Income & Fixed Interest Newsletter

Vimal Gor

We believe that January will set the tone for the rest of the year: one of disruption to the economic and political order and a resetting of the way the US does business. The end to US hegemony is here and it is being driven internally as President Trump and his team focus solely on the needs of America and step back from self-imposing itself as both role-model and policeman for the globe. For the first time since 2007, global macro markets will react differently to economics and politics in a way that may seem counter-intuitive to what we have seen over the last couple of years. There is a further risk that past correlations between asset classes will weaken further because the baton has been passed from central bankers to politicians, whose reaction functions are difficult to ascertain and change constantly with the political wind. While markets originally feared this switch, they are now embracing it wholeheartedly as the prospect of a move away from the regulatory hell of the last few years to more overt capitalism holds much allure.

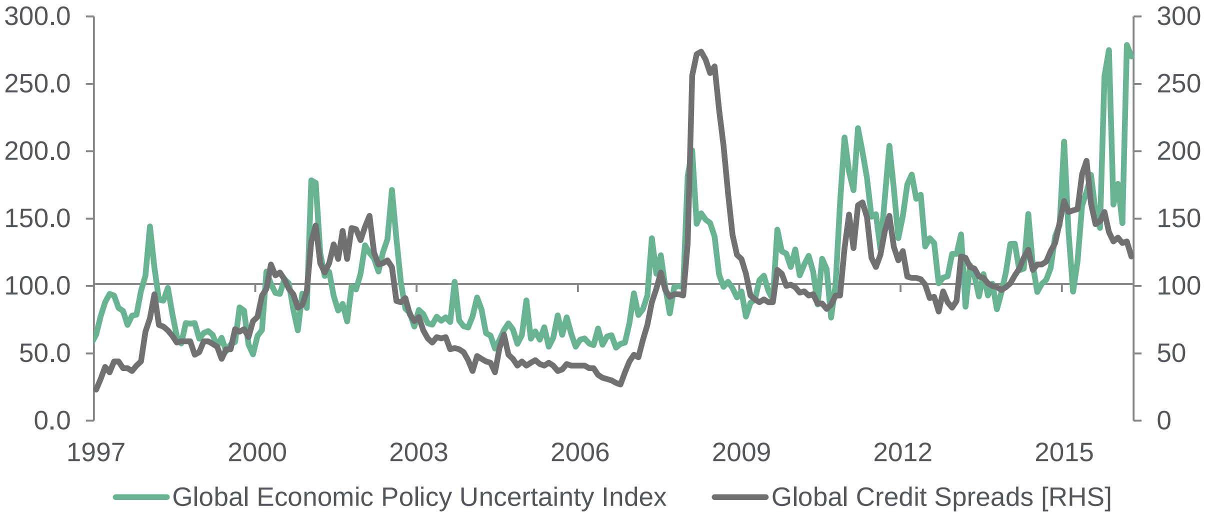
In this newsletter I want to look at why voters and markets are rewarding a rejection of the liberal ideals that purport open and frictionless trade as the only way forward. They are demanding a move away from the old guard that defend a political structure (e.g. Europe) that does very little to benefit the people as a whole. This acts as a wealth creating and protection mechanism for the privileged few who have amassed the most wealth over the last 30 years delivered by a playing field that has been solidly tilted their way. The populist voice has been heard and it is positive for economics and markets and therefore we expect this to run much further and much faster.

That said, while we believe the key beneficiary of these changes will be the US, the rest of the developed world should be pulled along in its slipstream. We have concerns though on two fronts: firstly that the Fed is likely to raise rates aggressively as fiscal stimulus risks overheating a capacity constrained US economy and this is likely to sow the seeds of the next recession. Secondly while we believe that US Dollar strength will be mild against the majors we fear that the emerging market economies and currencies (Asian especially) will suffer materially. It was a quiet month on the portfolios with most of the flagship funds performing in line with the index.

Market performance this year post the two main wildcards, i.e. Brexit and Trump, suggest that the market instead of fearing the unknown of first time politicians on populist tickets has been quick to embrace the change. The Trump election had the air of the divorcee's mantra "anything but this" and a change was sought no matter the size of the risk and the potential costs. Sometimes it just becomes an emotional rather than a rational decision.

This muted reaction to political swings away from the center and towards too far-right and far-left (which are the same thing these days) was highlighted by the response to the Italian referendum. This went as poorly as it could have for the existing pro-Europe establishment, with a declaration of a result less than an hour after polls closed such was the size of the result for 'no'. Markets hardly moved, even though the polls previously indicated a close win for 'si'. A year ago this would have resulted in bond yields dropping like a stone, the US Dollar being bid aggressively and spreads in corporate credit and sovereign markets heading for the moon. None of these things happened. In fact after a short hiccup it was back to normal programming which was trading for risk-on. A lot of people have been pointing towards the gulf between political uncertainty indices and risk markets (whether they be equities or credit), suggesting that risk markets are incorrectly ignoring political risk. We think there is a chance that both are right and while uncertainty is high, this delivers a change which is ultimately good for risk assets hence their strong performance.

Chart 1: Markets are starting to look at political risk another way

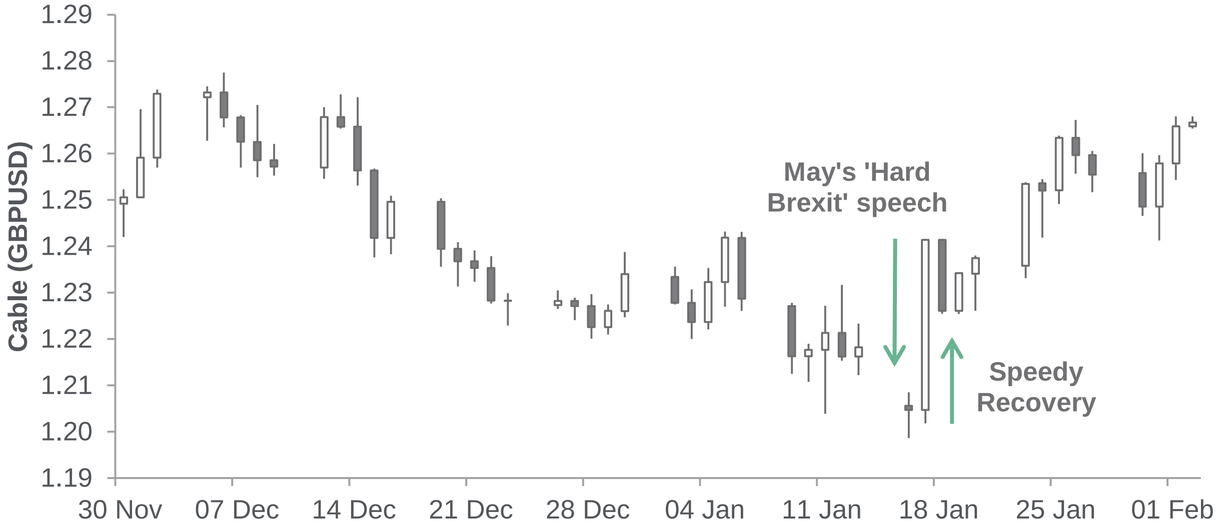


Source: Bloomberg

Theresa May's announcement of the roadmap for Brexit was one of the highlights of January. It represented another point at which markets have clearly changed their view on what is 'bad' and what is 'good'. The plan is simple: hard Brexit will be sought. This means that in return for being able to set her own laws and to make decisions about immigration, the UK will not chase access to the European common market, nor the single market of the European Economic Area. There will be no more games around trying to force the will of the establishment in Europe to try and obtain a result that is only possible in a fantasy world: where the UK still has free trade agreements in place with Europe but without any of the limitations of EU or EEA membership (such as immigration), otherwise known as the 'have your cake and eat it too' outcome.

May's plan is a masterstroke, as she is promising nothing and therefore cannot be hauled over the coals by the media if she fails to achieve it. Aiming for the absolute minimum achievable accepts the reality of the UK's choice and the confused but very vocal leadership in Europe. The expectation before her speech was that when Article 50 was triggered it would be a massive risk-off event. You would not know it from watching markets. Apart from Cable which moved 3% on the speech and Gilts which rallied a little bit, the market reaction was absent. There is a strong feeling now that the UK is in a strong position as data comes in better than expected with consumer confidence holding up. There is also the crucial point that President Trump's team are very anti-Europe and Germany in particular which leave the Europeans in a position of weakness from which to negotiate with the UK.

Chart 2: Markets are starting to look at political risk another way

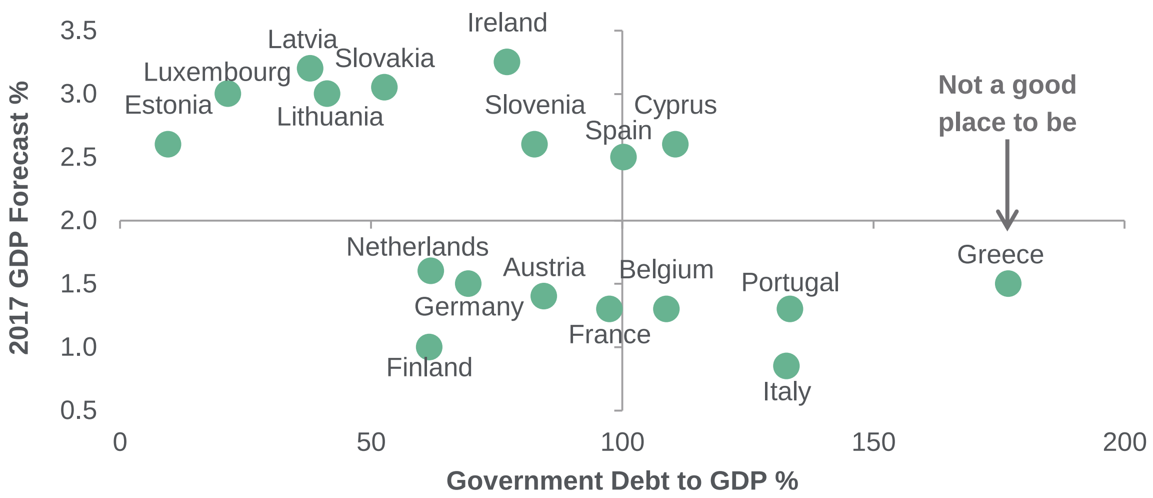


Source: Bloomberg

There are still challenges though, most significantly the lack of inward bound investment when the UK is running one of the largest current account deficits in the world. However the economic issues are not insurmountable and are nowhere near the complexity of, for example, Italy leaving the Eurozone, which could well happen. And if things go well, the UK may be able to find a comparative advantage by optimising legislation to favour herself and pivoting trade towards the US and Asia.

There are several other examples of this switch in market psychology that have occurred over the last few months. The increase in Marie Le Pen’s chance of winning the next French election have increased, but have hardly elicited any market response, apart from an widening in French OAT v German bund spreads. Greece has even fallen off the radar again despite some ridiculous “can kicking”. The Greek ‘solution’ represents the attitude of the establishment perfectly: reduce losses to those that have amassed the wealth at the cost of the populace. The hollowing out of Greece is example of this. If you were young and had the opportunity to get out of a country that will likely be in recession for decades ahead, why wouldn’t you? This is long-term negative as when a country loses its human capital then the problem compounds for future generations. A leaked report from the IMF agrees with these assertions, as much as the European establishment is pointing towards a barely OK result for Greek GDP this year.

Chart 3: Greece still insolvent

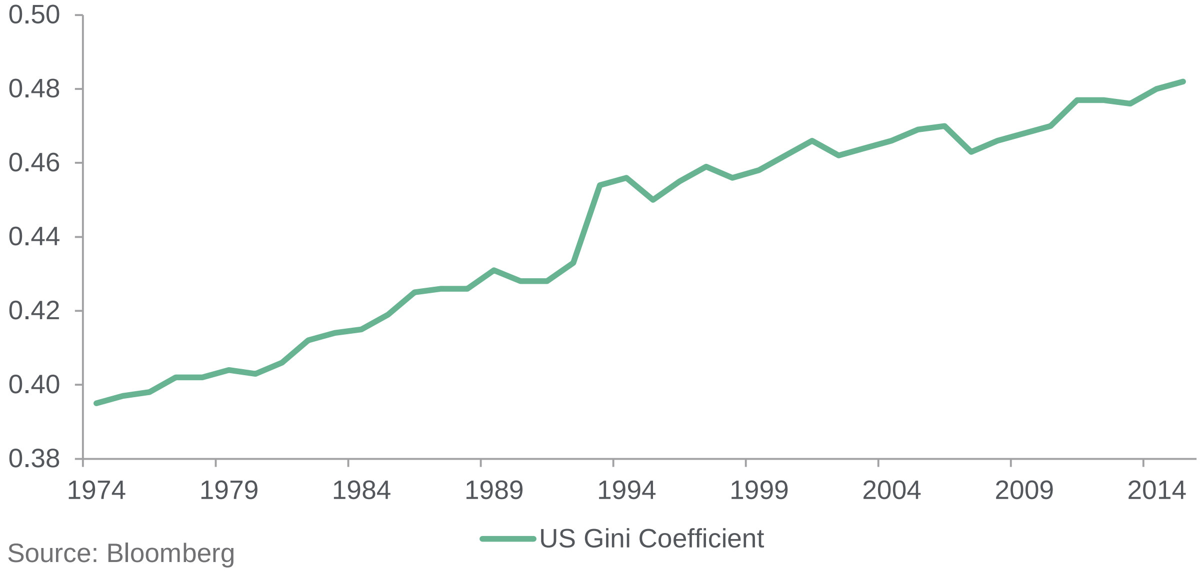


Source: Bloomberg

But the EU and its parliament, a bureaucrat's paradise, will be the last in the world to catch on that the old policies and old ideas do not work anymore. Many of these old policies and the intellectual framework upon which they are based are in fact self-defeating, making the situation far worse. The most important of these is protectionism and is by far the most interesting to think about. The dominant economic theory is that less free trade is unequivocally bad for the global economy, transforming the globe from an interconnected market for commerce to one where we are all huddled on our own island, making it more difficult to take advantage of each other's comparative advantages, the primary reason behind free trade.

The old thinking is that less free trade will mean an increased cost of goods as they will not be created as efficiently as before, resulting in lower consumption and therefore less economic activity. This is tough to argue against, as a result it will decrease global aggregate demand growth even below where we are now. This is a disaster, right? Perhaps not, as with most things the quality of aggregate demand may mean more than the quantity of it, especially when wealth and income inequality is as disparate as it is currently.

Chart 4: Wealth inequality is the most damaging macro trend



Source: Bloomberg

The drive towards globalisation really took off in the 1980s, as free trade agreements grew in number and magnitude and technology improvements saw inventory management techniques that turned companies truly global, driving prices of nearly everything lower. This prompted a strong move higher in the volume of global trade taking place which was supercharged in 2001 when China entered the World Trade Organization. Post the Asian Crisis, the Asian economies had decided to follow a new mercantilist route of building large trade surpluses to 'protect' themselves. When China joined the WTO, the access to the Chinese manufacturing machine turned the explosive growth of the US trade deficit into exponential growth.

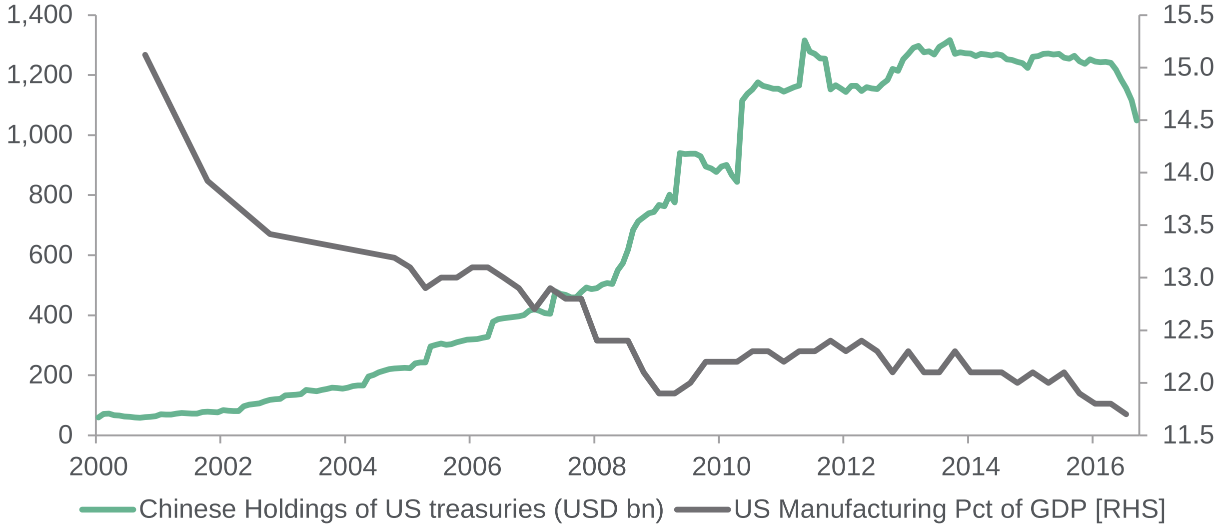
The benefit of free trade and globalisation is actually one of the few things the majority of economists agreed upon as the power of comparative advantage was appealing theoretically and was also able to be viewed empirically. It makes sense to smelt aluminium in countries where electricity is very cheap, freeing up resources elsewhere to be used more efficiently. It just takes the idea of job specialisation in a local economy (we don't all grow our own food because there are farmers that can do it better and cheaper) on the global level. This almost unanimous appreciation of globalisation has meant that Trump's protectionist stance has been presented as more proof that Trump's policies are just populist, taking advantage of an angry middle America who just do not know any better.

But what happens if globalisation only works in the rare case where everyone is an honest and open participant in the game? Consider two countries trading with each other. Similar to most 'game theory' problems in finance, the best outcome occurs when there is cooperation between the countries in that both eliminate tariffs, allow freely floating currencies, protect no industries and enforce the same quality of life for their citizens. This way the best industries in each country will thrive there and everyone will have a better quality of life. But if one country has far more advantages than the other (whether it be through resources, education etc.), a trade imbalance will open up and the currencies will adjust to eliminate it. The movement in the currency makes the workers of the poorer country cheaper to the richer, encouraging some industries to move production across which evens everything out again. This is great, if it happens. Trade between Australia and New Zealand can mostly be categorized this way, so it can work.

The problem arises however when 'cheating' becomes prevalent it can destroy the whole idea of globalisation being mutually beneficial. Cheating can mean protecting industries in other ways apart from tariffs which may mean cheaper financing, subsides, less rights for labour etc. If you can successfully do this you will end up owning a large piece of the other country as you will need to fund their trade deficit for years to allow them to buy the stuff you make.

The thing is if you look just at the relationship between the US and China this is exactly what happened. The trillions of dollars in Chinese reserves (held largely in US Treasuries) accumulated over the first decade of this century is proof that the currency wasn't being allowed to correct for huge trade imbalances that were opening between the two countries. Economists were saying during this time it was proof the comparative advantage China had, especially in manufacturing. Labour was definitely cheaper, but the implication was that this labour was just as productive at a cheaper price. Or was it more to do with the fact that the lack of any labour protection laws gave Chinese labour an unfair advantage that the US could never hope to compete against without significantly reducing the quality of life for so many workers? Or the lack of any environmental regulations in China which have led to widespread air, water and land pollution, making the cost that the US is wearing to protect its environment a heavy weight around its neck when trying to compete on price? While these factors may be considered a comparative advantage (the environment can be considered a resource that can be squandered like oil or iron ore), stepping backwards on labour rights or environmental protection would result in a lower quality of life which may be even worse than losing good paying, manufacturing jobs.

Chart 5: The causes of inequality are obvious…

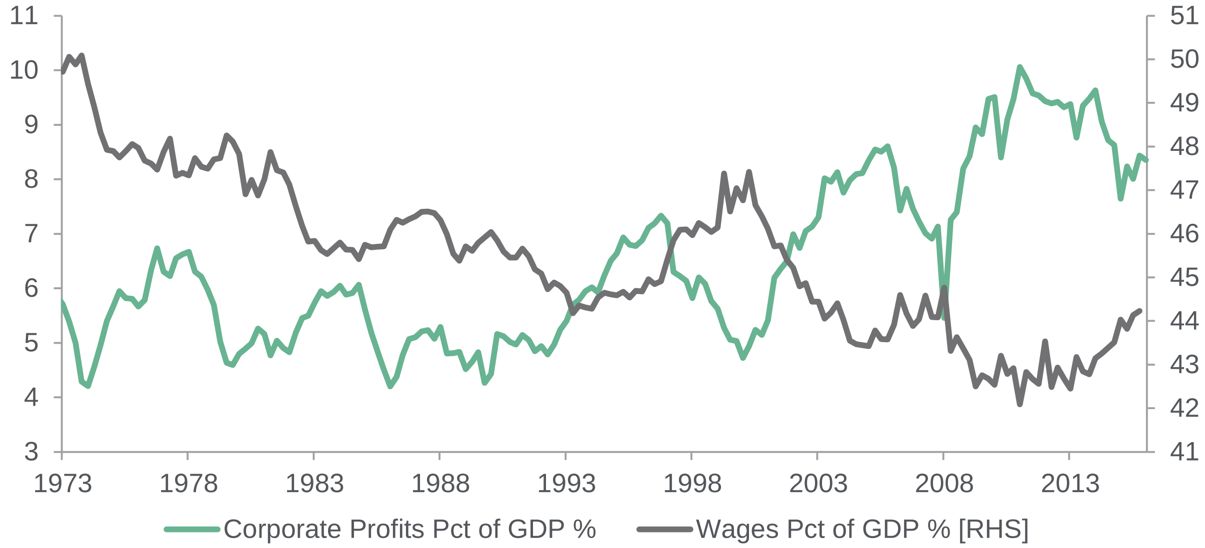


Source: Bloomberg

The question you may ask is why would the US subject itself to being cheated like this for such a long time? If China is the winner, surely the US was the loser? People knew they were losing jobs, and they knew they were losing them overseas, mostly to China. But the crucial point was not everyone in the US was a loser from this situation and this was very much the key to why the last election went the way it did.

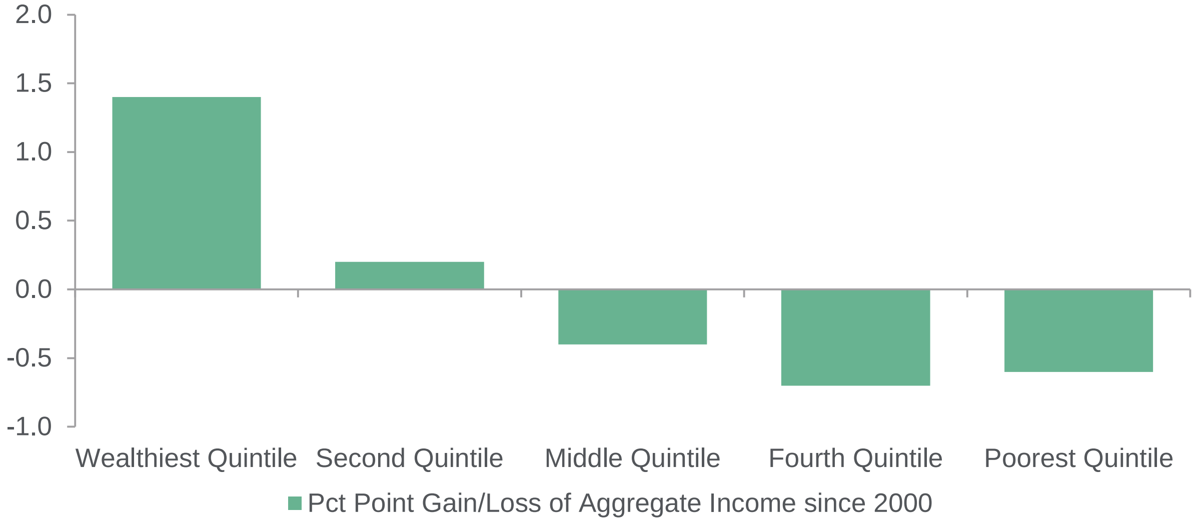
The beneficiaries of China being a cheap producer was the US corporate who could expand their margins while lowering prices by taking advantage of the cheap offshoring that China offered. Corporate profits as a share of GDP skyrocketed, while wages as a share of GDP kept falling. This chart is similar to the wealth inequality chart in Chart 4. According to the 2011 US Census roughly the top 15% of all households own 70% of the equities owned by all households, skewing the beneficiary of these gains to the richest, along with the skew of private companies being even larger. Household net worth over the latter part of the free trade period saw wealth only accumulate for the top two quintiles, everyone below that getting poorer, even though the GFC punished financial assets the hardest. The fall in the value of housing through the GFC hit the poorest disproportionately of course, but the credit that caused the housing boom in the first place are also rooted in issues with trade. To add to this these more powerful corporates started to 'own' the government through lobbying, ensuring their continued success.

Chart 6: …and the effects can be seen everywhere



Source: Bloomberg

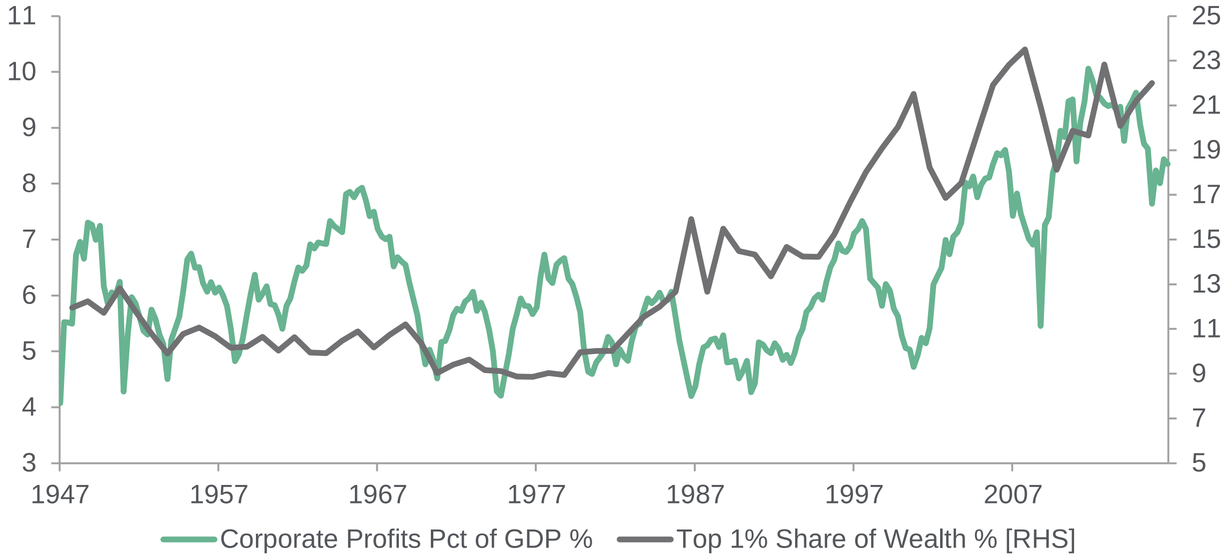
Chart 7: Income disparity has worsened since China entered the WTO



Source: Bloomberg

The longer run series show the ultra-rich accelerating their wealth in the late 1990s onward, the time when outsourcing and corporate profits as a share of GDP started making its multi-decade move higher. The theory of globalisation has made a lot of people rich beyond what could ever be imagined in the post-war period. The virality of a news article published in January stating that eight men are now wealthier than half of the world's population highlights the absurdity of this phenomenon.

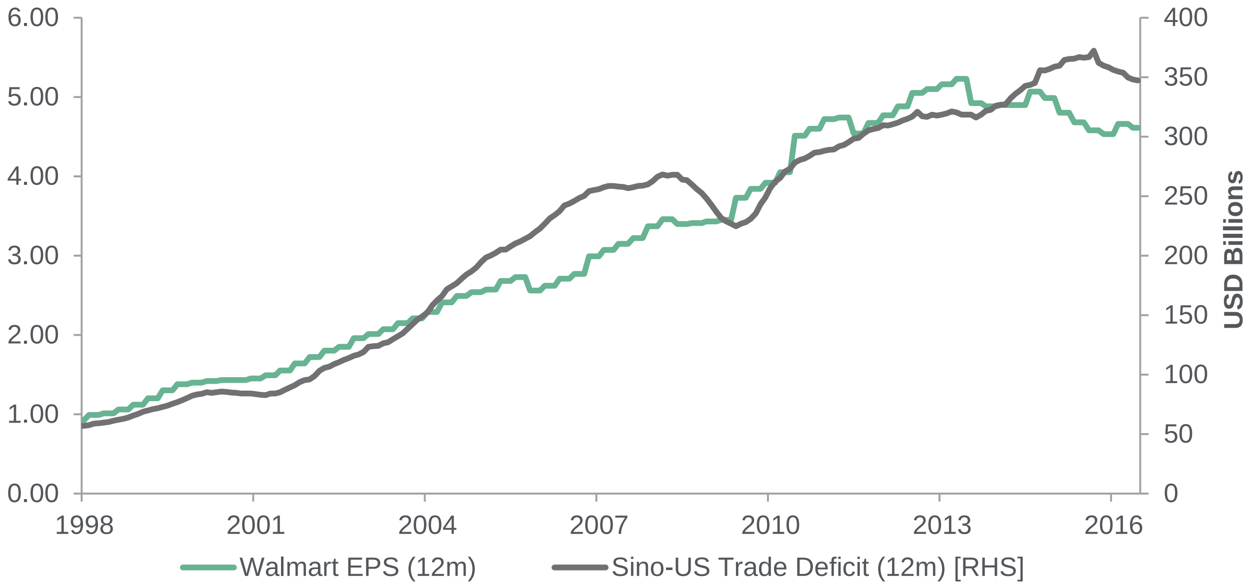
Chart 8: American firms have done well from globalisation



Source: Bloomberg, World Wealth & Income Database

Walmart as a company is proof of how the widening deficit with China benefitted business owners. The chart below plots Walmart's EPS versus the size of the trade deficit with China. While the EPS figure includes earnings from foreign expansion, the bulk is from domestic US. The correlation means that Walmart (who in reality accounted for more than 10% of the growth in the deficit from 2000) profited directly from the increase in imbalances between the two countries. These imbalances perpetuated by the 'cheating' that China has been doing, tilting the playing field towards itself and the US corporates who benefitted from lower production costs.

Chart 9: Walmart (and its shareholders) are globalisation winners



Source: Bloomberg

Incidentally the total return per annum over this period for Walmart was over 11% if you re-invested your dividends back into the shares, marginally better than the S&P as a whole (9.5%). At the same time the Economic Policy Institute (a left leaning think tank) estimated that Walmart itself displaced 200,000 jobs in the US from 2001[1] to 2006, a part of the estimated 3.2 million jobs lost to China from 2001 to 2013[2]. The disparity couldn't be any clearer.

So since the 1980s two key things happened in the US. Firstly, the elite in the US benefitted from China 'cheating' at free trade, making the middle and lower classes poorer over that period. But 'luckily' the high excess savings in China flowed back in to US Treasuries depressing yields which, when coupled with the ridiculous pro-cyclical loosening of financial regulation by the Fed, allowed Joe Sixpack to massively gear up and feel wealthy. You can only do this as long as the lower income brackets are willing and able to leverage up, but the GFC stopped this ability stone-cold. Thankfully the blowback happened in democratic elections rather than in a much worse, more violent way. Many of Trump's views are polarising to be sure, but he represents the hard-done-by working class that has finally risen and believes he actually has a plan that might work even against the ingrained leftist thinking.

Of what we currently know, the 'border-adjusted tax' has risen as the favoured way to start the protectionism by introducing simple, country specific, tariffs. A border-adjusted tax is less likely to be rejected by the WTO than straight tariffs and also less likely to get retaliation, as it is really just moving the US onto a level playing field with the rest of the world. All the details of the plan have not been sorted out yet, but in effect it's a whole new tax system for US companies. It throws away the old system in favour of one that is based on cash flows rather than net profit, with deductions for cash spent on inventory production that happens domestically, but no deductions available for cash spent on goods imported. In return the tax rate falls from a headline of 35% to 20%. This means for someone like a Walmart who imports a large portion of their inventory, their costs would immediately go up by 20% as the revenue made on those goods would be entirely taxable. No surprise Walmart (and its home state of Arkansas) are not supporting the deal.

While Trump has said that this taxing of the Mexican trade deficit through this mechanism will pay for the wall, it's really those US consumers that continue to buy Corona, tequila and Mexican made cars that will be paying for the wall. This means price inflation, something that

[1] http://www.epi.org/publication/ib235/

[2] http://www.epi.org/publication/china-trade-outsourcing-and-jobs/

will surely move the Fed when the time comes, especially if it happens when wages are rising strongly.

Next are the policies that really do get the Trump haters angry. One particular topic is the environment, which Trump appears not to care about one bit, enraging those who put it at the top of their global issues. We mentioned before that labour rights and the environment were two very big factors giving China the advantage. The EPA has been extremely aggressive in forcing through environmental regulations in recent history, increasing the cost of compliance for industry and widening this gap. While this is admirable, it makes the job of re-shoring all that much harder, and Trump knows it. Slowing down the increase in cost of compliance will put the US in with a fighting chance. He also knows that moving further away from fossil fuels will reduce your competitiveness against countries that have no qualm in abusing them. In the end a trade war could be one of the best outcomes for the environment - equalisation in environmental regulations could be sought as a possible negotiation between the US and China.

However whilst a trade war may drive up growth and inflation in the US while reducing wealth inequality, the effect globally will be nowhere near as positive. This will have to slow Chinese and EM growth, reduce commodity consumption and be deflationary for the rest of the world. If it works you can count on more countries doing it, worsening the effect. The story is a very US-centric one now which is concentrating on the positives there, but ignoring the serious effects elsewhere. The global story will surely eventually drive bond yields lower once again, albeit from higher levels, and this is even before considering the difficulties and tail-risk in Europe. Right now the global market is still feeding from the Chinese credit growth which will keep on pumping until the National People's Congress in November, plus the belief that Trump policies will drive not just US growth higher, but global growth. While Trump may end up delivering a better outcome for middle America, the rest of the world will suffer. Trade has already been slowing before the protectionist policies have even begun and it is not difficult to foresee the reversal of 20 years of global 'free' trade.

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About BTIM's Income & Fixed Interest Boutique

BT Investment Management's Income & Fixed Interest team of thirteen dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

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