POLITICAL RISK IN EMERGING MARKETS

THE POWER OF ARTIFICIAL INTELLIGENCE IN ASSET MANAGEMENT

GlobalEvolution

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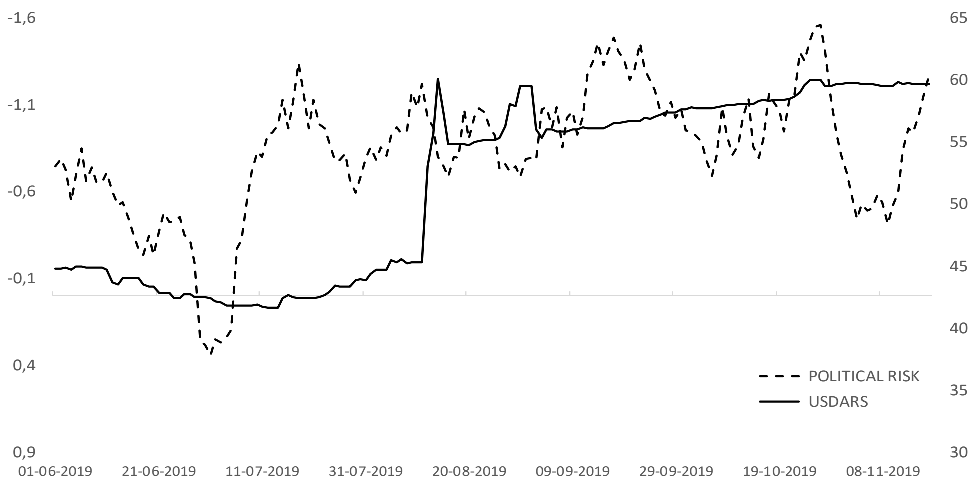
SENTIMENT DRIVES MARKETS; NOW WE CAN MEASURE IT! It is well known that prices of bonds and currencies trade to a high extent on sentiment and political risk. Perception and animal spirits of market actors drive a major part of asset price volatility; as Robert Shiller has taught us with Narrative Economics. Historically, market sentiment and political risk have been extremely difficult to observe and quantify, so information for one of the most important factors we every day consider as a central part of our investment process has not been available in a condensed and quantified format.

A computer can now do this work for us! Instead of hiring hundreds of analysts we can get a (strong) computer to read a news related to political risk and assess whether the news is positively or negatively biased. It can even dive into news databases and read news published every day, every year back in time. And, thus, provide us with high-frequent indices (time series) of how political risk has been biased over time. We use Natural Language Processing in combination with machine-learning to assess whether sentiment is positively or negatively biased. This gives us an AI-driven sentiment indicator that we never had before!

In the case of Brazil, 2.6 million news articles related to political risk was extracted back to year 2007, then read and scored by the computer in a matter of minutes, and a political risk index was estimated (difficult for any team of people to digest 500-1000 news articles per day, per country, and score the degree of political risk without getting tired). In addition to the intriguing nature of the political risk index itself, the correlation to bond prices and the exchange rate in Brazil is astonishing! More than two-thirds of the variation in the currency can be accounted for by political risk. It is hard to find a macroeconomic or financial indicator that beats this correlation. We have even found causal evidence that the political risk index seems to be a leading indicator (using Granger Causality econometrics; Transfer Entropy analysis).

In the case of Argentina, we saw a massive sell off in the currency and bond prices in early August 2019 up to the primary elections. Few expected such a dramatic sell off. Unfortunately, our AI-driven political risk index was developed a few months after this event. The leading nature of the political risk index is astonishing, as the figure illustrates. Notice the daily political risk index (dotted line; left axis) spiking about a month before the primaries, and again about a week before; clearly indicating that political risk was at extreme levels.

POLITICAL RISK IN ARGENTINA
AND THE ARGENTINE CURRENCY UP TO THE PRIMARIES IN AUGUST 2019



Source: Global Evolution based on data from Bloomberg; news articles from Dow Jones, in a proprietary AI-driven political risk model.

We can now "take the temperature" on sentiment, and our AI-driven political risk index delivers a daily indicator for political risk in emerging market countries. Our valuation models suggested ahead of the sell off that bond prices were leaning to the cheap side, and so did the currency. Unfortunately, we did not at that time have this political risk indicator to integrate into our valuation models; we now integrate the political risk index, and when we back-test the models we observe more depreciated fair value levels; thus, indicating lower positioning or outright zero-weights in Argentina's bonds at the time. We will now learn from these AI-driven political risk indices across countries in emerging markets and integrate these in our valuation models and our investment process.

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