Thumbs up, but….
Comments on debt, volatility and BIG TECH for investors
Bart Le Blanc

- *Near term macro outlook positive but need to continue structural reforms (better now than later e.g. in a coming cyclical downturn)*
- *But structural reform (e.g. liberalization of labour markets, reduction of workers' rights and welfare/social security) will create new socio-political tensions*
- *Positive developments on geo-political front (e.g. trade, Korea, EU leadership)*
- *Continuing worries over growing public and private sector debt, with private sector to suffer the most from a double whammy of higher interest rates and increased credit spreads.*
- *Volatility is back driven by inflation and interest rate fears.*
- *Investors need to refocus on long term horizon and ignore daily swings.*
- *Diversify between **and** within asset classes*
- *Urge managers to use risk budgets, avoid benchmark hugging; invest on the basis of longer-term trends/themes such as health/longevity.*
- *Big Tech will change but needs to stay in diversified portfolio. Growth and margins will reduce due to privacy issues, data protection, taxation and a more expensive business model.*

1. *"Cyclical Upswing, Structural Change"* is the title of the latest IMF World Economic Outlook (April 2018).
   And that captures it: the macro picture looks benign (a "thumbs up"), but the IMF warning that structural reform needs to continue and vigorously implemented is as strong as ever (the school master's last warning).

   Current projections for economic growth are higher than earlier expected (see table below) with the emerging economies showcasing a consumption-lead growth supported by higher commodities prices (e.g. Brazil), and developed economies such as the European Union countries (attention Spain!) strengthening substantially on the back of higher capital investment.

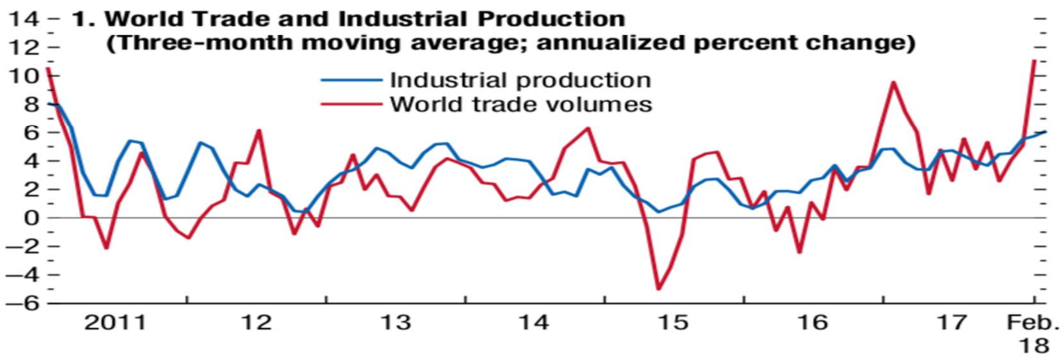
Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from January 2018 *WEO Update*[1]		Difference from October 2017 WEO[1]	
	2017	2018	2019	2018	2019	2018	2019
World Output	**3.8**	**3.9**	**3.9**	**0.0**	**0.0**	**0.2**	**0.2**
Advanced Economies	**2.3**	**2.5**	**2.2**	**0.2**	**0.0**	**0.5**	**0.4**
United States	2.3	2.9	2.7	0.2	0.2	0.6	0.8
Euro Area	2.3	2.4	2.0	0.2	0.0	0.5	0.3
Germany	2.5	2.5	2.0	0.2	0.0	0.7	0.5
France	1.8	2.1	2.0	0.2	0.1	0.3	0.1
Italy	1.5	1.5	1.1	0.1	0.0	0.4	0.2
Spain	3.1	2.8	2.2	0.4	0.1	0.3	0.2
Japan	1.7	1.2	0.9	0.0	0.0	0.5	0.1
United Kingdom	1.8	1.6	1.5	0.1	0.0	0.1	–0.1
Canada	3.0	2.1	2.0	–0.2	0.0	0.0	0.3
Other Advanced Economies[2]	2.7	2.7	2.6	0.1	0.0	0.2	0.1
Emerging Market and Developing Economies	**4.8**	**4.9**	**5.1**	**0.0**	**0.1**	**0.0**	**0.1**
Commonwealth of Independent States	2.1	2.2	2.1	0.0	0.0	0.1	0.0
Russia	1.5	1.7	1.5	0.0	0.0	0.1	0.0
Excluding Russia	3.6	3.5	3.6	0.1	0.1	0.2	0.1
Emerging and Developing Asia	6.5	6.5	6.6	0.0	0.0	0.0	0.1
China	6.9	6.6	6.4	0.0	0.0	0.1	0.1
India[3]	6.7	7.4	7.8	0.0	0.0	0.0	0.0
ASEAN-5[4]	5.3	5.3	5.4	0.0	0.1	0.1	0.1
Emerging and Developing Europe	5.8	4.3	3.7	0.3	–0.1	0.8	0.4
Latin America and the Caribbean	1.3	2.0	2.8	0.1	0.2	0.1	0.4
Brazil	1.0	2.3	2.5	0.4	0.4	0.8	0.5
Mexico	2.0	2.3	3.0	0.0	0.0	0.4	0.7
Middle East, North Africa, Afghanistan, and Pakistan	2.6	3.4	3.7	–0.2	0.2	–0.1	0.2
Saudi Arabia	–0.7	1.7	1.9	0.1	–0.3	0.6	0.3
Sub-Saharan Africa	2.8	3.4	3.7	0.1	0.2	0.0	0.3
Nigeria	0.8	2.1	1.9	0.0	0.0	0.2	0.2
South Africa	1.3	1.5	1.7	0.6	0.8	0.4	0.1
Memorandum							
European Union	2.7	2.5	2.1	0.2	0.0	0.4	0.3
Low-Income Developing Countries	4.7	5.0	5.3	–0.2	0.0	–0.2	0.1

In the current context of President Trump's sabre-rattling on trade and the ongoing Brexit debate, the IMF seems to take an almost sardonic pleasure in highlighting the importance of global trade for sustainable growth.

The graph below illustrates the recent increase in world trade volumes and its beneficial impact on industrial production and thus by extension economic growth.

Global growth surprised on the upside in the second half of 2017 amid strengthening industrial production and trade.



In addition to the improved commodity prices and higher trade levels, the US economy (and in the slip-stream of this the rest of the world) is starting to reap the fiscal benefits of the recently approved US tax reform.
However, the IMF concludes that part of the higher growth outlook is temporary: paid for by extra public borrowing in the US, which will need to be rebalanced in the future.
This fiscal rebalancing combined with progressive tightening of the monetary oversupply could lead to a cooling off in the near future. So in a way, the IMF asserts that the growth impact of the US tax reform could bring extra growth in the short term, which might very well be wiped out in later years. As such the net-net effect of the tax reform over time could be zero!

As Martin Wolf, the Financial Times economics editor aptly summarized the gist of the Q1 World Economic Report well in the headline of his FT article of 18 April: *"Times are good, but the fragility is real"*.

Hence the IMF's call for strong commitment to continue structural reform in order for national economies to withstand any forthcoming cyclical downturn. However, "structural reform" is such a container-word, one that sounds good but hides a lot.
As such we should not forget that such structural reform will primarily involve reduction of workers' rights (which were fought for a long time ago). It also means a retreating government in welfare and social security, which will affect the "weaker" parties in society. All in all easier said than done!

The IMF again voiced its multiple warnings against the perils of trade wars and provides an extensive description of the major risks for this growth outlook: the potentially negative effect of the interest rate normalisation and the return of wage-inflation (see in following comments on volatility).

So was the IMF report happy reading?
Not really, but one becomes numb following the repetitive warnings of the IMF and all other (Western) economic gurus over the years.

2. Financial markets are not exclusively dominated by macro-economic developments, and today's geo-political environment might easily

and unexpectedly push markets off course as we have seen happening in recent months. The long list of major geo-political risks keeps evolving.

The risk of a full blown US initiated trade war seems to have abated , and - it pains me to say - but maybe President's Trump bullying tactics could bring China closer to some form of transparent trade policies both in terms of dumping practices and respecting intellectual property rights of others.
And like it or not, the rapprochement on the Korean peninsula might ease (nuclear) tensions in the region…..

Brexit still rumbles on in the UK (and in Brussels) and the first economic impact has started to emerge. The IMF report emphasizes that uncertainty surrounding post-Brexit trade relationships will weaken investments in the short term. However, the certainty of higher barriers to trade after Brexit (tariffs or administrative) will impact foreign direct investment negatively.
Britain and the European Union will both be poorer in the end.

France is emerging as the new European leader with President Macron pushing through a broad reform package and a new European action plan.
His steadfastness in the face of many adversities has impressed many at home and abroad.
One needs to keep in mind the special position of trade unions in France. Their membership is exceptionally small with only 7% of the workforce being a registered union member, yet they carry an exceptional clout in the French social-economic landscape.
Maybe the fact that the national unions are mainly financed by employers on the basis of the company's wage bill ("*contribution patronale au dialogue social*") and subsidies from central and local government and *not by member contributions,* has something to do with it??
But with Emmanuel Macron as the new Thatcher for the millenials, the world may see change.

Other EU worries relate to Greece's debt programme and Italy's new political coalition. In both cases, progress has been made and erstwhile fears have been reduced to background noise.
However, major political tensions remain inside the EU (populist movements in Eastern European countries and on Europe's borders

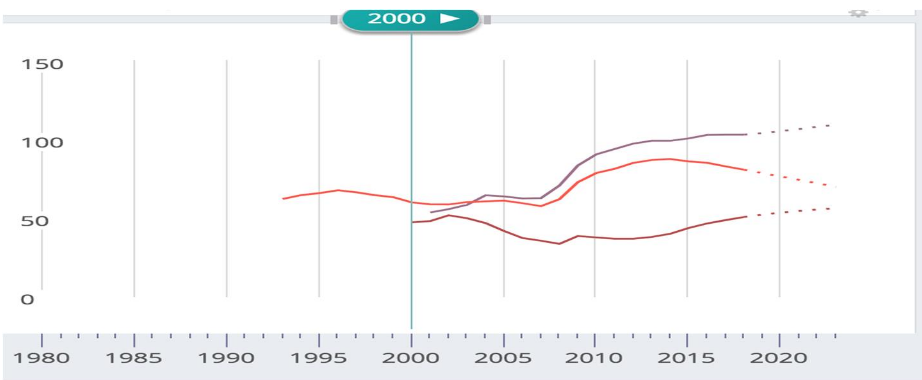
(Russia, Turkey) and unexpected political events could derail financial markets.

To hedge against these risks we look at a few specific topics: debt, volatility and some comments on the role of BIG TECH.

3. Indebtedness was identified as a major concern in the IMF report. Debt is not only an economic issue; it also carries an important political element.
   The rising levels of public debt in China have been criticized for years. Although the overall level of government debt is still modest by comparison to developed economies ("only" 51% of GDP in 2018), but the sharp increases over the last decades from 28% in 2000 to 34% in 2010 to over 50% today is worrisome. This is particularly true once seen in the context of the development of private sector debt in China (commented on below).

   The IMF report expresses worries over the un-funded US tax reforms which could lead to further rising levels of the already high US primary deficit which is expected to increase to 120% in the 2020s (see graph).
   At the same time the levels of government debt in the European Union have been falling since 2015.

Government debt levels in % of GDP
US (top line), China (bottom line) an the EU (red middle line)



Source IMF April 2018

Uncontrolled public spending will certainly lead to higher interest rates, particularly in a time when central banks are finally withdrawing from the massive monetary support provided since the financial crisis.

The impact of interest rate rises will be felt far beyond the public sector. It will force additional to government savings programmes and thus budget cuts, which will per definition affect the poorer/weaker parts of society.
It will also push up interest rates for other borrowers and will first hit mortgage rates and corporate lending costs.

US borrowers have already seen rates moving from 2.5% to over 3% for 10 year in the last few months. But they could be faced with a double whammy once credit spreads will rise as well.
And therein may lie a greater economic risk than in the increase of government debt.

Private sector debt normally moves with the economic cycle.
In times of economic growth, households feel confident that their income is secure for years to come so they borrow for housing and luxury goods while companies invest for future business growth.
Over the last decades we have seen a consistent increase in Chinese private sector debt which now exceeds 200% of GDP compared to around 150% levels in the US and Europe.

Many commentators speak about the risks of the Chinese credit bubble bursting and the economics editor of Sky News wrote just last week: "*We all suffer when the credit buddle bursts…it's private debt that sink us*".

However, I do not feel that the level of Chinese indebtedness is a major economic issue given that:

- It fits the current stage of China's development strategy and its infrastructure investment plan
- China will grow out of it rapidly with annual GDP growth of above 7% per year
- Domestic savings provide a major funding source at 50% of GDP (twice the level of Europe, the US and even of Japan today!

The corporate sector in Western economies (North America, Europe) has been borrowing record amounts since the financial crisis benefitting from cheap money.

Corporate debt funded investments programmes, corporate take-overs and share buy-backs have whipped into a new frenzy over the last 5 years.

In parallel with low interest rates, credit spreads have tightened over the last years (see graph below).
This is not per se an economic rational reaction as it totally disregarded the basics of credit risk development.
Surprisingly thus far, recent rate reversals have had no impact on credit spreads …. for the moment even spreads for high yield debt seem unmoved`.

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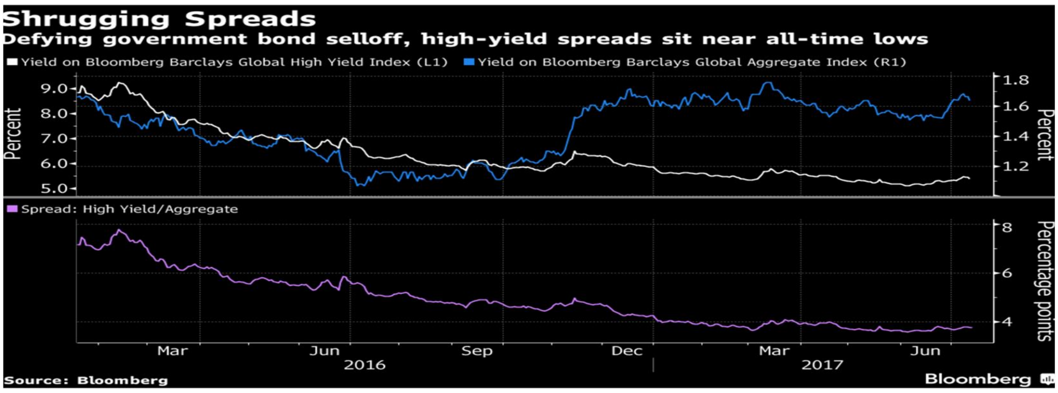
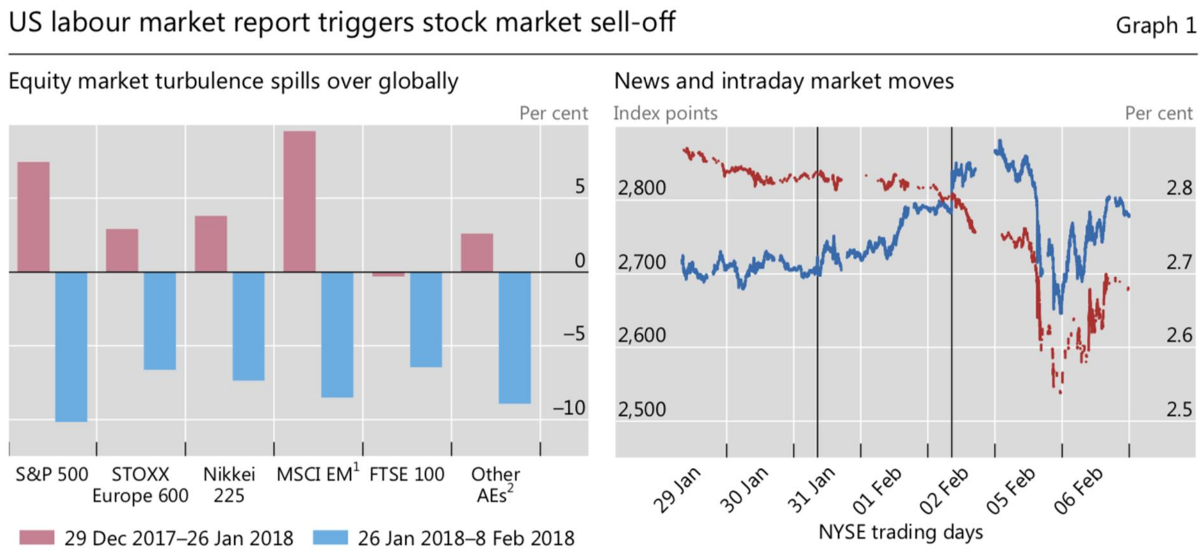


However, re-assessment of credit risk might not be far off as the current business cycle reaches a turning point. This might lead to higher corporate default rates and thus higher credit spreads.

Once credit spreads start widening and the overall rate levels increases simultaneously, the corporate credits could show significant loss of value for investors
The same will then apply to the more nascent asset classes such as growing market of securitized personal loans in the illiquid, alternative credit asset class.
So investors better be aware!

For the moment credits seem to be expensive, particularly in the high yield sector. In a search for yield some alternative credit options could be interesting provided that the investors' risk profile allows for reduced liquidity and potential valuation swings. Best to avoid general corporate or personal loan funds and focus more on thematic/trend type finance (seen also below).

4. Volatility seems to rear its head again.
After almost a decade of gradually fading volatility, the beast raised its head again in the first quarter of 2018. Following the publication of the US Labour Market Report which showed an unexpected rise in wage growth, the equity markets in the US and elsewhere fell and rebounded and fell again with very high levels of intraday volatility as demonstrated by the VIX index which broke through the 15 level for the first time in a long period (see graphs below).



Source: BIS Quarterly Review March 2018.

This coincided with increased volatility is the bond market which was already suffering the effects of creeping interest rates.
The related impact of inflation and interest rates increases the skittishness of already unsettled markets, and volatility in both equity and bond markets returned to levels long time not seen for a number of years.
And all this took place in an environment of US dollar weakening which brought its own volatility in the exchange markets. A recent study released by the Bank for International Settlements (“*Volatility is Back*”, *BIS Quarterly Review, March 2018*) implies that further volatility is likely on the cards as inflation and interest rates rises are expected.

In recent quarterly filings by US companies new worries about rising inflation were presented in an almost coordinated way across sectors (see Q1 2018 reports from Caterpillar, Google and Procter & Gamble).

For investors this new volatility in all markets may come as a shock. With no place to hide, there seem to be only a "wait-and-sit-it-out" option left. But at the same time it re-invigorated a debate over the purpose and the time horizon of investing and the role of investment managers.

The lessons to be drawn after too long a period of low volatility are:

- Re-affirm that **portfolio investments are not short term**; the investment horizon is at least 5 years
- **Diversification** still pays off but also needs to be implemented **within asset classes** (e.g. listed stocks, option strategies, private equity, hedge funds, etc).
- Select active managers who **actively use risk budget** in stead of "benchmark huggers"
- Invest in **themes and trends that drive the future**: health/longevity, technology, environment and where possible link these themes (e.g. invest in apps-development for health sector)

5. A brief comment on BIG TECH.
   Big tech companies like Facebook, Apple, Amazone, Netflix and Google have become under renewed scrutiny of late for a variety of reasons, some of them economic, some legal, some ethical and many of them political:
   - Big tech is seen as unacceptable monopolists who destroy many small and medium sized businesses in the retail and whole-sale sector.
   - It does not pay the expected corporate tax contributions as their business network set-up is global using tax arbitrage in an efficient, though legal way.
   - Social media companies deny any responsibility for content of what is disseminated via their platforms, even if its helps terrorism and criminal activities.
   - Major criticism is directed to their business model, which builds on the multiple usage of data of their customers for repeat business (sometimes elsewhere) without explicit consent. A free of charge service seemed all of a sudden an expensive service where you needed to pay by handing over your personal information! As the Financial Times wrote on 28 April: "*We know now if the service is free, you are not the customer but the product*".

In the short term, it is unlikely that these criticisms will go away.
The (international) coalition of opponents from economic interest groups, politicians, privacy rights activists, institutional investors, etc. has become too broad and deep.

Something needs to give although maybe not (yet) the heartfelt and passionate plea for a forced break-up by Scott Galloway, an American university professor and writer of the book "The Big Four".
He portrays the big tech companies as " *Silicon Valley's tax-avoiding, job-killing, soul-sucking machine*" (title of his article in Esquire of February 2018).
His views were recently echoed by the IMF's chief Christine Lagarde when she stated in a news interview: "*Too much concentration, too much market power in the hands of too few is not helpful in the medium to long terms, neither to the economy nor tot the well-being of people" (Times, 20 April 2018).*

How sensitive the tech firms are to particularly political/privacy protectionists' pressure was illustrated by the performance of their stock prices following the Facebook/Cambridge Analytica misuse of private data for political messaging in March 2018.
Facebook stocks dropped by 15% in the last 2 weeks of March.

Should investors therefore avoid big tech in their portfolios?
My initial answer is NO.
But the expectations around the performance of these stocks may need to be tempered for multiple reasons such as:

- It seems quite likely that possibly in an internationally coordinated way (OECD?) the big tech (and other global companies) will be forced to pay more corporate tax in the local markets where they earn their vast incomes.
- It is to be expected that regulation/legislation will force the companies to adapt their business model to incorporate more protection of privacy and consumer rights.
- In the case of social media it seems that a business model based on just-a-platform-for- exchange is nearing its end. Some form of editorial responsibility for content and of compliance monitoring might be required in the near future.

These developments will have an impact on the net margin of the tech businesses and ultimately on their share price.

Investors’ interest may be further triggered by opportunities where tech meets trends such as tech companies involved in health/longevity.

6. In summary, all seems well on the macro front for the near future but clouds may be on the horizon.
   Investors should be prepared for a new period of volatile markets.
   The best way is to forget the short term and daily swings and focus on a reasonable investment horizon of for example 5 years.
   And investors must dare to challenge the prudent and cautious managers and push them to look for outperformance not on a daily basis but always with an eye to the future!

May 2018.