The Inside Track

MAY 2018

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- **Global economic growth remains robust, but it is levelling off**. Tighter monetary conditions and supply side constraints mean that the peak in global economic activity is now behind us. Rising trade and geopolitical tensions are shifting risks towards the downside, both in the real economy and in the financial markets. **Tensions are brewing and risks conflating.**

- **Emerging markets (EM) are going through a rough patch, bound to worsen**. The USD, which remains the most important determinant of their finances, has strengthened over the past few weeks by about 5% on a trade-weighted basis, putting **huge stress on their aggregate 6.3 trillion dollar-denominated debt**. Continued dollar strengthening (likely in our opinion) will compel investors to further re-assess their EM exposure.

- Argentina (until a few months ago the darling of global investors) and Turkey are harbingers of those problems the global economy may face at a time of higher interest rates and currency swings. Both countries have seen their currencies collapse because of their balance of payments' deficit of around 5% of GDP (which poses a financing problem); but **the wider outlook is no longer favourable for any EM whose borrowing costs are set to rise**. They are now squeezed between the rock of US monetary tightening and the hard place of Chinese decelerating growth momentum.

- Despite running at more or less full employment, **the US economy is more fragile than it looks**. Several surveys - including one from the Fed - show that 40% of Americans couldn't cover a $400 emergency, while 43% don't earn enough to pay for food and rent (despite having a job). **It's hard to foresee robust personal consumption** (70% of US GDP) **when existential anxiety afflicts so many.** The anger and resentment of the "forgotten" class will shape the US economic and political outlook for years.

- Italy's political convulsions are severely testing our bullishness (when compared to the rest of the world) on Europe. An unholy alliance between the far left and the far right has tilted the country towards its own form of protectionism and nationalism. **While rising interest rates could still trigger a debt crisis of monumental proportions,** the recent appointment of a caretaker government until likely new elections suggests that **an immediate catastrophe will be avoided**. A plethora of scenarios means that a few months of radical uncertainty will ensue. **This said, we do not hold with the much-trumpeted risk of an Italexit** because: (1) It would be an economic aberration; (2) Though Italians are the most eurosceptic in the EU, 59% of them still favour the single currency.

- Our relative long-term bullishness for Europe is premised upon the following: it is stronger than it seems, but most importantly it is better placed than most other countries, regions or continents to mitigate the major global risks (like climate change) that we collectively face. Water is a case in point. Fresh water availability is changing fast, with **water insecurity becoming an increasing economic and geopolitical concern**. New research shows that Europe will not face significant water availability problems in the coming decades, contrary to some regions like the Middle East, northern India, north-east China or the Caspian Sea where the lack of water will become at best a source of acute economic stress and geopolitical tensions, at worst a question of survival.

- **Slowly but surely, the Atlantic Alliance** - the bedrock of Western stability since WWII – **is unravelling.** Indeed, its days could well be numbered**.** Trump's nail-in-coffin decision to pull out from the Iran nuclear agreement and his threat to inflict economic sanctions on Europe met with the following observation from Tusk (European Council President) **"With friends like that, who needs enemies"?** A sombre indication that global institutions are on the wane while economic / political nationalism is rising inexorably.

- Trump's most recent moves - (1) the trade capitulation to China (after it made a few meaningless pledges) followed by new threats, (2) the cancellation of the North Korea Summit, and (3) the withdrawal from the Iran nuclear deal – reveal **the "exorbitant cost" of the US going-it alone**. The US is ceding its leverage on the international stage and leaving in its wake disorder and greater uncertainty. For global investors and businesses, the US' long walk away from the global order it created will be a **source of increased international lawlessness and squared volatility for years to come.**

- Some conversations within our network have convinced us that **increased productivity will come after all, but with a lag.** In previous issues, we have often referred to the productivity paradox (i.e. the fact that despite all the hype about tech, productivity remains flat or is even declining), but new research shows that **the diffusion of new technologies into higher productivity can take as much as 20 years**. AI will be no different. This will be good news for the global economy, but let's not rejoice too fast: **the future of work will not be a lack of jobs, but flat wages**, which will in turn exacerbate inequalities and a sentiment of unfairness.

- **The exponential progress of AI entails a progressive commoditisation of complex IP (Intellectual Property) and know-how** that some companies took years to develop. Now, with a bit of tech and money, they can be reverse-engineered. This puts large Western incumbents (like automakers) at a strong competitive disadvantage vis-à-vis new entrants – particularly from China.

- In Q3 2018, top **"must-watch" issues include**: (1) Whether Italian yields will surge, unleashing another eurozone crisis and roiling the global markets (we think not); (2) The rebooted signs of trade tensions between the US and China, Canada and Europe; (3) The vast array of geopolitical risks with a focus on the Iran deal and the Korean peninsula.