POLITICAL AND GEOPOLITICAL RISK

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Geopolitical risk is frequently cited as a risk investors are, rightly, concerned about. However, geo-political and political risk are two different concepts which are often used interchangeably, despite their very different meaning. So let's first look at political risk.

Political Risk

Political risk is a measure of the impact of political tensions on the domestic economy. For example, concerns that a UK general election which caused a change of government in the UK from Conservative to Labour might lead to the perception of increased political risk (or reduced, depending on your political leaning). Rating agencies take account of political risk when assigning credit ratings, so you would not, normally, expect to need to add a risk premium for a country with higher than average political risk.

For example, let us assume that if political risk were excluded, a country would be rated Aa2. Under those circumstances a bond issued by that country with a 10-year duration should have a spread of 48 basis points.

Table 1. USD Universe – Spread over Treasuries

USD Universe - Spread over Treasuries

for a given duration and credit rating

	1	2	3	4	5	6	7	8	9	10	15	20
Aaa	18	21	24	26	27	29	30	31	32	33	37	40
Aa1	22	26	29	31	33	35	36	38	39	40	44	48
Aa2	26	31	35	38	40	42	44	46	47	48	54	58
Aa3	32	38	42	46	49	51	53	55	57	59	65	70
A1	38	46	51	56	59	62	65	67	69	71	79	85
A2	47	56	62	67	71	75	78	81	84	86	96	103
A3	56	68	76	82	87	91	95	98	101	104	116	125
Baa1	68	82	92	99	105	110	115	119	123	126	141	152
Baa2	83	100	111	120	127	134	139	144	149	153	170	184
Baa3	100	121	135	145	154	162	169	175	180	185	206	223
Ba1	122	146	163	176	187	196	204	212	218	225	250	270
Ba2	148	177	198	213	226	238	248	257	265	272	303	327
Ba3	179	215	239	259	274	288	300	311	321	330	367	397
B1	217	261	290	313	332	349	364	377	389	400	445	481
B2	263	316	352	380	403	423	441	456	471	484	540	582
B3	318	383	426	460	488	512	534	553	571	587	654	706
Caa1	386	464	516	558	592	621	647	670	692	711	792	855

Source: Stratton Street Capital calculations as at 5th March 2018

If political risk were such that the country was instead rated A2, then the fair spread should be 86 basis points. Consequently, there should, theoretically, be no need to adjust the spread to take account of increased political risk.

In reality though, investors do seem to demand a higher risk premium for countries they perceive as having higher political risk. Nevertheless, this perception of higher risk does not translate to actual defaults.

Table 2. Sovereign Foreign-Currency Selective Defaults

Country	Selective default date	Emergence date	Time in selective default	Rating one year before selective default	Rating three years before selective default
Russia	Jan. 27, 1999	Dec. 8, 2000	22 months	BB-	-
Pakistan	Jan. 29, 1999	Dec. 21, 1999	11 months	B+	B+
Indonesia, first default	Mar. 30, 1999	Mar. 31, 1999	One day	B-	BBB
Indonesia, second default	Apr. 17, 2000	Oct. 2, 2000	Six months	CCC+	BBB
Argentina, first default	Nov. 6, 2001	Jun. 1, 2005	54 months	BB	BB
Indonesia, third default	Apr. 23, 2002	Sep. 5, 2002	Four months	B-	CCC+
Paraguay	Feb. 13, 2003	Jul. 26, 2004	18 months	B	B
Uruguay	May. 16, 2003	Jun. 2, 2003	One month	BB-	BBB-
Grenada, first default	Dec. 30, 2004	Nov. 18, 2005	11 months	BB-	-
Venezuela	Jan. 18, 2005	Mar. 3, 2005	One month	B-	B
Dominican Republic	Feb. 1, 2005	Jun. 29, 2005	Five months	CCC	BB-
Belize, first default	Dec. 7, 2006	Feb. 20, 2007	Three months	CCC-	B+
Seychelles*	Aug. 7, 2008	-	-	B	-
Ecuador	Dec. 15, 2008	Jun. 15, 2009	Six months	B-	CCC+
Jamaica, first default	Jan. 14, 2010	Feb. 24, 2010	One month	B	B
Greece, first default	Feb. 27, 2012	May. 2, 2012	Three months	BB+	
Belize, second default	Aug. 21, 2012	Mar. 20, 2013	Seven months	B-	B
Grenada, second default	Oct. 8, 2012	Oct. 16, 2012	One week	B-	B-
Greece, second default	Dec. 5, 2012	Dec. 18, 2012	Two weeks	CCC	
Jamaica, second default	Feb. 12, 2013	Mar. 6, 2013	22 days	B-	SD
Grenada, third default	Mar. 12, 2013	-	-	B-	B-
Cyprus	Jun. 28, 2013	Jul. 3, 2013	Five days	CCC+	A+
Argentina, second default	Jul. 30, 2014	May 6, 2016	22 months	B-	B
Ukraine	Sep. 25, 2015	Oct. 19, 2015	One month	CCC	B+
Mozambique	Apr. 1, 2016	April 15, 2016	15 days	B	B+
Congo-Brazzaville	Aug. 2, 2016	Aug. 9, 2016	Seven days	B	B+

Note: Mali defaulted in 2012; we withdrew its rating in 2008. *The rating on Seychelles was withdrawn while it was still in default. Source: "Sovereign Rating And Country T&C Assessment Histories," RatingsDirect.

Source: Standard & Poors

The table above shows that no country rated investment grade defaulted within 12 months and only Indonesia defaulted within three years having been originally rated investment grade. In the case of Indonesia, although S&P rated the country as investment grade 3 years before the subsequent default (i.e. in 1996) at the time Indonesia was highly indebted and rated only 2 stars using Stratton Street's NFA model, based on NFA calculations by Lane & Ferretti. By the time Indonesia defaulted Indonesia's

Net Foreign Liabilities had reached 101% of GDP. This example highlights the need to consider the extent of indebtedness and not just rely on credit ratings.

In fact, according to our calculations, no country with positive net foreign assets has ever defaulted.

Table 3. Sovereign Defaults 1998 – 2012

Country	Default	NFA	Country	Default	NFA
Argentina	Nov-01	-39%	Nicaragua	Jun-08	-106%
Belize	Sep-12	-144%	Nicaragua	Jul-03	-197%
Belize	Dec-06	-111%	Pakistan	Jul-99	-47%
Cameroon	Jan-04	-48%	Peru	Sep-00	-58%
Cote d'Ivoire	Mar-00	-126%	Turkey	Aug-99	-35%
Cote d'Ivoire	Jan-11	-47%	Ukraine	Sep-98	-35%
Dominican Republic	Apr-05	-36%	Ukraine	Jan-00	-43%
Ecuador	Aug-99	-127%	Uruguay	May-03	-13%
Ecuador	Dec-08	-45%	Venezuela	Jul-98	-22%
Greece	Mar-12	-156%	Grenada	Dec-04	-114%
Greece	Dec-12	-156%	Seychelles	Jul-08	-242%
Jamaica	Feb-10	-137%	St Kitts	Jun-11	-272%
Moldova	Jun-02	-93%			

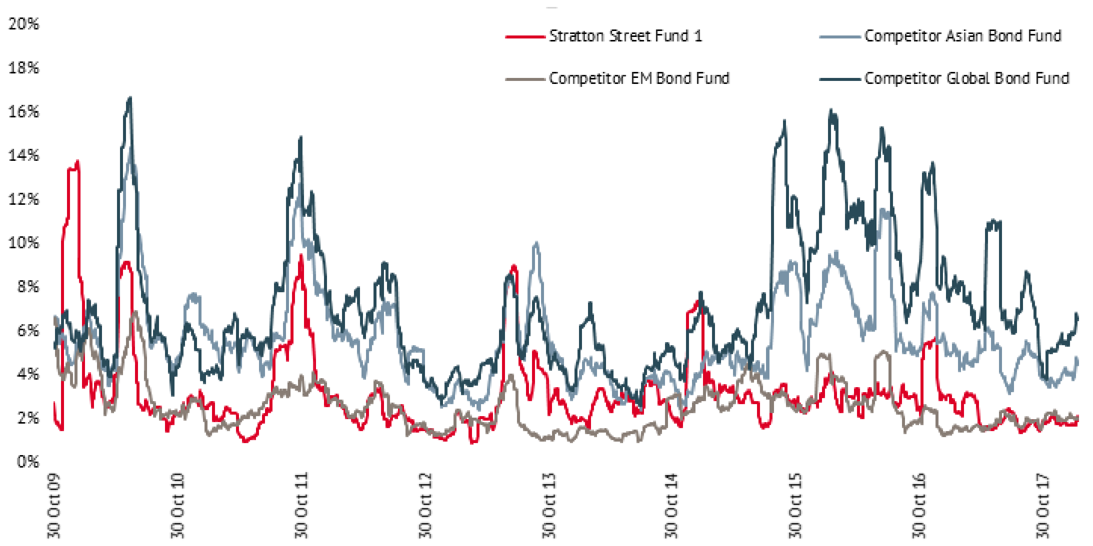
Source: Lane & Ferretti, Stratton Street calculations

Geopolitical risks are much more difficult to measure. Unlike political risk, increased geopolitical risks affect third countries. For example, US trade tariffs could affect a wide range of countries and whilst the US is at the epicentre the impact will be felt around the globe and not just in the US. Consequently, we can't measure the impact by looking at US asset markets alone.

Similarly, increased geopolitical tensions in the middle east may impact countries in the region, but are equally likely to affect countries in other parts of the world. Consequently, geopolitical risks embedded in a portfolio cannot be measured directly and can only be assessed relative to something else.

In order to try and assess the impact of heightened geopolitical concerns, we have plotted the rolling 30-day volatility of one of our funds versus three competitor funds, selected simply because their range of funds is very well known. If our country exposure led to increased volatility during periods of heightened geopolitical tensions, then we should see this manifest itself in higher volatility in the short term. This is not what is observed in the following chart.

Chart 1. Rolling 30 Day Volatility vs competitor Funds



Source: Bloomberg

The conclusion we draw is that country allocation alone does not lead to an increased vulnerability to geopolitical shocks. Instead, we argue that portfolios with low credit quality are more likely to be exposed during periods of heightened geopolitical risk as these countries have less economic flexibility to cope with adverse shocks. Holding a portfolio of high quality bonds each of which is independently undervalued is the best way, in our opinion, to diversify away the risk of increased geopolitical tensions.

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