Market Crises – People and Politics

By Quintin Rayer | August 16, 2018

Despite regular periods of falling prices in markets, advisers often seem to focus on the upside, with relatively little thought towards spotting the next crisis.

This is the second of two articles exploring some of the reasons why market crises can develop. The previous focus was on secular trends [1], while this article examines the role of people and political forces. Political developments often affect markets, as events over the past few years have shown. Although unexpected outcomes may upset mainstream opinion, media coverage rapidly moves on, and adverse market events can be quickly forgotten.

2018 has seen rising bond yields following the US tightening and perceived inflationary pressures. Protectionist developments may have spooked investors and developments over recent years have shown how political events can impact markets (for example the UK's EU referendum and the 2016 US general election).

Market Crises

'Bull' or 'bear' markets can affect individual asset classes, or else be more widespread, although tending to refer to equities unless otherwise qualified. Declines are a source of great concern

for investors since a stock market crash can result in a drop of 25% or more in real equity values [2]. Markets can suffer from 'irrational exuberance' [3] as suggested by US Federal Reserve Board chairman Alan Greenspan during the dot-com bubble of the 1990s. Often appearing to be driven as much by sentiment as by economic reality.

Since market participants must attempt to anticipate investment opportunities ahead of competitors, markets are forward-looking. Thus, investors must make forecasts about economic and investment outcomes with incomplete information. This increases the likelihood of error and decisions coloured by human psychological and behavioural biases. The involvement of many market participants means a wide range of views are generated, and not all of these can be correct.

People and Politics

National economies are subject to external influences from foreign countries via trade, decisions made by their governments, and broader geopolitical events. Some nations may be 'serial defaulters' on their sovereign debt – tending to overborrow during good times, but then vulnerable during the inevitable downturns [4], [5].

Political pressures can tempt governments to treat unexpected surpluses as indicative of permanent developments, resulting in a spending and borrowing spree that eventually ends badly. Financial innovations can appear to make illiquid assets more accessible, permitting them to command higher values than before, such as during the US subprime mortgage crisis of 2007 [4].

The over-anticipation of future developments (both good and bad) seems to be an aspect of human nature, leading to inflated valuations. Fickle human confidence plays an important role [4]. People tend to prefer simple explanations, and prefer any reason rather than none – unfortunately, that does not mean such explanations are correct [5].

Financial sector leaders may believe that innovations have genuinely added value and underappreciate the risks their firms are taking. Alternatively, financial product providers may be responding to inappropriate incentives in less well-regulated areas. Almost all bubbles require some form of new technology or financial engineering.

Governments play an economic role in maintaining a balance between producers and consumers to assure fair market prices. However, other forces are also at work in politics, with constituencies attempting to influence governments either through money, polling or petitioning.

Governments respond to political influences both to silence critics and because these actions help them stay in power. Financial authorities can also respond to market events in an attempt to address current difficulties. However, these are likely to sow the seeds of future problems, such as quantitative easing [5].

The results can lead to financial bubbles, caused by governments creating artificial criteria to achieve political goals. Governments can exert their power over financial markets and on public thinking in ways that can set things up for a future disaster [6].

What to do?

These considerable uncertainties create challenges for portfolio management. Such risks are unlikely to be captured by conventional risk measures (such as volatility, or value-at-risk), but, stress-testing portfolios may help [7], [8], [9].

With support from wealth managers, advisers can explore issues associated with these risks and construct scenarios of possible outcomes that attempt to quantify asset movements. If test results affect portfolios to an unacceptable degree, they can be restructured to make them more robust.

Given the difficulties of anticipating such crises, advisers should always be on the alert, particularly during quiet periods when everything seems to be sound and markets are generating consistent positive returns.

How this helps Advisers

Wealth managers and advisers should be attempting to judge the likelihood of market crises developing. By discussing these with clients, this should help ensure they have a more complete and realistic understanding of the risks their investments may entail and facilitate a better discussion around portfolio investment allocations. It will also be clear that advisers, in conjunctions with their wealth managers are actively working to protect the value of their clients' assets.

References

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