US region as a whole, which may have a negative impact in the short term. Given the uncertainty around Trump's economic policy and the potential for increased political isolationism, certain US cyclical counters (such as Tempur-Sealy and Harley-Davidson) may bear the brunt of negative sentiment. In addition, as indicated above, outsourcing companies (such as Cognizant and TCS) may come under pressure.

Some of our holdings may benefit from a Trump presidency, particularly in the pharmaceutical sector. We have been increasing our holdings in the sector amid negativity about an expected regulatory clampdown under the presumed Democratic presidency. A lighter-touch Republican regime should be positive for the sector.

We are also underweight banking stocks. This sector may come under pressure given expectations that a US interest rate hike will be pushed out.

Lastly, given our focus on managing downside risk in our portfolios, we hedged against the risk of an election upset by buying short-term protection. The impact on our portfolios was therefore mitigated.

Conclusion

As you may know, we like to emphasise our long-term investment outlook. The events over the past few days confirm why this is important. Markets rallied hard earlier this week on expectations of a Clinton win and are now selling off on the reality of a Trump presidency. Lots of market activity means lots of transaction costs, but in truth, the underlying long-term valuations of the majority of companies **have not changed materially**. In the past two decades, we have experienced incredible shocks in the US that have reverberated around the world. The terrorist attacks of 9/11, the Dotcom bubble which burst spectacularly in the early 2000s, and the 2008 global financial crisis (precipitated by a housing market crash). The election of a populist Republican president over a Democrat is not anywhere near the scale of any of these previous events. While the election has been divisive, one should not forget that the US has been a two-party state for over a century.

Politics have often been described as the art of the possible, implying that it is not about what is right or what is best. It is about what you can actually get done. This is the essence of realpolitik, a political philosophy that prizes pragmatism over ideological goals.

In valuing long-term assets, fundamentals trump rhetoric every time.

Should you have any queries, please feel free to contact your fund manager.

Kind regards

Kirshni

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