

# Part 2: How Should Investors Think about Political Risk?

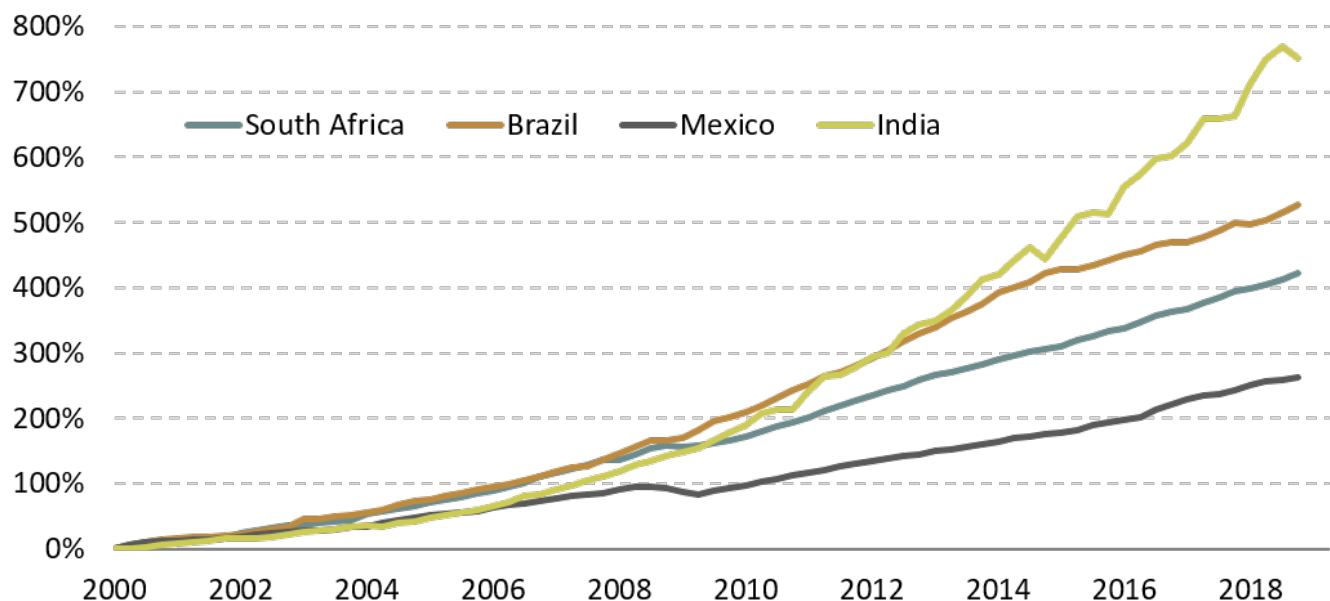
Reina Berlien |

- ▣ We continue our political analysis which leverages economic indicators to identify important structural shifts in emerging market countries.
- ▣ Although household consumption has steadily risen, the change in nominal wages suggests that deeper issues like income inequality may spark changes in political sentiment.
- ▣ The public's perception of governance and corruption should also be factored into this analysis, as economic data may betray sentiment.

The economies of Brazil, India, Mexico, and South Africa have undergone an important structural shift since the 1990s, where private consumption has overtaken government spending and exports as the main contributor of GDP. On the surface, consumption remains intact in [Chart 1](#):

## Chart 1: GDP: Household Consumption

As of 12/31/2018

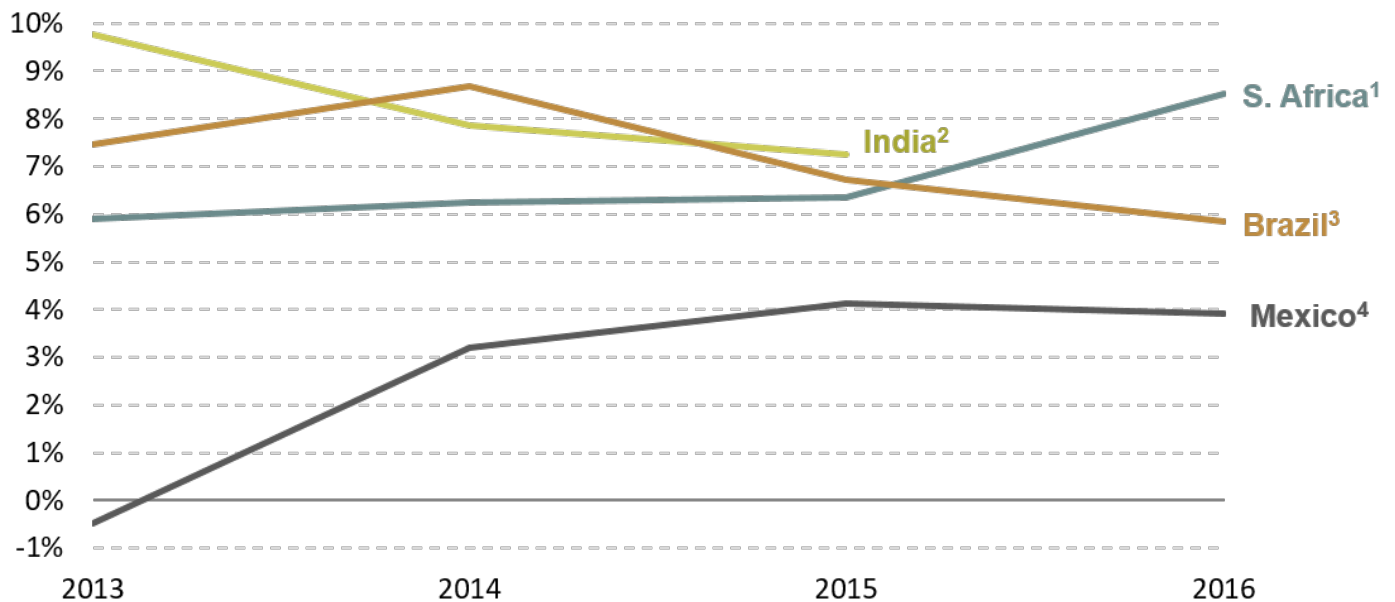


Source: Haver Analytics

While consumption might be increasing over time, what's of paramount importance is whether the average person is getting his/her "fair share" of that economic pie. Looking at the percentage increase of nominal wages year over year in [Chart 2](#) doesn't paint a particularly sanguine outlook, even in South Africa, given the unemployment rate has stayed around 25% since the GFC and now stands at 27%.

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**Chart 2: Percent Change in Nominal Wages**



*Source: International Labor Organization, 1. Statistic South Africa, 2. Government of India Ministry of Statistics and Programme Implementation, 3. Brazilian Institute of Geography and Statistics (IBGE), 4. Mexico National Employment Service Job Portal*

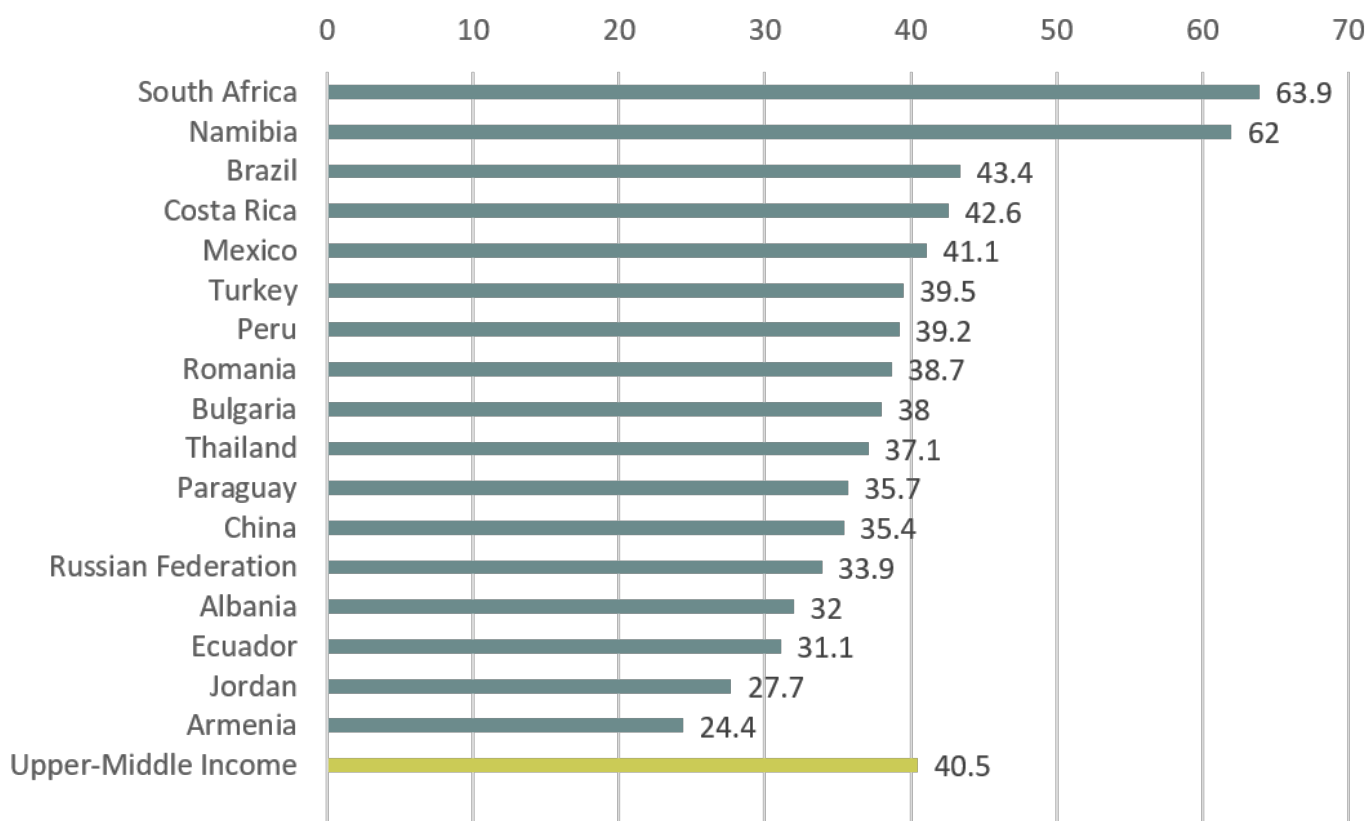
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## Sentiment Factors

Once wage inequality is factored into the analysis, investors could get a better sense of the latent discontent within the populace that may belie traditional economic indicators. These quantitative and qualitative factors may collectively signal when domestic conditions are primed for a shift toward populism. South Africa, Brazil, and Mexico all have higher incidents of wage inequality relative to the average for upper-middle income economies; India is noticeably absent from the International Labor Organization's study.

### Chart 3: Gini Estimates of Wage Inequality in Upper-Middle Income Countries

Hourly wages, Gini coefficient



Source: International Labor Organization

Evaluating the perceived level of corruption within a given country should also complement a review of income inequality. For example, the World Bank created a corruption index that estimates the effectiveness of governance on a scale from -2.5 (weak) to 2.5 (strong). The table below shows a significant deterioration in Brazil and Mexico over the last decade, while the perception in India weakened to a decade low shortly before Modi and the BJP won the election.

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**Table 1: Perceptions of Governance and Corruption**

Country	2008 Estimate	2013 Estimate	2017 Estimate
South Africa	0.21	-0.07	-0.01
India	-0.34	-0.52	-0.24
Brazil	0.01	-0.08	-0.53
Mexico	-0.24	-0.51	-0.93

Source: World Bank

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While these estimates are merely a gauge for sentiment, we can perhaps use them to anticipate a significant shift in political ideology that could price information risk into local assets.

## Conclusion

For investors looking to handicap a political outcome or simply understand a country's civic undercurrent, we suggest taking a comprehensive look at economic datapoints such as GDP growth and unemployment along with sentiment factors like perceived income inequality and corruption. Traditionally bond investors have focused on valuation models but more recently, political uncertainty has played an increasing role in short and longer-term volatility. Though our focus is on the long term, there is merit in trying to gauge the difference between short- and long-term spread widening resulting from political and geopolitical volatility. The recent election results in India highlight the importance of factoring sentiment indicators into an economic analysis, as domestic perceptions of corruption have improved while Indian GDP has undershot market expectations. Modi's landslide victory also raises the question of how long these cyclical shifts toward populism will last. Therefore, adept investors should leverage hard and soft indicators to anticipate or better understand these shifts and the potential changes in legislative representation and policymaking.

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