10 Seconds Into 2020. Geopolitics and US Elections.

Welcome to a long rambling piece about the economic and market outlook. There is a lot to think about but in the end, if all you are interested in is the direction of the financial markets, go to the end of the article on **US Elections and Trump**.

Geopolitics. A key driver of economics and markets.

In the China versus US conflict we have a good old-fashioned rivalry between a rising power and a declining one. The conflict is already joined on the trade front. It is unlikely that two powers who are already at high levels of wealth would risk a shooting war, however, proxy wars are possible. One is likely already being fought in Hong Kong. More will likely emerge in unexpected and exotic locales, such as cyberspace.

China is rising. Proof of this can be found in US policy towards China, surely a defensive response to what it regards as a threat to its hegemony. Economic growth will slow as it does in all mature economies. Constant positive growth implies exponential growth which is unreasonable. The nature of China's growth is changing as well. Once the 52nd state of the USA, tasked with being the cheap factory of America, China is shifting from exports to a balanced, self-supporting economy with a more diversified export base. The Belt and Road Initiative is very interesting and parallels the US Marshall Plan in some respects. It will extend China's influence globally and further threaten the US hegemony. It is reasonable to expect an American response, but the scale of financial resources China is holding out to the rest of the world is probably more than can be ignored, even by America's allies.

That the US is turning its back on the rest of the world does not help its own cause, as China further integrates into the international community. As America builds walls, China builds

bridges. America's trade war is not only with China but with its neighbours and with its traditional allies, the Europeans. Not only is America turning away from business with Europe, it is turning away from NATO. This is a puzzling strategy given that NATO was the martial plan accompanying the Marshall Plan to address a belligerent Moscow. The direction America takes will depend somewhat on the outcome of the 2020 US Presidential Election.

Europe is a weak point in the global economy, especially under conditions of trade war. Brexit will soon be underway robbing the EU of its business lobby. At the same time, German leadership of the EU may not be as certain as Germany herself faces political uncertainty in the post-Merkel era. Meanwhile Macron's differences with the French people remain unresolved and Italy continues to be plagued by populist politics.

In all this, trust Russia to strategically align itself with the China bloc. Already Russia has aligned with India and China on military exercises as well as building parallel redundancies in financial infrastructure to reduce reliance on American standards. It is almost normal to expect more electoral interference by Russia in the coming US elections.

And speaking of India, the Prime Minister continues to operate a risky form of Hindu nationalism. Meanwhile the economy flounders as poor execution hamstrings an otherwise useful raft of reforms. Most recently, its insolvency law was confounded by an inexplicable ruling by the National Company Law Tribunal, the body to implement these very laws.

And finally, Japan, host of the Olympics this year. Who will replace Abe? The Prime Minister is in his third and final term as head of the LDP, although he may be able to get an extension for a fourth term.

Trade War.

As previously noted, the trade war is most visibly one between the US and the rest of the world, with special attention paid to China. If successful, the US will have reduced trade account imbalances, caused a great unwinding of globally supply chains, catalysed a spike in capital expenditure as capacity is relocated globally, and led to more robust but less efficient production. The result is likely to be higher prices at each given level of growth. This limits already limited central bank policy. Simply, it means either higher prices or lower growth and less capacity for policy to deal with it.

Fiscal and monetary policy. Central banks at their limits.

10 years of loose monetary policy has inflated assets while failing to raise growth or inflation. Orthodoxy is slowly pivoting towards fiscal policy.

In 2019 we saw the US Fed do a U turn and reverse its rate hikes, not only cutting rates 3 times but basically restarting QE and calling it something else. Most other major central banks were already in easing mode. The ECB had previously contemplated reversing QE but realized that the economy was too weak for that and in the end had to formally restart QE and cut rates further into negative territory. The PBOC had been easing all year, albeit in less noticeable fashion.

Why the need for so much monetary easing? The global economy had begun to slow, in part in line with its natural cycle and in part to do with a trade war. Either way, regulators were unwilling to let nature take its course and thus had to cut rates, buy bonds and provide liquidity somehow.

The ECB has recognized that it is at the end of its monetary rope. The negative rates are waterboarding the financial system. Banks, insurers and pensions are suffering. Outgoing ECB president Mario Draghi called for fiscal help even as he announced QE and a rate cut. Incoming ECB president Christine also called for fiscal help

further signalling that more monetary easing would be of limited utility.

Among central banks, the ECB and BoJ are probably at zero marginal effectiveness. The US Fed has room to cut and may need to do so just to maintain the economic status quo. The PBOC has its own toolkit and is far from exhausted.

This fiscal policy. Europe has the most reason and room to do it but has political frictions to overcome. In the end, the relative weakness of the German economy will likely lead to some give from the Germans. The other members of the EU are less likely to press for budgetary discipline.

In the US, the Republicans are most likely to maintain fiscal discipline except that they are led by Trump, a natural profligate. The Democrats are unlikely to be any more disciplined given their current agenda.

Fiscal policy seems almost like an idea whose time has come again.

The textbook dangers of unlimited monetary and fiscal support are excessive and rising national debt and the eventual loss of confidence in policy and currency leading to runaway inflation or a currency crisis. This has not happened in Japan where nearly 3 decades of constant support have failed to either provide results or induce a crisis. Whether such policies can be operated elsewhere with such benign and ineffective results remains to be seen. Japan might be a special case.

A more fundamental question is, what is the right level of growth that policy should aim for? Is it that level that maintains low unemployment? And what if inflation resurfaces?

Since the 1980s most policy responses to recessions have been monetary which exerts downward pressure on interest rates. The engagement of fiscal policy exerts upward pressure on interest rates and will have unfamiliar implications for markets and the economy. Additionally, fiscal policy is not only an economic

decision but involves many political ones and can raise lines of division.

Inequality. Beyond fairness.

In a knowledge economy the ability for capital or institutions to accumulate generations of intellectual capital versus a human being’s ability to store one lifetime of IP encourages a chronic decline in labour’s share of output. Owners of capital benefit from passive accumulation of intellectual property and hence wealth whereas labour must constantly actively acquire intellectual capital to maintain relevance. This increases inequality, potentially without bound.

In many countries, electoral success correlates with the ability to raise campaign finance such that political outcomes are influenced by wealth. Political lobbying is also a costly activity further biasing outcomes towards the interests of the wealthy.

Inequality in moderation encourages progress. However, excessive inequality lowers the informational efficiency of an economy and lowers growth. It is also a risk to social order. The awareness of inequality has risen in recent years. When inequality begins to feel like injustice, social stability is threatened. Dissatisfaction can manifest in many ways which may be appear only tangential to the real issue.

Greater inequality also means more financial investment which means richer assets. That inequality slows growth by skewing the marginal propensity to consume of a population means that demand for financial assets rises as growth slows leading to higher valuations.

Global Outlook

A temporary respite. A difficult future.

Growth had slowed but is currently flattening out. Expect 6 months to a year of recovery in the global economy but that this is only a temporary respite as the world reorganizes itself to a new trading environment. It is likely to be a capex driven recovery as new capacity is built and old decommissioned in the reorganization of supply chains. Beyond this, there is unlikely to be any game-changing technological advance to drive growth to a protracted and new cycle. Growth likely peaks within a year.

With the supply chain reorganization following the trade war, inflation is likely to resurface. Fiscal policy, if engaged by then, will keep economies at close to full employment and could fuel more price pressures.

US equity markets have done well in the past year and are expensive. For them to rise further would require rising earnings, a cessation of trade war, more rate cuts or rising share buybacks. If the US economy slows, the Fed could resume rate cuts. It is already operating QE in all but name. Rising earnings or a cessation of trade war are low probability events. For buybacks to re-accelerate would require low interest rates.

There is a heightened risk of underperformance from US equities relative to the rest of the developed markets.

Credit markets should correlate well with equity markets. Duration is another story. There is significant risk around duration as geopolitics impacts the treasury market. The Presidential Election coupled with threat of a Trump impeachment, will add volatility. One should be cautious around duration exposure, which will be less predictable than credit spread exposure. Household credit (RMBS) is preferred to corporate credits. Floating coupon is preferred to fixed. A year’s outlook is too short to prefer IG or HY with the preferences probably switching through the year.

European equities also did well despite a weak economy, so even Europe is no longer cheap. European rates have been cut to rock bottom and it is hard to see any more rate cuts, or acceleration

of QE. If fiscal policy is engaged, the EUR curve will likely steepen. European equities, however, are supported by cheap funding which is advantageous if they do significant business outside Europe. For banks, a steeper term structure will be a relief. Apart from banks, European equities are at risk of underperforming developed Asia.

European credit will correlate with equities. The IG term structure has done well and there is no need to extend spread or rate duration. The duration outlook is less rosy as fiscal policy looms in the background. CoCos have been an area of focus and while the outlook remains good, extension risk will have to considered.

China’s growth while slowing remains high. Also, there is some visibility to future growth as investments in Belt and Road Initiative pay off. This is, however, not a 2020 trade but one for the longer term. The PBOC is likely to remain accommodative and provide significant credit and liquidity via the formal banking system. In the shorter term, this dovish monetary policy is likely to drive equities.

The credit market will be more challenging. It is clear that China is balancing between stability, which it craves, and a more robust credit system. Robustness requires a working NPL resolution process, which by definition involves some level of instability as companies file for bankruptcy or default. The market may take some time to absorb this new reality. It is best to avoid any reliance on moral hazard, and to remain with quality credits until bankruptcy becomes part of the normal course of business.

US Elections and Trump:

Many factors can move the market but at any one time, only one does. The challenge is identifying that one factor. In 2019, that one factor was central bank policy. It doesn’t mean its easy to figure out the market, since its just a transformation of the

problem from figuring out the market to figuring out central bank policy. Sometimes, central banks themselves can seem a little lost.

In 2020, financial markets will likely be driven by geopolitics. 2020 has not a busy election calendar except for the US Presidential Elections. The European calendar is fairly quiet, though ructions can arise off-calendar. French PM Macron's ratings seem to have stabilized after falling sharply during his spat with the gilet jaunes. Even with impending Brexit, the UK now seems stable as the recent election allowed PM Johnson to consolidate his control. The risk may come from Germany, the pillar of stability which is now rocked by the rising support for AfD and the challenge Merkel successor Kramp-Karrenbaur faces in holding her coalition together. Spain seems to be seeking to form a government on a continual basis.

The most important event in the calendar will be the US Presidential Elections. The incumbent Trump heads into battle under the shadow of impeachment. His strategy for staying out of trouble and in the White House will determine influence the path of international and domestic politics, which will in turn impact markets in 2020. Given also, his psychological profile, **President Trump will make this election all about him**.

Trump versus the Fed.

Having won previous rounds, there is a good chance Trump will continue to harass the Fed in 2020. The economy is slowing and data could support a resumption of rate cuts. That said, given treasury issuance and a possible international buyers' strike, the Fed may face a steepening term structure even if it keeps short rates low. Trump may pressure the Fed to restart QE. The Fed is in fact already back on QE, just not calling it that. On balance, short rates are capped and could be cut. In the longer term, inflation will likely support the term structure but in the short

term, the curve might go nowhere.

Trump versus China.

This is a fundamental struggle and one that will not go away. Here, Trump finds bipartisan support, although his methods may confound the more strategic plans of business leaders and more strategic minded policy makers. Before you wage war, get your assets out of there. Expect a disengagement of commercial interests and supply chains. The result will be slower growth, higher inflation and in the interim, a rise in capex.

Taiwan holds elections this Jan 2020. The result will hold opportunities and risks for both China and the US. For the US, Taiwan is an opportunity to stir trouble in China’s backyard. The strategic goals are not clear, but it would be too good an opportunity to inconvenience and embarrass China if a pro independence party won the election, or if a pro-China party wins, to stir up protest and revolt. If this happens, it could be the start of a threat to the semiconductor industry and their clients.

The ongoing Hong Kong troubles are an excellent area for stoking trouble for China. If the US has not already done it, it would make sense for them to fund, instigate or otherwise encourage more anti-China sentiment and action in Hong Kong. This could lead to another year of underperformance for Hong Kong stocks.

There is a risk that Trump’s engagement with China becomes more reckless and takes on a military dimension. This could arise in the South China Sea. Such a conflict has the potential to ignite acute risk aversion globally.

However, given China’s rising strength and influence, Trump may be more careful to pick a fight he can back out of, or win easily.

Trump versus Europe.

The Trump view of Europe is a transactional and tactical one. President Trump has cited contributions to NATO and bilateral trade deficits with the EU as areas of concern, seeking to extract greater commitment from Europe on defence spending as well as efforts to close the trade gap. It appears that Trump has abandoned a 70-year-old thesis that a strong and united Europe is good for America. Complicated relationships between Russia, the Middle East, Europe and the US are likely to create more tensions.

In an election year, Europe is a good target. It is still a friend and it is relatively weak. For Trump it is important to engage in a fight he can win easily and or back out of, which could be difficult with China.

Trump versus the Middle East.

In a region where the line between friend and foe is sometimes blurred, the aggressive approach of President Trump is likely to stir up all sorts of uncertainties. Generations of strategic thinkers have grappled with the issue in the Middle East with limited durable success. The Trump approach is likely to alienate some friendly forces while the risk of making friends of foes seems remote. Depending on the European response to Trump's Middle East policy, the risk of further tensions between Europe and the US are heightened.

Buy oil, gold and TIPs. Keep duration short but non negative.

Trump versus Democrats.

At this time the Democrat front runners are Biden, Sanders, Buttigieg and Klobuchar. So far, their campaigns have been too much about Trump. Can the moderates compete against the erratic charisma of Trump? Will the progressives alienate the people? A Warren Presidency would be good for America, but only if she could

do two terms and the benefits would only accrue to her successors. Warren would be immediately painful for America, like bitter, necessary medicine. A Warren or Sanders Presidency would be negative for risk assets but an opportunity for healthy reform.

Bet long the moderates, and short progressives.

Trump versus Russia. Its complicated…