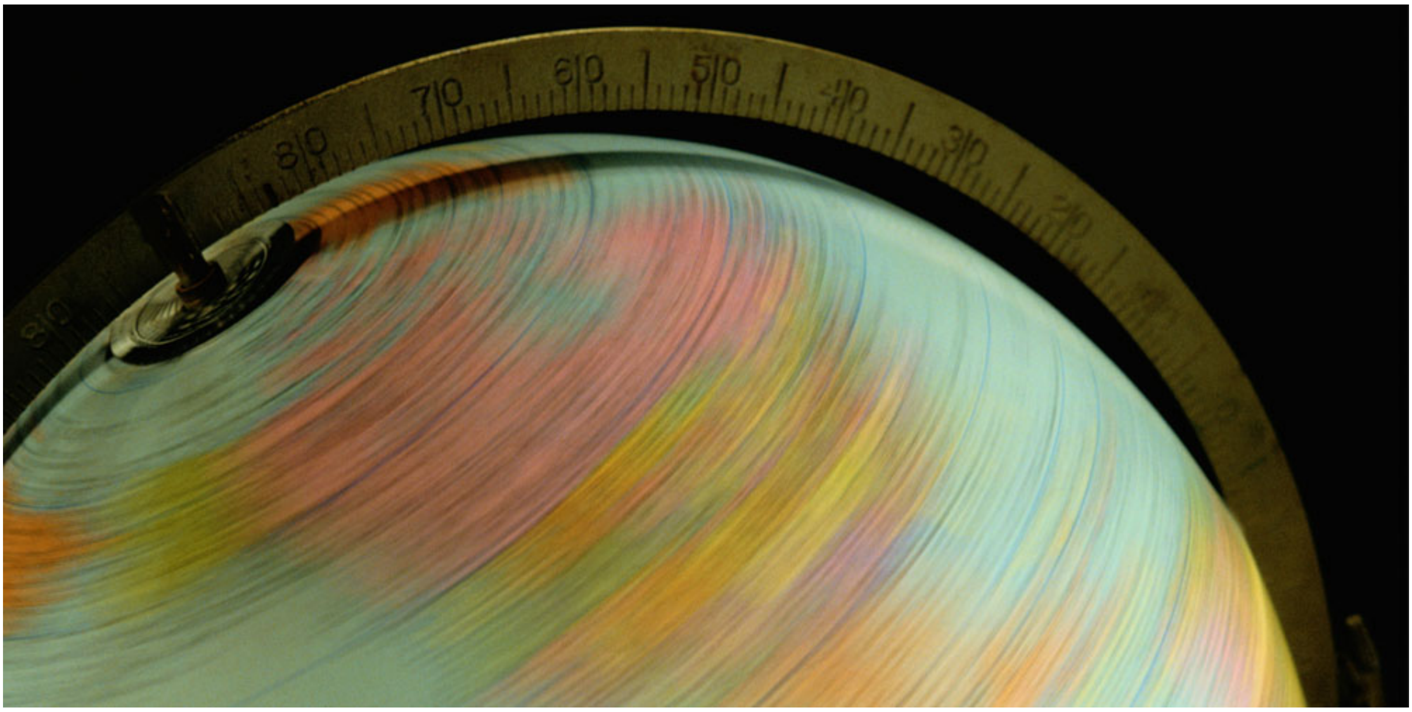
William Blair | Blog
REPRINTED FROM THE WILLIAM BLAIR FUNDS BLOG



How Geopolitical Forces Influence Markets

December 12, 2016

Brian Singer, CFA, Partner
HEAD OF THE DYNAMIC ALLOCATION STRATEGIES TEAM AND PORTFOLIO MANAGER
RELATED FUND: *Macro Allocation*

In our post-Cold War world, geopolitical developments have become larger and more frequent—and because these developments affect market and currency prices, investors need to navigate them.

Those of you who follow my commentary know that I often speak of fundamental value as the tide that inexorably pulls prices toward it over longer-term time horizons, and waves as shorter-term developments that impact market and currency prices.

Geopolitical developments, such as the U.S. election and the Brexit referendum, are good examples of waves, which we can separate into near-term, medium-term, and long-term forces. Let's look at some that are currently influencing markets.

Short-Term: Populism and Central Bank Activity

In the near-term, which I consider one to three years, I see two significant forces, or waves. Perhaps the most evident is populism. An anti-establishment movement harboring unique ideologies that are opposed to the existing establishment (sometimes in the extreme), populism is nothing new. It's been around in various forms since the Cold War ended and the Berlin Wall fell in 1989.

Following those events, we experienced a period of calm, but since 2000, populism has been on the rise. The Arab Spring, a series of anti-government uprisings that spread across the Middle East beginning in 2010, is still rumbling below the surface. Occupy Wall Street, a protest movement against social and economic inequality, took hold in 2011.

Then, this year, we began to see the political manifestation of populism—a pushback against the current state of affairs and the elites who brought us to it. We're seeing it across Europe, most notably with Brexit, and more recently in the United States, with Donald Trump's defeat of Hillary Clinton in the presidential election.

Populism isn't going away; I think we'll see it, in various forms in different countries, for the next decade. It brings positives and negatives, which we'll have to navigate. On the positive side, the sweeping and intense desire for change can lead to innovation.

But one thing we're watching closely is the possibility that populism leads to an environment in which xenophobia sets in, resulting in protectionism. If hard-won free trade agreements are reversed, we'll find ourselves in a very different environment to navigate.

Another short-term force influencing markets is central bank activity, which is preventing normal asset pricing. When the government manipulates interest rates, it removes corporations' ability to make capital expenditures, which is their form of investment. Because they can't accurately determine the price they want to pay for an asset, investors and corporations sit on cash.

They're more willing to hold cash, buy back shares, and buy and spruce up other companies rather than engage in productivity-enhancing investments. And that's happening today: There's significant uncertainty associated with the asset-pricing environment.

Medium-Term: Mal-Investment and Secular Stagnation

Over the medium-term, which I consider five to eight years, we have what I like to call mal-investment. We've experienced a lengthy period of ultra-easy monetary policy, and that has led to some very inappropriate investment decisions. These mal-investments—think new factories—have helped support economic growth, but they've come at a cost, and that cost is future growth.

These investments won't be viable once interest rates rise to normal levels. Then, they will hobble along until the economy grows enough to absorb them at current productivity levels. Or, they'll be shut down.

Another medium-term force influencing markets is secular stagnation, which is a condition of negligible economic growth that, unlike cyclical stagnation, has to play out in its own time. One reason for this stagnation is demographics: An aging population limits the workforce, which slows productivity and, thus, growth. Secular stagnation could last as long as 10 years, and there are both negative and positive arguments for how it will play out.

The primary negative scenario is that there's no way out of it. The Industrial Revolution has come and gone, this argument goes, and we've reaped all of its benefits. There's nothing left to spur the type of growth that most of us alive today have experienced.

But the positive argument, which we find more appealing, is that once mal-investment works its way through the system, we'll see that we're in the midst of what some call a second Industrial Revolution, a digital information technology revolution. Some feel that this second revolution is even more powerful than the Industrial Revolution. I don't know if that's true, but something very significant is happening.

Long-Term: Optimism

Longer term, by which I mean 10-plus years, the big force influencing markets is optimism. Cultures are colliding, as I've discussed, and that brings some negatives. But so much innovation also occurs when different cultures collide and that's happening around the world today.

The internet is enabling cross-cultural communications, multi-disciplinary university programs are growing, and these developments are enhancing productivity.

Why It Matters

Typically, we focus on tides, navigate the waves, and ignore the ripples. But in the end, they're all relevant to asset pricing. All assets, liquid or illiquid, are claims on the underlying global economic engine. If the engine grows, real asset returns are high; if the engine doesn't grow, real asset returns are low. It's important, then, when you think about the return you can expect, to look into the future and examine those growth prospects.

Disclosure:

Please carefully consider the Funds' investment objectives, risks, charges, and expenses before investing. This and other information is contained in the Funds' prospectus and summary prospectus, which you may obtain by calling +1 800 742 7272. Read the prospectus and summary prospectus carefully before investing. Investing includes the risk of loss.

Any statements or opinions expressed are those of the author as of the date of publication, are subject to change without notice as economic and markets conditions dictate, and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC or the Investment Management Division of William Blair & Company, L.L.C.

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Investments are subject to market risk. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

William Blair does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax questions and concerns.

Distributed by William Blair & Company, L.L.C., member FINRA/SIPC.