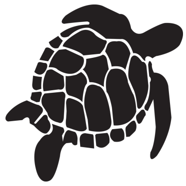
LOBNEK
WEALTH MANAGEMENT

Adjusting To A Slower Secular Growth



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"Man only likes to count his troubles, but he does not count his joys"
Fyodor Dostoyevsky (1821 - 1881), Russian novelist

Mindsets are like habits, they can be difficult to change, especially when they have been lingering on for very long periods of time. Take Gross Domestic Product (GDP)[1] which is a well-established, standardized measure of the aggregate economic output of a country or a region. We look at its change to get an idea of how well (or not) an economy is performing. Governments, especially those elected democratically, have a real incentive to maximizing the growth rate of GDP[2]. The trick is to engineer higher growth without triggering runaway inflation, which compromises the economy. This becomes a risky proposition when operating under the time constraint and pressure of elections, which is why a separation between the executive branch and the central bank is so big a deal. You don't want to have your central bank to be "managed" by the short-term whims of politicians.

Removing the short termism of politicians from the equation doesn't mean that higher growth should not be a goal worth pursuing. Stronger growth does after all lead to an improvement in the overall "wealth effect". It is how you go about it that matters. Central banks do aim for higher growth, albeit indirectly, by focusing on such matters as price stability or keeping employment at its maximum non-inflationary rate. The question then becomes what numerical value should that target higher growth rate have? We can forget the double-digit economic growth rates that a select few emerging markets enjoyed in past decades (there is a reason why such stellar growth rates were confined to such a small subset of countries[3]), but even attaining or reverting back to more "modest" upper single digit growth rates may be an unrealistic endeavor to pursue, given the circumstances.

As emerging markets continue to mature and as wealth spreads across broader populations, birth rates are plummeting at accelerating rates. The result of these "dynamics" is the ageing of the population, a major change in the composition of demographics which has profound long-term implications on economic growth. This single major secular headwind has been leading to a recalibration of the global recovery towards a lower "natural" glide path, which means that any efforts to boost growth beyond its "new" rate cannot be realistically sustainable over the long run. This is also why growth in developed markets have remained stuck below their "historical averages", despite the protracted stimulus efforts including the use of quantitative easing and negative interest rates[4].

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[1] https://en.wikipedia.org/wiki/Gross_domestic_product
[2] There is a well-established correlation between the health of the economy and chances of getting re-elected. A sometimes significant lag between economic actions and their actual effects can lead to significant distortions whereby a newly elected government takes credit for the actions of the previous one or vice versa.
[3] https://en.wikipedia.org/wiki/Four_Asian_Tigers
[4] The long-standing tight labor markets, as observed in the US, is another piece of evidence that economic growth is likely around its new "natural" rate.

What if we are aiming for something that is not attainable, but we continue to insist because we have been conditioned to do just that[5]? Habits are after all hard to shake off. If major alterations in the fundamentals are taking place, if the conditions around you are changing in such radical ways that they are ending up baring little semblance to what they are changing from, the manner in which they are observed, measured or evaluated should probably also be revised. If we are transitioning from a "bricks and mortar" economy to one that is predominantly digital, you can rest assured that the consequences of this are going to be more than just "consequential". Should it matter that the economy might be slowing or even shrinking if per capita income growth is increasing? When the economy is shrinking less rapidly than the population, per capita income tends to rise, which effectively means that the population becomes "wealthier", not at all the deleterious situation that a shrinking or slowing economy would make you think.

A reconfiguration of the world order which has been taking place over a good part of the last decade and which involves the "recalibration" of trade is another powerful headwind that appears to be weighing heavily on the global recovery. The implications of this dynamic are profound through the uncertain ways it is upending a country's pathways towards economic "betterment". Traditional drivers such as skilled labor, infrastructure and the existence of free markets do not seem to suffice anymore to move entire populations to higher income brackets[6]. What seems to matter increasingly is the way in which a number of technology-related "disrupters" are being handled. In this new world order, it is the mastery of the key technologies of AI, robotics, automation or the degree of "digitization" of the economy that are going to determine whether these "disrupters" act as headwinds or tailwinds.

No one knows yet how these dynamics are likely to play out. Suffice it to say that such technologies have higher barriers to entry than the traditional drivers, which means that the world is going to end up being divided between those that have an edge and those that don't, the winners and the losers if you will. So in the end, the secular slowing down in the global recovery is probably more the result of deep seated structural changes which means that we should not only be paying more attention at other types of metrics that capture this, but also maybe rethink the policies that are being applied before they end up backfiring on us. Food for thought.

Where Do We Go From Here?

It has been a rocky start for the year on matters regarding the environment, from the continued ravaging effects of the Australian wildfires to the emergence of a potentially lethal coronavirus in China and a high magnitude earthquake that struck eastern Turkey, causing extensive damage. These events together with others in recent months appear to be prompting leaders and activists to step up their efforts in tackling a broadening climate change challenge. The World Economic Forum event that concluded recently is notable for its marked departure from the past, emphasizing ways in which corporations can help reverse the damaging effects of climate change. Large firms such as Microsoft have announced major initiatives along these lines, reflecting potentially major shifts in corporate mindsets on such matters[7].

The pressure to take action and deliver is bound to rise. Businesses, especially those that are quoted on exchanges, are likely to become increasingly scrutinized on matters regarding the environment, as awareness and interest on climate change take on far greater significance. Firms will likely be increasingly evaluated on their "carbon footprint" and the measures that they will be taking to reduce that footprint. Climate change will continue to polarize opinions, but most of that will continue to be the indirect result of the post great recession economic inequality than any ingrained belief on the impact we may be having on the environment.

[5] The human mind's innate linearity renders it error-prone when it comes to projecting into the future. We expect the future to bear at least some semblance with the past, as if establishing a certain continuity is a default condition that needs to exist in order to give the projection a modicum of legitimacy.
[6] These are the traditional drivers that Japan, South Korea and more recently China, Vietnam, Turkey have embraced in order to significantly expand their economies. See last month's year-end Review & Outlook newsletter for a more in-depth discussion on drivers and disrupters.
[7] https://blogs.microsoft.com/blog/2020/01/16/microsoft-will-be-carbon-negative-by-2030/

The other major dynamic at play over the coming decade and beyond will be the effects of a global transition from "free" trade the world has become accustomed to since the end of the great war to one that is "managed". In this new world-order configuration, the free markets will play a less significant role on setting prices and the flow of goods and services between countries. Governments will increasingly negotiate the "terms of trade", like the US under the Trump presidency has been doing, which means that flows will be more quantitatively driven and with a mercantilist flavor rather than by traditional demand and supply forces. A significant benefit of managed trade will be in the paradoxical way in which it promotes a more "level" playing field by diminishing the potential for abuse. The major risk will be in the way it reduces the bargaining power of smaller or less influential economies[8]. This is a danger that will need to be taken into consideration as it opens the door to conflicts.

The latest composite purchasing managers index (PMI), a closely watched measure of business activity indicates an overall improvement in the global recovery[9]. The US service industry remains expansionary whilst the manufacturing sector slowdown shows signs of decelerating. European economies remain fragile but even there, the figures appear to be less negative than just a few months earlier, which means that the recent lull in the US-China trade war might be having a powerfully positive effect on overall sentiment. Although these developments set an encouraging tone for the rest of the year, none of the major lingering issues that had caused turbulence in the earlier half of last year have been resolved. US and China trade contentions are still waiting to be ironed out, and will most likely drag along to sometime after the November elections. And then there is Trump's continued impulsive and volatile nature, which means that a major global crisis with unpredictable consequences cloud flare up at any moment.

There are plenty of other areas where things could go terribly wrong, the China flu outbreak could turn into a global pandemic in the event that the virus mutates into a more deadly and difficult to treat form, Italy could revert back to its ugly populist ways or the Brexit proceedings could head into another crisis. Trump could also still impose tariffs to the European car industry, which would most likely sink its fragile economy, triggering a broader crisis along the way. Although global fundamentals are not stretched to an extent that can induce major bubbles, there are a couple of "black swans" lurking out there, it might just be a question of time before one of them strikes. This might just be the right moment to rebalance a portfolio to lock in the gains and build up some defenses with the proceeds. More food for thought!

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[8] Managed trade appears to have played a significant role in opening up China's economy to further competition but the additional "quota" of goods that China has agreed to purchase form the US is going to be at the expense of other regions such as the EU that don't have such agreements in place.

[9] https://www.bloomberg.com/news/articles/2020-01-24/germany-starts-to-shake-off-slump-with-better-start-to-2020