GLOBAL MARKETS

The anger factor

INVESTMENT CONCLUSION

The global anger vote will have lasting effects on politics and, with it, the long-term economic outlook. It is reshaping government policies, forcing the mainstream political parties to turn away from globalisation and embrace “New Populism”. Fiscal and monetary policies will merge as low interest rates and high levels of debt make the latter impotent. Social pressures will force governments to spend more. That means more state intervention in the form of social support as well as at an industrial level. And, of course, populism means more immigration control.

This backdrop will prove counter-productive. This is likely to dampen any recovery in productivity, pushing already low growth rates even lower — a potentially self-feeding cycle. This is bad for long-term financial assets and equities. The winners and losers on the currency front are likely to be determined by who can do what, with helicopter money a likely principal determinant. It is also bad news for EMs, which depend on globalisation to converge economically with rich countries, as well as commodities and energy. However, in a world of rapidly debasing fiat currencies gold can only shine.

ANALYSIS

The other day I sat down with a friend to supper in Bantry, in the extreme South West of Ireland. Bantry is remote and isolated but this person is not. A talented architect, he understands how the world works. He may not be an economist, but he is far from being an eejit. He said how happy he was that locals and not an international chain, had won the bidding for the town's hotel, which is being sold by NAMA. I said that would probably make it less efficient and a less great place to stay. He countered that local ownership is a real commitment to the community and unlike a faceless international chain, local management would be committed to staff, employ some disadvantaged kids and the place would have “character”. It might, he admitted, be less efficient economically but it would tick a lot of life’s other boxes. The fact that my companion is a net gainer

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The anger factory — the inputs

The anger vote is a manifestation of numerous stresses that have accumulated over the past forty years. Together they undermined the social contract between workers, owners and governments that had built the post-war economy and set up a significant shift in the social mood.

Globalisation has attracted much of the blame. DM workers (particularly the male working class) have seen incomes stagnate or decline. This effect was masked for much of the period by falling interest rates and rising credit. But it led to a hollowing out of the "good" manufacturing jobs in DMs as production moved to lower cost centres overseas. New jobs were created in DMs, but they were in new services that were often low skilled (and thus have little pricing power), low paid and came with irregular hours.

The political classes took up some of the slack in the early years. Inflation was beaten back (allowing interest rates to fall) and economic liberalisation also delivered tax cuts). But economic reform momentum faded over the period, as did the desire to enact the reforms needed to raise productivity and, with that, growth. This is partly a secular story as demographic shifts have altered the balance of incentives for politicians with an increasing number of votes tied to welfare and healthcare spending over the needs of pro-growth departments of education and investment. While the effects are limited over a political cycle, long-term pressures on "discretionary" spending over "entitlement" spending begins to manifest itself in growth rates and productivity.

These forces have created a sense of alienation both within countries and between countries. Stagnation has become more evident post-GFC which has added a further dynamic to this mix, a fear of the future. The problems of high debt, low GDP and low wage growth and rising entitlement costs (which are now visible with rising retirement ages and declining pension provisions for today's workers) are now visible to all. And if you are a worker, that is confidence-sapping, appearing as a road back to the serfdom that democracy and capitalism promised to free you from.

Democracy itself has failed in many respects, mainstream political parties from both sides of the spectrum have stuck increasingly to the status quo. That has removed choice from an electorate that needs real choices. And the fringes are the only alternative. Even in instances where politicians have been forced into action they have failed materially to reform their economies in order to restore their ability to grow. Europe is the most acute example with austerity applied in an entirely counter-productive way. Taxes were raised while spending cuts focused on the very areas of discretionary spending that could have supported growth (investment). Very little was done to reinvigorate stagnant labour markets or move to further liberalise the economy, thereby increasing flexibility and, with it, productivity.

Electorates need someone to blame for the lengthly list of failures. These are the components that power the anger factory.

Inset 1. *Source: Independent Strategy*

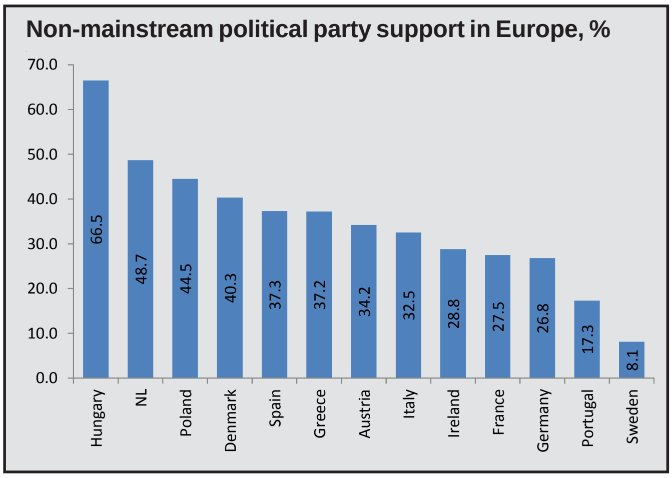

Figure 1. *Source: National polling agencies, JP Morgan*

from globalisation (building for FDI and homes), his perspective is especially interesting. He benefitted from globalisation but was turned off by it. What are the feelings of those who lost out or failed to gain from globalisation? They must be much deeper, bitterer and a great deal less rational.

My architect's comment seems to sum up peoples' fatigue with globalisation and economic reform. It marks a complete reset of their priorities. It is a microcosm of the macrocosm that will set the shape of politics and economics for decades to come. It spells the death knell of globalisation and the rise of something a good deal less likely to benefit people (Inset1).

Anger is global

The anger vote is global. The responses are likely to be national and inadequate for that reason. The advent of the global anger vote is not a forecast but a reality. Brexit's Johnson and Farage, the rise of populism across Europe (Figure 1), Trump in the US, Xi in China, Duterte in Philippines, Putin in Russia, Erdogan in Turkey — all of these leaders are different. But all of them are nationalist (if not explicitly racist), rather than internationalist. They are also economically irrational (Inset 2).

Trump, trade and tragedy

It might be difficult to divine any real coherence from Donald Trump's campaign to become US President, but his soundings on trade are alarming for those who believe in the benefits of globalisation.

His criticism of NAFTA, specifically the relocation of manufacturing jobs to Mexico, has certainly struck a chord amongst blue collar (and traditionally Democrat) voters. His response — beyond building a very large wall — was a demand for 35% tariffs on US imports from Mexico. He has also called for a 45% tariff to be levied on Chinese goods, accusing them of anti-competitive practices and currency manipulation. And potentially there is the "nuclear option" of withdrawing from the WTO entirely.

Of course this is bluster; even Trump doesn't expect to enact these threats as countries will realise what's "good for them" and "renegotiate". While there may be some twisted logic to that thinking, a worst case scenario where the US did impose such restrictions would certainly derail Trump's promise to raise US GDP growth to 4% per year. In fact, the Peterson Institute thinks his trade policy (in extremis) would tip the US into recession, triggering a decline in employment of more than 4%.

While most trade agreements are approved by Congress, all international treaties have escape clauses or "exceptional" clauses. And the President can still implement measures (under foreign policy legislation, which has accumulated over time) to restrict foreign trade on a case by case basis. There remain elements of legal oversight to this process; first he'd need to get the legal opinion of the Attorney General (still a significant barrier, even if this is a political appointment), but appeals go right up to the Supreme Court. So the process of checks and balances can ultimately de-fang irrational behaviour. Nevertheless, in the short-term the President has scope to substantially interfere with trade agreements, if not to the extremity of the restrictions Trump has threatened during the campaign. And that would clearly carry a significant economic cost, one that the economy in its current state would struggle to bear.

So while the "worst case" scenario that the Peterson Institute has modelled is not likely or feasible, it does prove a useful illustration as to the costs that forced de-globalisation presents. And that applies not just to the US but more broadly.

Inset 2. *Source: Independent Strategy*

Rational assessment unequivocally supports the case for globalisation, which has lifted 30% of the world's population out of abject misery (Figure 2) and billions out of the gulag economies of Marxism to relative freedom. Economic reform, vilified as "austerity" today (thanks mainly to the abject failure of EU politicians to sell it for what it was), in both rich and poor economies hefted global productivity immeasurably and well-being with it. It also led to a decline in global income inequality (Figure 3)

World poverty ratio: % of population living on less than $1.90 per day (2011 PPP terms)

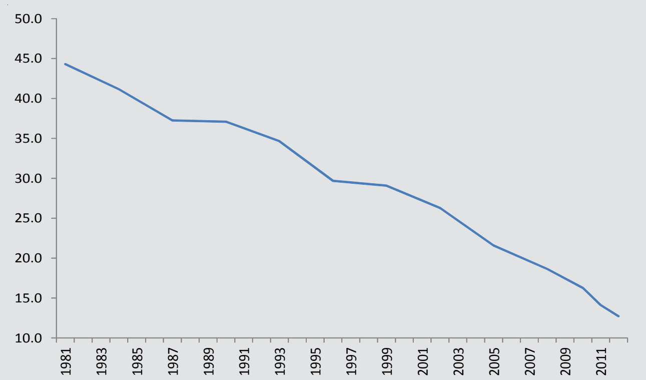

Figure 2. *Source: World Bank*

Change in global real incomes by income percentile (1998-2008, %

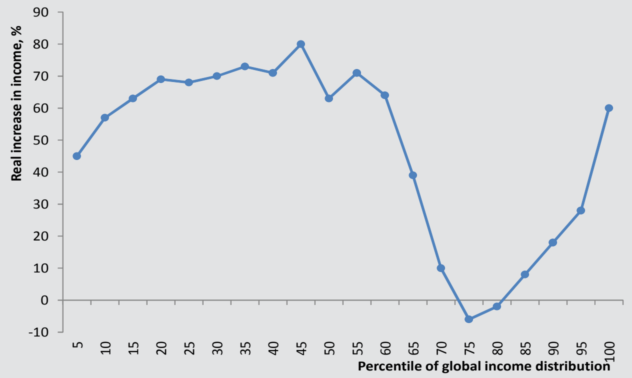

Figure 3. *Source: Branco Milanovic*

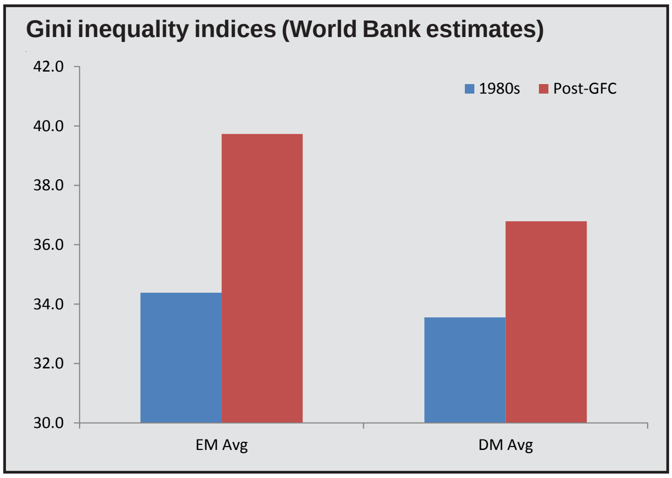

Figure 4. *Source: World Bank, Independent Strategy*

thanks to economic convergence between EMs and DMs. However, within the rich democratic countries and a sizeable chunk of EMs, income and wealth inequality grew markedly (Figure 4). If the fruits were unevenly shared in these places that is an issue that should be addressed, but not by chopping down the orchard.

McKinsey, in a recent study (*Poorer Than Their Parents*, July 2016), estimates that "in 2015 65-70% of households in 25 advanced economies, the equivalent of 540-580mn people, were in segments of the income distribution whose real market incomes — their wages and income from capital — were at or had fallen below their level in 2005. This compared with less than 2%, or fewer than 10mn people, who experienced this phenomenon between 1993 and 2005." Of course, in some countries (e.g. Sweden and France) fiscal policy in the form of automatic stabilisers, welfare transfers and tax cuts offset some of the detriment. But that was rare.

Brexit is perhaps the laboratory test of this winter of discontent among economic losers, or those that perceive themselves as being so. The vote was economically irrational but supported by those who felt ignored by elitist politicians and devoid of any benefit from the touted economic recovery, globalisation and EU membership before that. It was of course crystallised into a vote to leave (by older, white countryside dwellers) as a movement to "preserve Britain's cultural homogeneity and identity". But the mantra was fuelled by economics, even if it was not economically rational as a result. Andrew Haldane of the BoE bares the issues expertly in his paper *Whose Recovery?*, June 2016.

Democrisis

Our own book, *Democrisis*, first published in 2012 and recently reedited and available on our website (Link) analyses the failure of democracy since the fall of the Berlin Wall in 1989. The end of Communism deprived democracy of much of its purpose as a fundamental pillar of freedom. Traditional parties lost their grip on power. Politics became trivialised. Policies became dictated by "marketing campaigns" to capture voter preferences and pander to prejudices rather than lead opinion by principle and vision. The soundbite and tweet replaced the debate of issues. The social contract sought to protect rich countries' voter living standards from the negative impact of globalisation on wages. But such policies were based upon unsustainable social transfers and debt bubbles fostered by the democratisation of credit with inadequate regulation. This all came unstuck with the bursting of the credit bubble and the global financial crisis.

The bad news is that the years since have seen a worsening global political and economic environment, leading to:

- increasing political fragmentation;

- a widening demographic deficit and labour displacement;

- slowing productivity and rising low-skill, low-pay employment;

- rising wealth and income inequality and generational and regional disparities;

- growing nationalism.

Faced with these challenges, politics has failed to provide:

- an economic dividend for the majority from the post-GFC economic recovery;

- economic reforms to heft living standards;

- supra-national projects to deepen globalisation;

- effective geopolitical military intervention;

- coherent, humane, policies to deal with the diaspora from failed states.

The end of globalisation

Judged by growth in global trade, advances in globalisation stopped dead in 2008. According to a study by the Peterson Institute for International Economics (*Why Has Trade Stopped Growing?* March 2016) the momentum came to a halt because of failure of the Doha round of trade talks and the advent of myriad micro protectionist measures post the 2008 global financial crisis. Obvious next steps in the path of globalisation with huge potential, such as liberalisation of trade in services, have simply not happened.

It could take years to repair the damage done to democracy. It could only be done by economically rational polices that deliver sustainable and well-distributed wealth.

There can be no such rise in living standards with productivity stuck at such low levels. The jobs that are being created are low skilled and low pay. That does little to address the anger vote.

There is a myriad of reasons for low productivity: the legacy of misallocation of resources during the credit bubble; lack of investment in the recovery; demographics; and the effect of DTs (Disruptive Technologies) productivity gains being adopted slowly and limited to a small nucleus of corporations.

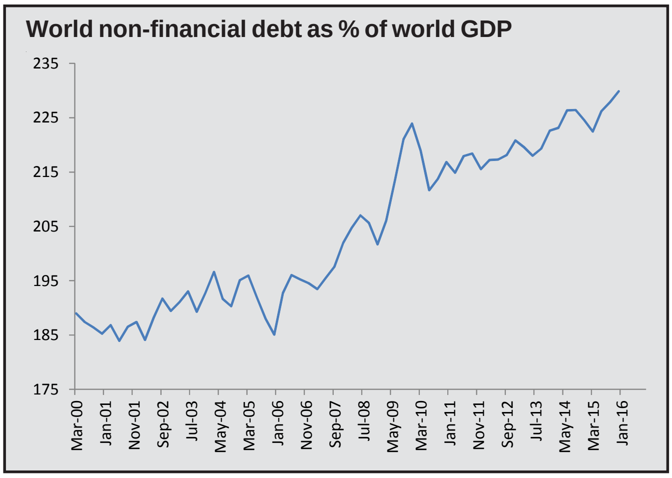

Figure 5. *Source: BIS, Independent Strategy*

But one reason stands out. As long as capital is mispriced by central banks, like free water it will be misused (e.g. keeping zombie corporations alive and borrowing being used for financial gain rather than productive investment). Yet central banks may not be able to normalise policy for reasons they never mention or discuss: the global explosion in debt (Figure 5), which they have fuelled. Doing so would cause the economies to collapse. Therefore, we are locked in a loop where mispriced capital inhibits productivity-led growth. Pricing capital appropriately for risk would cause economic collapse. Surely this means that the anger vote is set to increase dramatically?

For the moment, voters are intent upon punishing the established elite. Bad as the elite were deemed to be, what replaces them will be worse. Slogans replacing soundbites are hardly an improvement. And neither are policy solutions.

The existing elite does not have to be “replaced” by the rule of populists for political and economic damage to be done. The incumbent elite only has to be consistently under threat from populists. After all, UKIP only had one seat in parliament and a leader who had failed to be elected as an MP seven times. But UKIP achieved Brexit, splitting the country and shattering the political system in the process.

This will be the pattern elsewhere. The populists will force much of their policies onto the agenda of traditional parties. Populists will be abetted in influencing policy by the lack of principle and vision of the elected politicians of traditional parties. The traditional elite seek political survival at any cost and ahead of anything else.

Rise of populism

The rise of populism is far more dangerous for the European Project than the sovereign debt crisis ever was. Popular support for the EU is now below 50% in the biggest countries and only about that level for the EU as a whole. Faced with fragmentation (of which Brexit is the most extreme indication so far) Europe has to choose between greater federalist integration (e.g. fiscal) or more nationalist policies. The pattern since 2008 is for the nation states (particularly Germany) to grab back more decision-making from the EU institutions (hence the arcane decision-making processes the EFS/EFSF and the flawed implementation of so called "Banking Union"). It is likely to continue.

Nowhere is this clearer than in Westminster where a majority of elected politicians are against Brexit. But if Brexit is put to a parliamentary vote the vast majority will nevertheless vote for it. Not to do so would lose them their jab at the hands of their constituency selection committee. *Bassesse oblige*!

Moreover, it would be a mistake to think of the threat of populism as being a purely rich-country, democratic dilemma. In China, President Xi is another populist pursuing centralised power in a manner that reverses many of the freedoms enjoyed by citizens in recent years. There has been a heavy emphasis on a mixture of Communist Party rebranding and rampant nationalism — just short of outright xenophobia. The irrational populism of his policies is evident in China's aggressive geopolitical stance that flies in the face of the country's need to integrate fully into the global economy to support its efforts to become a domestically driven consumer society. Instead, China is increasingly being "contained" militarily and economically by the undeclared coalition of its EM neighbours and all the rich countries.

Bring back Bacon

And there is another thing — abstract but determinant. It relates to Francis Bacon, the great 17th century essayist who died of pneumonia contracted while experimenting with the effects of refrigeration on a dead chicken he buried in snow. He was a great literary thinker, social analyst but a scientific mind too — in other words a generalist.

First, think of "knowledge" as three stacked disks a 'spinning. The top one contains knowledge about great societal plate shifts — like the anger vote, DTs and new economic norms (low productivity, inflation, growth, demography) etc. The middle one contains policies to deal with these shifts and the bottom one is all about the tools to implement them.

To deal with the crises of democracy we need great generalist minds capable of understanding what's afoot and then communicating and enacting the policies that are needed.

Now zoom in on Jackson Hole. The theme was to develop a framework for monetary policy that would meet the challenges of the day. Only academics and central bankers are invited. That used not to be the case. Not one paper looked at the big issues of the day — the top or even middle disks. All the papers were about the crowded bottom disk: the tools to do more of what CBs are already doing without asking whether they were doing the right things in the first place (you can't model that)! The topics were: helicopter money, negative interest rates, maintaining big central bank balance sheets and reducing banks' dependence on market funding by using CB deposit reserves instead.

My question is whether we have pilots in the cockpits of society that are qualified to fly the plane for the entire journey (take-off, cruise, landing and emergencies)? I doubt it. And this has significant negative implications for effective policies to deal with the anger vote.

The policies we are likely to see in rich democracies will in many ways hark back to those of my youth some 60 years ago. And they will fail now for the same reason they failed then.

New Populism

The component economic policies of the "New Populism" will likely comprise:

• An undoing of globalisation and a refocus on national economies;

• the creation of national corporate champions at sector level which will be prioritised and subsidised versus international competition;

• reintroduction of economic planning;

• the reintegration of the functions of monetary and fiscal policy for the pursuit of economic and ultimately political domestic goals (helicopter money etc.). The achievement of 4% inflation through "enhanced" policy tools;

• cashless societies with savings and deposits used as cyclical policy tools (e.g. deposits and spending controlled by negative interest rates or time-limited transfers to boost spending);

• social protection (labour markets and safety net);

• immigration controls;

• regulations limiting the impact of DTs on labour markets (protection of the low skilled);

• income and wealth distribution, through taxation and public spending, probably facilitated by helicopter money.

Some of these policies will be realised now; the UK is leading the move to immigration control. Others will require another crisis or recession to be activated, for example helicopter money, cashless societies and overtly nationalistic economic policies.

Does this seem far-fetched? Well so did NIRP a couple of years ago (seen as an academic fad with no bearing on economic reality).

Of course, we could be saved from this if DTs suddenly caused a seismic productivity lift-off that led to much higher growth rates and is complementary (rather than substitutive) of labour markets. The most likely outcome though is that while DTs have the potential to heft productivity and growth their impact will be gradual.

INVESTMENT STRATEGY

If such serendipity is not in the stars, what does this means for investors?

What is described here is a process where more economic decisions will be based on national rather than global priorities, and upon policy rather than market criteria. That is supportive of a "kinder" society perhaps (at least if you are local), but a much less efficient economy at all levels. It is thus negative for all long-term financial assets.

Bonds cannot escape this as their returns are ultimately dependent on the returns and growth of the economy they represent. And, of course, inflation will be higher and cycles more pronounced. Nevertheless, the political goal will remain the policy control of interest rates to achieve growth and inflation targets. So the argument for and against individual bond markets will be set by the interplay of these determinants and can only be judged on a case-by-case basis.

Equities would suffer from the drop in efficiency intrinsic to this new policy world. But “national” (less efficient) corporations could do quite well as could beneficiaries of micro (or macro) protectionism and state subvention.

In FX, areas that preserved central bank independence (such as the ECB, which is enshrined in law) and that could not implement helicopter money, would see their currencies benefit from being a safe-haven asset.

This is a bad world for EMs. They depend on globalisation to converge economically with rich countries.

It is also a bad world for commodities and energy. There will be less growth. And what there is of it will be less commodity-intensive. And DMs championing domestic industries would also raise energy independence up the agenda.

Gold does well out of this scenario. It is a substitute for increasingly corrupt fiat money as a store of wealth. It protects an individual’s control over his savings/deposits. Gold’s zero-yield is attractive if deposits have negative yields. And the low productivity world is also one of higher inflation.

This vision raises the risk of increased geopolitical instability as the anger vote grows in both EMs and DMs. But also because EMs do not do well and have less of a stake in integrating into the world economic system. This gives greater licence to maverick political behaviour.

Brexit will entail heavy economic losses for the UK economy over time. There will be no sweet EU deal granting the UK both access to the single market and border controls to stop the free movement of labour. It looks like the UK government will prioritise control of its borders. The EU, to contain its own populists, cannot be seen to “reward” the UK with access to the single market or the "passporting" of its financial sector. But UK economic losses may come in terms of lower growth, rather than shrinking GDP. Ultimately, the losses will make Theresa May's "inclusive society" undeliverable. That warrants a continuing short on UK assets and the British pound, in particular. But we could be waiting a while, with sterling showing intermittent bouts of strength, if the economy avoids recession.

INDEPENDENT STRATEGY
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