July 2022

CQS Asian Macro Fund

The Big Picture

by Geoffrey Barker

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Outlook for the Global Economy and Markets

The Shape of Things to Come

The chorus of voices now calling for global recession has become a cacophony. If there is one thing that we should have learned over the last couple of years, it is to beware of bold predictions. The current economic "cycle" has little resemblance to any in recent memory, being subjected to unusual shocks – trade sanctions, Covid, war etc – and horribly skewed by unconventional policy responses.

Investors should keep in mind that equities can undergo bear markets even without recession. The Wall Street collapse of 1987 – Black Monday – was triggered by sharply rising rates and did not presage any meaningful growth slowdown. Neither is a GDP recession needed to generate a decline in corporate earnings. Profits can be more susceptible to margin compression, driven by cost increases and perhaps amplified by exchange rate volatility, than to changes in top-line sales. Such cost pressures are obviously pertinent to the earnings outlook today.

Talk of global recession overlooks wide disparities in the sectoral and regional growth pictures. China has already had a "double-dip" recession and is gradually emerging from the latest lockdown-induced decline in activity. Several European economies, including the UK, are probably now back in recession thanks to surging energy prices but tourism supports others. Japan remains vulnerable to import cost pressure but is "opening up" domestically. The US has been the strongest link thus far. By sector, industrial activity and international travel are weak but domestic services are in better shape.

Our base case has been that recession in Europe and weakness in Asia would be transmitted to the US via the exchange rate, crimping the profits of multinationals. Meantime, the US Federal Reserve would continue to tighten monetary conditions until unemployment began to rise – to tame labour costs – thereby making an outright contraction in the economy all but inevitable.

This still seems plausible but there is scope for positive surprises. To begin with, inflation could start to fall more quickly than now anticipated as supply-side shocks dissipate. China has been adapting its zero-Covid policy to limit disruptions to production and shipping. Chinese purchasing managers are reporting rapid improvements in supplier delivery times and producer prices are dropping. In the US, producer margins that widened sharply to take advantage of goods shortages have similarly peaked out.

Of course, a turnaround in these "transitory" factors will not count for much if energy prices keep spiralling and absorb consumers' discretionary income, notably in Europe. What is really needed to dispel uncertainty would be a breakthrough in the Russia-Ukraine war. This seems like a tall order today, with Putin's Russia treated as a pariah state, but were Russia to gain territory and then declare a ceasefire then some of the tail risks could drop out.

The point to recognize is that there are many tactical permutations and non-economic variables at play. Rather than being dragged into the maelstrom of short-term noise, it would be helpful to take a step back and try to discern the larger forces shaping the long-term outlook.

Regardless of the timing of the next recession, our view is that we are witnessing a paradigm change in the global growth outlook and a more challenging era for investors in financial markets.

The heart of the issue is that most major countries have exhausted the scope for increasing leverage – the ratio of debt to GDP. The so-called "debt super-cycle" – that was given a new lease of life in the aftermath of the global financial crisis in 2008 by the expansion of central banks' balance sheets – has finally reached its zenith and a period of retrenchment is likely.

The secular downtrend of inflation since the 1980s allowed central banks to run asymmetric policies, keeping rates too low for too long. Cheap money encouraged greater borrowing – by households, by companies and by governments, in Europe, in the US and in China.

As the deflationary forces of globalization, deregulation and demographics have been replaced by cost-push from Cold War, ESG and shrinking workforces, so productivity has been steadily eroding. Covid has served to accelerate the process, triggering inflation and forcing a reversal in policy.

The global economic challenge therefore is to stem the declining trend of productivity and ultimately improve the "growth-inflation" trade-off. This is no small matter since geo-political divisions are not going to disappear, and there will be inexorable pressure on government budgets from pension and welfare burdens.

Without an improvement in productivity, the avenue of simultaneously easy fiscal and monetary policies is closed off by inflation – as we are now experiencing. The global economy will be condemned to a series of shorter boom-bust cycles.

Neither should investors place much store in expensive government investment programmes – even if we could afford them. Top-down directives are no substitute for the market when it comes to allocating capital efficiently. The march towards authoritarianism in China and in parts of the developing world does not bode well.

Although there may be specific projects that require public support, the best advice is for governments to "get out of the way." Reduce red tape, simplify tax codes, improve the quality of education and training, enforce anti-trust legislation, and do not offer bailouts.

Of course, what will happen in practice is that discipline will be imposed by markets. The primary mechanism will be higher borrowing costs, as central banks withdraw from their QE policies, and as widening credit spreads reprice risk. A period of Schumpeterian creative destruction will follow thereby reallocating resources to stronger hands. But this may take a number of cycles to play out.

To improve efficiency, we need to see a new wave of private capital investment focused on innovation, be it in new energy sources, battery storage, biotechnology, blockchain, artificial intelligence etc. The countries that create the conditions for such investment will emerge with greater vitality.

What is the process that will drive this outcome? What are the likely contours of the new economic paradigm?

To begin with, there cannot be a new wave of private capital investment unless it is profitable for companies to expand and take risk. The main barrier to such expansion is the cost of energy. Most countries are paying the price for failing to secure reliable power supply and for imposing unrealistic and artificial timelines on the transition from fossil fuels to green energy sources.

The first order of business – starting in Europe, Japan and parts of EM – has to be a period of "demand destruction" to bring down energy costs and restore profitability.

But energy is not the only factor of production that is mispriced. We should also expect to see property prices – that have been the source of speculation in many major cities over the last few decades – peak out and begin a multi-year adjustment. The combination of rising mortgage costs, retirement of the baby-boom generation, higher taxes and the drying-up of demand from China and Russia is a toxic brew.

A substantial decline in the cost of real estate over the next decade or more, bringing down rents, will help to restore profitability for small businesses and release purchasing power for younger generations who have a higher propensity to spend. Improved affordability will boost productivity in the real economy. But the adjustment will not be painless for investors.

Another major change to the shape of the global economy, stemming from the end of globalization and the trend towards "on-shoring" of production facilities, is likely to be an end to the "mercantilist" growth model. Countries that subsidize their exporters via exchange rate intervention, favourable tax treatment, lower energy costs and the like, and that fail to nurture a vibrant domestic economy (often because of over-regulation) will struggle.

China remains a key risk to global growth for both the reasons cited above. China was a primary beneficiary of globalization, but its growth model is now broken and there is no quick fix to its bloated and overvalued property sector. While a closed capital account keeps the economy liquid and reduces the risk of a financial crisis, there is no obvious growth driver.

Investors should be aware that changes in the global economy are bringing with them a shift in the political zeitgeist. Cheap money and access to credit were partial substitutes for weaker income growth for the mass of western consumers. But, since the housing crash in 2008, politicians have been under pressure to re-distribute income. Rising inflation intensifies this pressure.

The upshot is that financial markets have lost their policy backstop. The so-called "Fed put" is gone… and the bar for restarting any QE programme is very high.

Many commentators seem persuaded that balance sheets are in good shape and any recession will be short and shallow with relief coming once inflation falls. The truth is that global debt-GDP ratios are too high, and credit has been artificially cheap. The game is over – it's payback time!

Geoffrey Barker

13th July 2022

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2478658273 / G-22-0120 / 07.22