Political Risk, Portfolios, and Perspective

Key Takeaways

» Financial markets may be complacent in the face of accumulating political risks.

» Nevertheless, investors should avoid trying to predict political outcomes around the world.

What It May Mean for Investors

» Instead of trying to predict events, we recommend some concrete steps that may help to blunt a portfolio’s vulnerability to political risks of any type and timing.

Political risk broadly is the uncertainty that comes from trying to predict political decisions. When the decisions potentially affect multiple countries, the risks become geopolitical. In general, political uncertainties are not always negative, nor always from overseas. They do seem to concentrate around common themes of historical regional rivalries, diplomatic isolation and, more recently, a pervasive problem of slow personal income growth. This week’s cover story offers some perspective on political risk and suggests some specific steps that could help to mitigate or manage effectively a portfolio’s potential exposure to negative political surprises.

Perspectives on Political Risk and Markets

Financial markets were sensitive to political risk early in 2017 (U.S. health care reform uncertainty, tax reform proposals that are slow to develop, a U.S. bombing raid in Syria, and North Korean nuclear tests are but a few examples), but seem more sanguine at midyear. After all, the global economy is improving, interest rates remain low, and credit is widely available. What’s more, the historical impact of most geopolitical risks has been short-lived and modest. For example, aside from the terrible loss of human life from the September 11 attacks, the lost economic activity and physical damage totaled $178 billion, or just under 0.2 percent of U.S. 2001 economic output.¹

And some of the risks evolve slowly. Geography and cultural differences can create persistent political fault lines across centuries. Geography forces large countries with long, unfriendly borders (e.g., Russia and China) to work hard to maintain secure borders. The leadership competition in the Middle East is another age-old theme, dating back at least as far as the Egyptian dynasties. More recently this has been fueled

¹ Rose, Adam Z., “Advances in Economic Consequence Analysis of Terrorism Events” (2009), paper 33. Homeland Security Center at the Univ. of Southern California.
by oil revenue and by Turkey’s rediscovery of its Middle Eastern roots, which resulted in a more religiously conservative outlook that helped precipitate the military coup last summer.

Other risks seem more worrisome. One example is the current North Korean situation regarding nuclear weapons that have the possibility of reaching North America. Pyongyang’s main ally (China) and adversary (the U.S.) want to roll back the threat, and we are watching for a plan that ends the danger and preserves regional stability.

Globally, another risk is the social disillusionment from globalization and the practice of free trade, whose benefits have not been shared equally among Western democracies. If populist policies shrink trade, the West may see lower living standards and investment returns.

Unfortunately, trying to predict such low-probability, high-impact events usually encourages two, often sequential mistakes. First, when probabilities are low, people tend to underestimate them. Before the September 11 attacks, the risk that someone would fly an airliner into a skyscraper seemed remote, for instance. Then, once the event occurs, people tend to overestimate its likelihood of repeating. Thus, after September 11, Americans canceled plane trips and jumped into their cars. There were no terrorist attacks in 2002, but the number of traffic fatalities increased.²

Six Ways Investors Can Help Manage Political Risk in Their Portfolios

Rather than trying to predict which (and when) political risks may materialize, investors may more effectively aim to blunt their overall vulnerability to negative political events. A number of specific steps may help:

1. Create an investment plan and stick to it: Before thinking about hedging political risk, among others, we believe investors should prioritize among key financial goals—capital preservation, growing principal over inflation, and generating income—taking into account their time horizon to achieve their goals, which will affect their risk appetite. Following a long-term investment plan based on investment goals, time horizon and risk tolerance can help reduce the temptation to make emotionally-based investment decisions regarding political outcomes including selling on declines and potentially missing positive market moves.

2. Focus on quality: “Quality” is a subjective term but, in our view, it includes investing in companies whose securities, such as stocks and bonds are considered liquid (meaning they are easily sold in the marketplace), and whose balance sheets show no more than moderate debt. In non-investment-grade credit, we advise exposures below long-term target levels.

3. Diversify broadly: Diversification may benefit a portfolio, whether the political risks are positive or negative, and whether these risks are domestic or foreign in nature. For instance, international positions can support overall returns even if potential U.S. tax reform and infrastructure plans disappoint markets. Additionally, investors can consider real assets, such as real estate, given their potential hedging characteristics—especially in times of turbulent financial markets. We have recommended holding above-target allocations to public real estate since January 2017.

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4. **Invest for economic growth:** Our basic outlook is for U.S. and international economic improvement. We expect U.S. cyclical equity sectors to benefit the most from our outlook, and the rebounding global economy potentially creates a chance to take international positions toward long-term target allocations.

5. **Rebalance:** Rebalancing periodically, taking profits and reallocation into areas with greater upside potential. This process can preserve target risk levels and promote regular “buying low and selling high.” Generally, the time to rebalance is while profitable positions are still outperforming. Although the S&P 500 Index has enjoyed an eight-year outperformance against many asset classes, and we recommend, where appropriate, that investors rebalance from equities into public real estate, and restore long-term target allocations in fixed income and international equities.

6. **Make “cash” exposure fit your overall plan:** Investors whose cash-alternative exposure persistently limits other allocations run the risk that even today’s modest inflation will undermine their plan for meeting future spending needs. A disciplined plan to put these allocations to work at regular intervals should foster more frequent conversations with investment professionals and reviews of new opportunities that may arise.
**The Case for Cyclical Sectors—Even as Rates Rise**

As investors have registered some concern over the U.S. economy’s growth rate, and the S&P 500 Index has risen by only three percentage points over the past three months, cyclical issues have continued their outperformance in the second quarter and the last year (through June 30). This outperformance should not be surprising, given the continuing improvement in leading economic indicators. U.S. inflation has remained more tepid than one might expect, energy prices have retrenched a bit, and the Federal Reserve (Fed) has been slow to tighten.

Over the last year, the top six S&P 500 Index sector returns have been registered by the Financials, Information Technology, Industrials, Materials, Consumer Discretionary, and Health Care sectors. We believe these sectors of the U.S. large-cap market should be beneficiaries of an increase in domestic and international growth next year.

In the chart below, we have plotted cyclical versus defensive market sectors (in blue). This line shows the one-year percentage change of deeply cyclical market segments in excess of less cyclically-sensitive segments. We also have plotted the percentage change in the 10-year Treasury note yield (in green). Although the correlation between changes in the 10-year Treasury note yield and our cyclical index was only 0.43 back to September 1987, that correlation rose to 0.63 from the start of this recovery, and 0.81 since early 2014. During the 12 months ending on June 30, 2017, the 10-year Treasury yield rose by almost 60 percent (but from a very low base), and we believe that a relatively high correlation between these measures will remain into 2018 as cyclicals continue outperforming while rates move higher

**Key Takeaways**

» Cyclical sectors were the top performers in the last year (as earnings recovered).

» We expect cyclical sectors to continue to outperform defensive sectors into 2018.

**Cyclical/Defensive Index versus 10-Year Treasury Note Yield**

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3 Keep in mind correlation measures the degree to which asset classes or investments move in sync. It does not measure the magnitude of that movement. Although the information above is compelling, you should remember that past performance is not a guarantee of future results or that historically low or non-correlation will be the same in the future.

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Sources: Thomson Reuters, FactSet, Bloomberg, Wells Fargo Investment Institute, 7/6/17. Cyclical/Defensive index is composed of the following indexes: S&P Information Technology Sector Index, S&P Industrial Sector Index, S&P Consumer Discretionary Index, S&P Utility Sector Index and S&P Consumer Staple Sector Index. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. Yields fluctuate as market conditions change. The current 10-Year Treasury Note yield may be higher or lower than that quoted above.
Worried About Higher Rates? Don’t Sell Bonds.

We recently increased our interest-rate outlook for 2017. Our new year-end 2017 10-year Treasury target yield range of 2.25-2.75 percent suggests that we expect longer-term rates to rise modestly by the end of this year.

If interest rates appear ready to increase even modestly, should investors sell their bonds? With the potential for negative price returns, investors may be considering significantly reducing fixed-income allocations, or eliminating them entirely. There are several factors to consider before making such a move. First, we strongly recommend that investors consider the total-return picture, which includes both interest income and price returns. In our view, this is the most accurate measure of fixed-income performance. We believe that, over the next several years, an investor should anticipate a very low average annual total return (price return and interest income) that is likely to be below the longer-term, historical average fixed income return of 4.3 percent. This low anticipated level of return may outpace the returns of cash-alternative allocations. Investors who neglect interest income and consider only price movement are missing half the picture.

In addition to income generation, fixed-income positions can offer a number of other positive attributes:

- **Diversification:** The future is often uncertain. Taking too large a bet on any one particular outcome can increase investment risk significantly. Investment strategies based on concentrated allocations generally incur much higher risk.

- **Reduced volatility:** One of the primary reasons to continue to own high quality fixed-income investments, even if interest rates increase, is the lower volatility these investments have typically offered when compared to stocks.

- **Liquidity:** Bonds have a maturity date at which principal is returned to the investors if the issuer has not defaulted.

**Key Takeaways**

- Investors should consider total return, not just price movement, when deciding whether to hold bonds.

- Fixed-income positions typically bring a number of attributes to a portfolio beyond return, including diversification, reduced volatility and liquidity.

- We expect a high-quality fixed-income portfolio to produce very low single digit returns over the next several years—which we believe should exceed returns on cash-equivalent allocations,
Platinum Looks Quite Interesting

Platinum is one of only a handful of precious metals (gold, silver, palladium, and a few others) that are supplied predominantly by two countries (Russia and South Africa), and bought largely by car and jewelry manufacturers. Precious metals are called that because of their rarity and because of their physical and chemical properties (high shine, heat and energy conductivity, durability, malleability, etc.). While not perfect substitutes for one another, they can be (and often are) swapped.

Prices between the precious metals do vary widely, but typically remain within certain (price) bands of each other. This is because, if one precious metal becomes excessively expensive versus the others, buyers will begin selecting a cheaper option. In 2017, platinum has become the cheaper option, especially versus gold and palladium.

Gold is considered the patriarch of the precious metals family—the metal to which all are eventually compared. Since 1979, gold prices have averaged a 20 percent discount to platinum. Today, the relationship has flipped to an extreme—gold is now trading at a 30 percent premium to platinum (Chart 1, bottom panel).

Palladium also is an important benchmark, because it is the main substitute for platinum in catalytic converters—the largest market for both platinum and palladium. Since 1979, platinum prices have averaged a 200 percent premium to palladium. Today, the platinum premium has shrunk to a paltry 10 percent. For investors interested in buying precious metals today, platinum is preferred.

Key Takeaways

» Platinum is looking exceedingly cheap, especially versus gold and palladium.
» For investors looking to buy precious metals, we prefer platinum today.

Gold versus Platinum

Sources: Bloomberg, Kitco, Wells Fargo Investment Institute. Monthly Data: 1/31/1979-6/30/2017. Data is shown in a log scale. Ratio is gold price divided by platinum price. Dates were selected to show the modern history of platinum prices compared to gold prices. Investing in precious metals is not suitable for all investors. Investing in gold, platinum or other precious metals exposes a portfolio to material risk considerations such as potentially severe price fluctuations over short periods of time and storage costs that exceed the custodial and/or brokerage costs associated with the portfolio’s other holdings. The value of precious metals is expressed and traded in U.S. dollars subjecting a portfolio to exchange rate risk. Products that concentrate their investments in the gold, platinum and other precious metal industries increase their vulnerability to international, economic, monetary and political developments affecting their industries.
Diversification as a Potential Hedge to Political Risks

Market timing is extremely difficult, if not impossible, and is not a practice that we recommend. Trend following, on the other hand, can be a valuable source of diversification and is the essence of many “Macro” strategies. Though many varieties exist, the main objective is to isolate trends in (and among) global asset classes. Examples would be taking positions that are long U.S. equities, short the U.S. dollar, or long German interest rates. Due to both long and short exposure across nearly all global assets, Macro strategies implicitly add diversification—and can improve portfolio efficiency over the long run.

Some investors are mistaken if they believe Macro strategies should be a hedge against political risks. So much depends on portfolio positioning at the point in time when a political risk escalates into a market correction (or worse). In other words, if equities are trending upward prior to a correction, there is a high likelihood that Macro strategies will be long equities and not be used to hedge equity risk. Fortunately, Macro strategies typically are the most nimble among the four main hedge fund strategies and can adjust quickly to changing market conditions. The chart below shows the rapidly changing correlation to global equities, which is just one example of Macro Strategies’ dynamic nature. (Correlation measures how two investments or indices move in relation to each other.)

Key Takeaways

» At their core, Macro strategies search for trends—either long or short—in nearly all global asset classes (equities, fixed income, currencies, commodities and credit).

» The potential benefit of an allocation to Macro Strategies may be its ability to improve portfolio-level diversification, which often can be the best way to navigate political risks over the long run.

Correlation between HFRI Macro (Total) Index and MSCI World Index

Sources: Hedge Fund Research, Bloomberg, July 2017. Index returns reflect general market results, do not reflect actual portfolio returns or the experience of any investor, nor do they reflect the impact of any fees, expenses or taxes applicable to an actual investment. Unlike most asset class indices, HFR Index returns reflect deduction for fees and expenses. An index is unmanaged and not available for direct investment. See disclosures for a definition of the indices.

4 Correlation does not measure the magnitude of the movement. Keep in mind, correlation represents past performance and past performance is no guarantee of future results. Although this information is compelling, there is no guarantee that future correlations between the indices will remain the same.
Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Stock markets, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Foreign investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Small- and mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks. Bonds are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. High yield (junk) bonds have lower credit ratings and are subject to greater risk of default and greater principal risk. The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. Real estate has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Correlation is a statistical measure that describes the degree of association between two asset classes. That is, it reflects the degree to which two asset classes move in the same direction.

HFRI Macro (Total) Index is composed of a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. Although some strategies employ Relative Value (RV) techniques, macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than realization of a valuation discrepancy between securities.

The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed market countries.

The S&P 500 Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

S&P Industrial Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrial sector.

The S&P Consumer Discretionary Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

S&P Utility Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

S&P Consumer Staple Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.

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