A World of Bullies, Copycats and Chickens: is short-term economic forecasting still relevant?

Comments on IMF's July World Economic Outlook.

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- *Are quarterly economic forecasts still relevant in today's world?*
- *If the answer is NO (as I think,) where should investors seek guidance in a world of geo-political bullying, emerging trade wars and strongly volatile markets.*
- *My answer is simple: Take your guidance from YOU. Your personal situation and future liabilities should be the only driving forces.*
- *So copy what all the big institutional investors are doing and pursue Investing for Personal Liabilities (IPL); it is the only answer.*
- *But note: The IPL approach requires all cards on the table and brutal honesty, thorough analysis and a lot of soul searching (example provided).*

1. If I were you, I would not spend a lot of time on the recent IMF World Economic Outlook (July 2018).
   No, l am not saying forget short-term economic forecasts.
   But recent events have proven that political actions of major power players cannot be modelled and will surprise markets and sometimes upset the short-term outlook.

   We have seen plenty of examples over the last few months.
   Up until recently, international tensions were to a large extent dealt with through international *cooperative* action with the United Nations and its agencies, NATO and the European Union. They were normally used as consultation platforms for world powers.
   Whenever the need for retaliatory measures arose, action was done in consultation and in coalition (see for example in the case of sanctions against Russia after its interference in Eastern Ukraine and the annexation of the Crimea or Iran in response to its perceived military nuclear programme).

   However, in the spirit of his campaign promise of "Making America Great Again", US President Trump has initiated a series of unilateral

actions - particularly in the trade area and with these actions has displayed significant disregard for the existing rule-based global trading system.

Using schoolyard bully tactics Mr. Trump has launched trade restrictions and used sanctions as weapons in international relations for example through:

- trade barriers and tariffs for all major US trade partners China, the European Union, Canada, Mexico, Japan.
- sanctions against North Korea in view of their nuclear programme.
- more sanctions against Russia over Russian meddling in US elections and the use of chemical weapons against citizens,
- against Iran over its role in the Middle East and its nuclear programme,
- against certain officials of NATO ally Turkey over the "house arrest" of a US preacher held for supposed support of a Turkish dissident imam.

What is worrisome is the fact that these bully-tactics seem to have triggered a copy-cat behaviour by other "strong leaders":

- Turkey has threatened certain EU countries (e.g. Germany and the Netherlands) following these countries reluctance for local Turkish political activities
- Turkey has also responded to the US with specific sanctions against named US officials.
- Saudi Arabia announces trade sanctions against Canada over Canada's stance on the treatment of human rights activists in Saudi Arabia.

And the rest of the world and particularly Europe, seems to stand by, or whimper in fear for US bully tactics and the proliferation of these tactics by other "strong leaders" in Russia, Turkey and the Saudi Crown Prince.
Chicken behaviour is seldom heroic or effective, as I will further illustrate below.

2. However, for the residual believers in economic forecasting let me summarise the IMF's July 2018 message in brief.
   The July World Economic Outlook contains nothing surprising: Major political and economic risks could push economic development off-course.

The Outlook points particularly at:

- World trade could suffer under Trumpian trade disputes;
- Central bank re-normalisation policies could dampen growth perspectives, and
- Disruptive populist politics in the US, in Europe (e.g. Poland, Hungary, Italy, Czech Republic) and the UK (Brexit), could slow necessary policy reform and much needed investments, and thus economic growth.

As a result, Euro-zone growth is likely to be slightly lower, the emerging economies (e.g. Brazil) could suffer and Brexit will hurt the UK economy (see table below).
The current outlook however is basically back to where it was in the beginning of 2018. IMF's more optimistic views of this Spring seem to have disappeared.

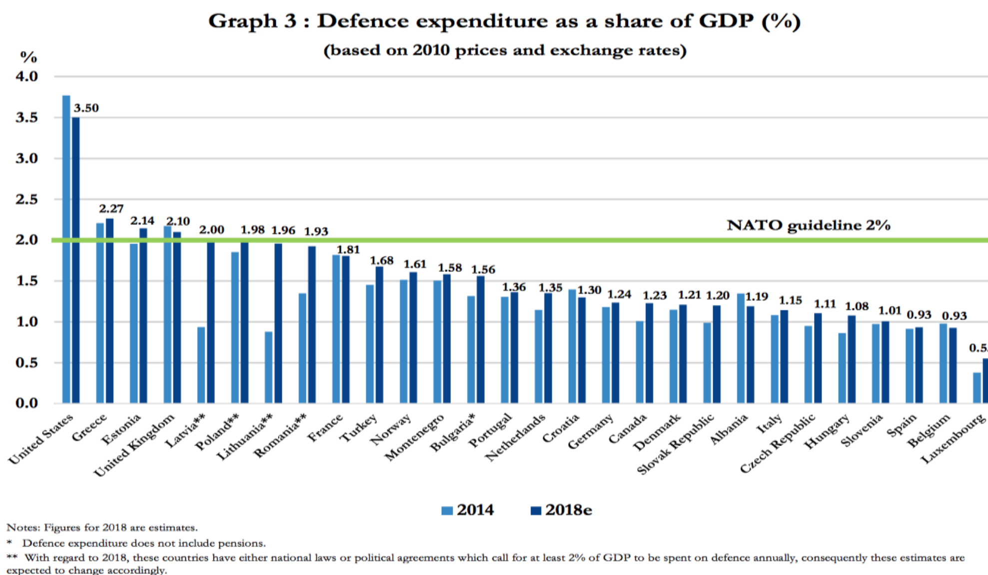
Table 1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

	Year over Year						Q4 over Q4 2/		
			Projections		Difference from April 2018 WEO Projections 1/			Projections	
	2016	2017	2018	2019	2018	2019	2017	2018	2019
World Output	**3.2**	**3.7**	**3.9**	**3.9**	**0.0**	**0.0**	**4.0**	**3.8**	**3.8**
Advanced Economies	**1.7**	**2.4**	**2.4**	**2.2**	**–0.1**	**0.0**	**2.6**	**2.4**	**1.9**
United States	1.5	2.3	2.9	2.7	0.0	0.0	2.6	3.0	2.4
Euro Area	1.8	2.4	2.2	1.9	–0.2	–0.1	2.8	1.9	2.0
Germany	1.9	2.5	2.2	2.1	–0.3	0.1	2.9	2.1	1.9
France	1.1	2.3	1.8	1.7	–0.3	–0.3	2.8	1.4	1.8
Italy	0.9	1.5	1.2	1.0	–0.3	–0.1	1.6	0.9	1.2
Spain	3.3	3.1	2.8	2.2	0.0	0.0	3.1	2.5	2.2
Japan	1.0	1.7	1.0	0.9	–0.2	0.0	2.0	1.0	–0.6
United Kingdom	1.8	1.7	1.4	1.5	–0.2	0.0	1.3	1.5	1.5
Canada	1.4	3.0	2.1	2.0	0.0	0.0	3.0	2.1	1.9
Other Advanced Economies 3/	2.3	2.7	2.8	2.7	0.1	0.1	2.9	2.9	2.7
Emerging Market and Developing Economies	**4.4**	**4.7**	**4.9**	**5.1**	**0.0**	**0.0**	**5.2**	**5.0**	**5.4**
Commonwealth of Independent States	0.4	2.1	2.3	2.2	0.1	0.1	1.5	2.4	2.1
Russia	–0.2	1.5	1.7	1.5	0.0	0.0	1.1	2.2	1.9
Excluding Russia	1.9	3.6	3.6	3.7	0.1	0.1	. . .	. . .	. . .
Emerging and Developing Asia	6.5	6.5	6.5	6.5	0.0	–0.1	6.7	6.5	6.5
China	6.7	6.9	6.6	6.4	0.0	0.0	6.8	6.5	6.3
India 4/	7.1	6.7	7.3	7.5	–0.1	–0.3	7.5	7.4	7.8
ASEAN-5 5/	4.9	5.3	5.3	5.3	0.0	–0.1	5.4	5.3	5.4
Emerging and Developing Europe	3.2	5.9	4.3	3.6	0.0	–0.1	6.1	2.1	5.9
Latin America and the Caribbean	–0.6	1.3	1.6	2.6	–0.4	–0.2	1.7	1.7	2.6
Brazil	–3.5	1.0	1.8	2.5	–0.5	0.0	2.2	2.3	2.4
Mexico	2.9	2.0	2.3	2.7	0.0	–0.3	1.5	2.8	3.0
Middle East, North Africa, Afghanistan, and Pakistan	5.0	2.2	3.5	3.9	0.1	0.2	. . .	. . .	. . .
Saudi Arabia	1.7	–0.9	1.9	1.9	0.2	0.0	–1.4	2.8	2.0
Sub-Saharan Africa	1.5	2.8	3.4	3.8	0.0	0.1	. . .	. . .	. . .
Nigeria	–1.6	0.8	2.1	2.3	0.0	0.4	. . .	. . .	. . .
South Africa	0.6	1.3	1.5	1.7	0.0	0.0	1.9	1.5	1.1
Memorandum									
Low-Income Developing Countries	3.5	4.7	5.0	5.3	0.0	0.0	. . .	. . .	. . .
World Growth Based on Market Exchange Rates	2.5	3.2	3.3	3.3	–0.1	0.0	3.4	3.2	3.1

Long-term investors should continue to look beyond the frenzy of daily news (fake and factual) and Twitter feeds.

3. But first let us come back to the bullies and the chicken.
   A perfect example of chicken behaviour with regards to the US “bully tactics can be found in Mr. Trump’s aggressive stance on NATO defense spending at the NATO Summit last month.

   Mr. Trump has consistently qualified European NATO members as the “free-riders” of the military alliance, who rely on the American security umbrella for which the US defense budget spends significantly beyond the NATO agreed norm of 2% of GDP (current estimates of US defense spending is 3,5 %). In undiplomatic terms he has particularly bullied the major NATO partners from the EU into committing to higher military spending.



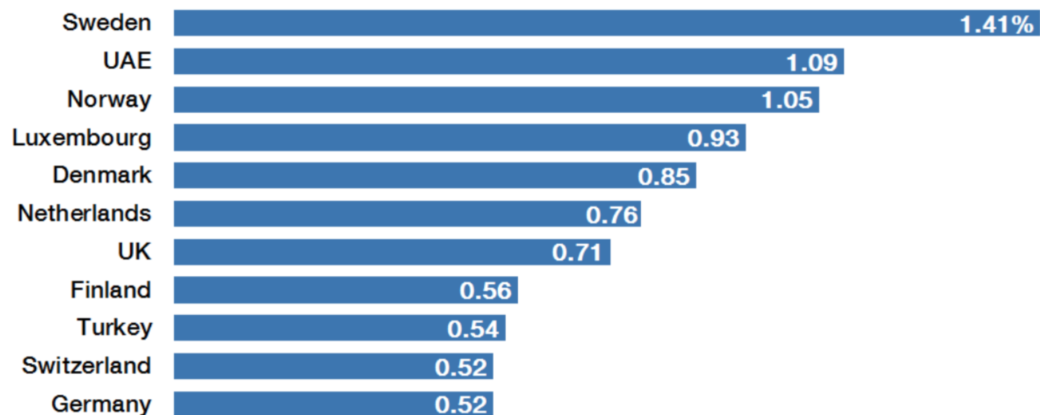
Source: NATO report July 2018

At the first glance the US President seems to have a point (see graph above). However, many European NATO members had already committed to increase real defense spending in the coming years. So there was no need for bullying tactics apart from bully-megalomania.

It should also be noted that in modern international relations and security policies, it has long been argued that defense spending (*hard power*) is just one side of the policy towards promoting a more peaceful world. Accompanying international programs, particularly in the area of International Development Assistance (*soft* power) is widely acknowledged to be a necessary complement to defense spending. Development assistance helps nations in development away

from unstable and potentially aggressive policies and promotes peaceful development towards democratic and economically sound societies, which tend to be less prone to wage war.
Defense and development assistance are therefore seen as two sides of one balanced security policy.

The international community has set a target of annual spending on Official Development Assistance (ODA) of 0.7% of GDP per country.
The graph below summarises the current level of ODA spending per country.
And guess which countries comply with or even exceed the 0.7% target….
See graph below: all NATO partners bar the US contribute significantly and the US does not even figure in the list. The US annual contribution in GDP terms is below 0.20%, so falling significantly short of the international target of 0.7%.



So the question is: why did nobody stand up during the recent NATO Summit and explained to Mr. Trump this double pronged, soft *and* hard power, approach to world security and peace?
Why this radio silence over the significant under-performance in development assistance by the US, while at the same time accepting the harrowing “lectures” over military spending?

Unfortunately today’s reality illustrates that bullies more often then not, get away with their behaviour.
Chickens allow them to win….

As a result, the world needs to live with "strong man" politics.
And economies and markets will suffer and market volatility may become once again a permanent feature.

4. In an earlier note I wrote about hedging strategies and a more active use of option strategies in such volatile markets (see Thumbs up, May 2018).
   In this note I would like to take the debate one step further and go back to the roots of any investment strategy: *your personal liabilities* or in plain words: "*what is it for?*"

   In the world of institutional investors any investment strategy starts with an analysis of their liabilities and how they develop over time.
   For pension funds and life insurers, these liabilities consist of pension commitment and future income promises made.
   They build their investment portfolios in a way that best responds to the commitment they have undertaken which in some cases are commitments for the very long term.
   For example: a starting young worker entering a pension scheme may expect to receive a retirement income in 40-50 years time and this will run for the rest of her/his life which depending on the life expectancy could be 20-30 years.
   So the pension fund's investment approach of today needs to be aimed at securing a steady flow of income in the years 2070 till the end of the century!

   No wonder that the pension fund and life insurance industry spend a lot of work on the analysis and study of their future liabilities.
   This liability study is particularly relevant as many of these income promises are made in real terms i.e. with some adjustment for inflation (note: over a 60 to 80 years' time horizon!!).
   So inflation is a major factor to consider while investing for future retirement income.
   Interest rates are an important factor as well as they are a yardstick for the calculation the value of future liabilities. The higher the interest rate, the lower the present value of future liabilities (and vice versa) is, as the liabilities are discounted on the basis of the (risk free) interest rate.
   In addition the future pension commitments are logically impacted by the recipients life expectancy, as higher expectancy means longer payout periods.

As a result the investment strategies of pension funds and insurance companies are very much liability driven. Their Asset & Liability Management (ALM) is the central starting point of any institutional investment approach. Matching the liabilities is key for millions of (future) pensioners as underfunded pension funds and insurance companies are a social time bomb.
Hence the significant level of regulation and supervision the pensions and insurance industry and the reasoning behind the political focus on funding coverage and solvency ratios.

My thesis is that private investors need to follow the example of the institutional investor world.
No one should ignore their liabilities before starting an investment portfolio and we should also start from the concept that each of us will have our own specific individual set of liabilities.
Some of us have a life(style), which makes us more vulnerable to certain external risks (health care , energy consumption, educational expenses, longevity, etc.) than others and that needs to be reflected in a proper investment strategy.

My strong plea is that every investor needs to do hers/his own liability check before embarking on an investment strategy which may seem attractive but is not aligned with their personal circumstances.

5. This all sounds conceptually interesting but remains an abstract topic.
   In order to make it more concrete, I am willing to share my personal liability profile as an example and show how this moulds the investment strategy for my (modest) investment portfolio; my personal ***Investing for Personal Liabilities*** approach.

   In my ALM I have identified the following issues:
   - My current total asset base is heavily skewed towards property. The value of my houses far exceeds the total value of my cash savings and investments.
   - There are no liabilities in the form of loans or mortgages.
   - My current liabilities are expected to remain in Euro and related Western European currencies (particularly GBP).
   - I do not foresee any short-term cash income requirement from my savings/investments. Any medium to long term cash-

income supplement should in principle be modest (less than 4% per year).

- My children have finished school/university, have jobs and call themselves now "independent" (hmmm..) , so no remaining exposures to school/tuition fees or subsistence allowances.
- I do not foresee major cash requirements in the next 5 years while not excluding some inter-generational transfers in the longer term, which -I hope- will preferably not lead to major cash outs.
- My tax liabilities are manageable from my annual income.
- My life style (significant travel requirements, substantial fuel consumption, high electricity/gas bills) makes me vulnerable for sector inflation particular in areas such as energy prices. This is an expensive hobby given the (volatile) price inflation of energy consumption.
- My medical consumption is expected to be higher than before due to general ageing factors and I am aware that medical inflation is much higher than the general CPI.
- I feel that my life style is relatively healthy, which should have a positive impact on my life expectancy. Although this is good news for me privately, it unfortunately will strongly inflate my liabilities.

So translating this into my IPL-investment approach my investment profile looks like this:

- Given the possible future income requirements, target returns over the medium to long term need to be above average for an averagely balanced portfolio. I accept that this means the need for a higher level of equity type investments to more than half of the portfolio and thus its related higher than average risk profile.
- Allowance can be made for illiquid alternative investments up to a substantial level of the portfolio (40-50%) as there are very limited short-term cash requirements.
- The IPL investment policy is aimed at "full employment"; any cash holdings need to be kept at minimum level.
- Within this growth-oriented portfolio over-allocations to certain geographies are allowed, for example to Chinese equities with levels better reflecting the country's global economic weight (18% of world GDP but only 0.3% of MSCI world index).

- Given the existing exposure to property there is no wish to further invest in real estate exposures through portfolio investments.
- To hedge for specific characteristics of my liability profile, I would like to see an over-allocation to investments in the energy area. Not just general energy through oil majors or utilities, but focused investments in funds that specialise on energy transition and green energy.
- Furthermore I would like to see investment opportunities in the health care/medication area and in particular investments related to longevity issue. In that context I would appreciate a specialized approach to the use of IT/Big Data/Artificial Intelligence on health and healthcare issues and accept that this means the use of (expensive) thematic funds.
- In order to hedge against interest rate developments a substantial allocation is to be made to Fixed Income investments (up to 25% of the portfolio) with private debt and floating rate credits including high yield (no perpetuals).

As a result my IPL portfolio looks like below:

6. IPL portfolios require a lot of insight in personal liabilities.
   I understand that not everybody is happy to share these broadly with a bank or a distant investment manager. But everyone can do this her/himself and just instruct the manager on the basis of clear instructions.

   If you have a trusted adviser who is geared at tailor made investment approaches, you should ask them to develop an IPL portfolio proposal for you.
   You may find yourself challenged but in a good way.

The IPL approach requires all cards on the table and brutal honesty, thorough analysis and a lot of soul searching.
In the end you will feel more comfortable with truly your own portfolio: Investing for Personal Liabilities!

And also: ask your investment adviser/manager to explain potential hedging possibilities against short-term volatility. The bullies and chickens are still around….

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