HOVING & PARTNERS
WEALTH MANAGEMENT

The Inside Track

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- With the global economy growing at its fastest rate since 2011, the global output is moving from being below potential to above potential. In other words, excess capacity is shrinking or even evaporating (like in the US and the UK), sparking fears of inflation. Are these concerns justified? Deflation fears are gone and inflation expectations are up, but it is important to remember that **potent structural factors restrain price inflation: ageing, technology and inequality** – all three put a lid on long-term inflation.

- **The US is embarking on one of its largest fiscal expansions in history**, doing so from a situation of (1) full employment, (2) short-term real interest rates at almost zero, and (3) a substantial wealth effect due to rising markets (stocks are now 21% higher than a year ago). Yet, **growth is unlikely to exceed 2.5% this year**. The culprits: an ageing workforce and a disappointing productivity performance (0.6% for the past 7 years). The US growth potential will only improve when companies invest in new technologies, instead of spending cash on dividends and share buybacks ($171bn-worth announced so far in 2018).

- The growing US deficit compels us to revisit earlier calls about USD appreciation. In the short to medium term, the opposite will happen: the federal budget bill just signed into law **will most likely accelerate USD depreciation**. As a weaker USD makes US-produced goods and assets cheaper relative to those from overseas, US inbound tourism should benefit, but so far it hasn't. The USD has depreciated by 10% since the election, yet the US is currently the only country out of the world's top 12 tourism destinations to suffer from a decline in inbound tourism. **The "Trump tourism slump"** is proof that governments with an unwelcoming attitude towards foreigners deter tourism, a fast growing industry and one of the very few capable of increasing employment in the face of automation.

- Much is made of recent US wage growth acceleration (+2.9%). It took the limelight as a possible catalyst for the stock markets' correction, and many commentators see it as a sign of stronger demand and resurgent inflation. But it is a fluke. It will neither increase consumption nor raise inflation significantly because it is limited to management and skilled employees. **The large majority who compose the "rank and file" haven't seen any acceleration in pay.**

- The situation is fundamentally different in Germany, where the largest union (IG Metall) just secured a deal for a pay rise (+4.3%) well above inflation. Under the new agreement, workers can also take lower pay for working less (28 hours per week); do anything they wish with the 7 hours of extra time (spend it with family and friends, take another job…) and later return to fulltime employment (35 hours per week). **This is a landmark deal that other countries will try to emulate**: not only does it improve workers' wellbeing but it will also increase overall consumption and help the ECB to hit its inflation target.

- The IG Metall agreement to which we just referred illustrates a critical change in attitude: work-life balance matters and increasingly **younger workers tend to favour free time over wages.** More generally, the younger generations (particularly in the rich world) work and consume in a way that has far-reaching implications for business executives and investors, **placing greater priority on sustainability and ethical issues**. In the US, for example, 58% of millennials claim they only buy brands that invest in, or support, causes they care about. This explains why so many companies are now ending their relationship with the National Rifle Association after the Florida mass shooting.

- Blackrock, the world's largest investment company, has created an AI lab in Palo Alto to help generate alpha for clients by creating efficiencies based on big data analysis. It will be able to comb through large amounts of data like credit card purchases, satellite imagery and social media analysis to augment the efficacy of its investment decisions. This move shows how ubiquitous AI has become and the extent to which machine learning can be leveraged for so many different functions. We've chosen the example of finance, but we could have equally highlighted Schlumberger's new Software Technology Innovation Centre, also in the Silicon Valley… **Advanced data analytics is engulfing the world of all traditional industries**.

- **Cyber villains have a new arrow in their quiver: deepfake porn.** Machine learning can now insert heads of other people (like decision-makers or celebrities) into pornographic videos in a way that makes it impossible to tell the fake appearance from the real thing. Increasingly, AI is capable of creating fake content that outflanks both our ability to judge and the defence mechanisms built in our digital systems. **Digital manipulation can now subvert elections, shareholders' meetings… and more**.

- The incontrovertible evidence that Russia meddled in the US presidential elections epitomizes the fundamental shift unfolding in the military-technological environment. **Cyber**, in its many different guises (from cyber-disinformation to cyber-weapons), is likely to accelerate the pace of military engagement, **increasing the risks of miscalculation and misunderstanding**. For investors, cyber warfare introduces an element of radical uncertainty: a **"slippery slope"** has the potential to lead from tension and crisis to conflict and destruction – be it in a country, an industry, or even a company.

- The market's wild gyrations have brought complacency to an end. The unnatural situation of low interest rates, low inflation, low yields and expensive equities is unlikely to be sustained for much longer. As central banks reduce their intervention in the markets and engage in quantitative tightening, **credit spreads and volatility will rise**.

- In Q1 - Q2 2018, top "must-watch" issues include: (1) Whether the rise in yields will be sustained – posing a fiscal challenge for most governments; (2) Whether Trump will cause a significant deterioration in global trade relations; (3) Whether Xi's power grab will change anything and cause the "Bad Emperor problem"; (4) Whether the USD will depreciate further (causing headaches for the ECB and many EM currencies) (5) Whether the Italian elections on March 4 will impact the Eurozone; (6) The vast array of geopolitical risks and potential conflicts (Korean peninsula, Iran and Saudi Arabia…).