Divergence.

Investing after Maurice Obstfeld's gloomy swan song.

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- *IMF's recent World Economic Outlook places its current assessment of the world economy in the context of 10 years since Lehman Brothers collapse…. Depressing reading.*
- *Growth expectations are downgraded as expected following trade disputes and nationalist and populist pressures.*
- *And the IMF fears that much of the traditional fiscal and monetary policy actions have become in-effective and blunt tools.*
- *However we should not forget that the big economic blocks are in different stages of their business cycles and divergence between markets is to be expected.*
- *Such divergence offers also opportunities.*
- *However: there is no room for playing the hero!*

1. "*Risks to global growth skew to the downside in a context of elevated policy uncertainty*" (IMF World Economic Outlook October 2018).
   This is IMF jargon for: better prepare for lower than earlier expected growth or even recession.

   Step-by-step we have seen this year's IMF's optimistic outlook disappearing with their forecasts for world growth dropping down to the morose levels that we have seen previously.
   With the exception of the United States (tax relief driven growth), all developed economies are facing lower growth due to the increased uncertainty brought about by trade conflicts and populist political movements (see summary table below).

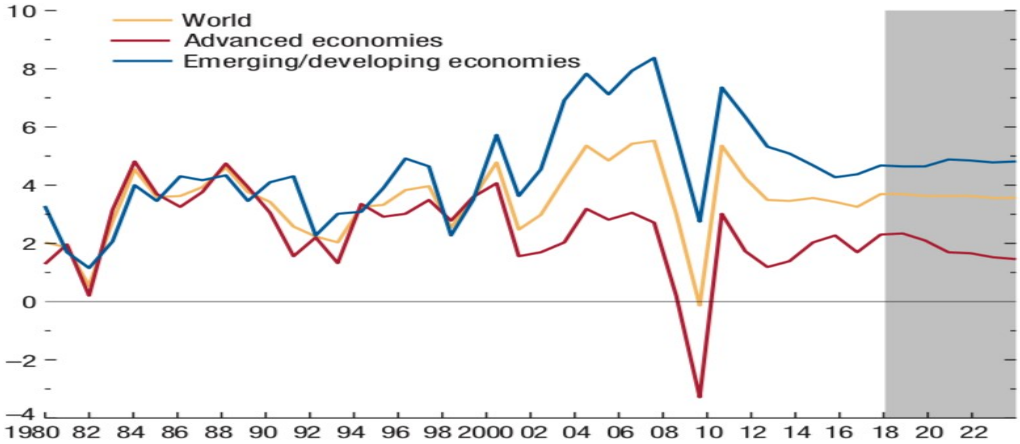
Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from July 2018 *WEO Update*[1]		Difference from April 2018 WEO[1]	
	2017	2018	2019	2018	2019	2018	2019
World Output	**3.7**	**3.7**	**3.7**	**–0.2**	**–0.2**	**–0.2**	**–0.2**
Advanced Economies	**2.3**	**2.4**	**2.1**	**0.0**	**–0.1**	**–0.1**	**–0.1**
United States	2.2	2.9	2.5	0.0	–0.2	0.0	–0.2
Euro Area	2.4	2.0	1.9	–0.2	0.0	–0.4	–0.1
Germany	2.5	1.9	1.9	–0.3	–0.2	–0.6	–0.1
France	2.3	1.6	1.6	–0.2	–0.1	–0.5	–0.4
Italy	1.5	1.2	1.0	0.0	0.0	–0.3	–0.1
Spain	3.0	2.7	2.2	–0.1	0.0	–0.1	0.0
Japan	1.7	1.1	0.9	0.1	0.0	–0.1	0.0
United Kingdom	1.7	1.4	1.5	0.0	0.0	–0.2	0.0
Canada	3.0	2.1	2.0	0.0	0.0	0.0	0.0
Other Advanced Economies[2]	2.8	2.8	2.5	0.0	–0.2	0.1	–0.1
Emerging Market and Developing Economies	**4.7**	**4.7**	**4.7**	**–0.2**	**–0.4**	**–0.2**	**–0.4**
Commonwealth of Independent States	2.1	2.3	2.4	0.0	0.2	0.1	0.3
Russia	1.5	1.7	1.8	0.0	0.3	0.0	0.3
Excluding Russia	3.6	3.9	3.6	0.3	–0.1	0.4	0.0
Emerging and Developing Asia	6.5	6.5	6.3	0.0	–0.2	0.0	–0.3
China	6.9	6.6	6.2	0.0	–0.2	0.0	–0.2
India[3]	6.7	7.3	7.4	0.0	–0.1	–0.1	–0.4
ASEAN-5[4]	5.3	5.3	5.2	0.0	–0.1	0.0	–0.2
Emerging and Developing Europe	6.0	3.8	2.0	–0.5	–1.6	–0.5	–1.7
Latin America and the Caribbean	1.3	1.2	2.2	–0.4	–0.4	–0.8	–0.6
Brazil	1.0	1.4	2.4	–0.4	–0.1	–0.9	–0.1
Mexico	2.0	2.2	2.5	–0.1	–0.2	–0.1	–0.5
Middle East, North Africa, Afghanistan, and Pakistan	2.2	2.4	2.7	–1.1	–1.2	–1.0	–1.0
Saudi Arabia	–0.9	2.2	2.4	0.3	0.5	0.5	0.5
Sub-Saharan Africa	2.7	3.1	3.8	–0.3	0.0	–0.3	0.1
Nigeria	0.8	1.9	2.3	–0.2	0.0	–0.2	0.4
South Africa	1.3	0.8	1.4	–0.7	–0.3	–0.7	–0.3
Memorandum							
European Union	2.7	2.2	2.0	–0.2	–0.1	–0.3	–0.1
Low-Income Developing Countries	4.7	4.7	5.2	–0.3	–0.1	–0.3	–0.1
Middle East and North Africa	1.8	2.0	2.5	–1.2	–1.3	–1.2	–1.1
World Growth Based on Market Exchange Rates	3.2	3.2	3.1	–0.1	–0.2	–0.2	–0.2

In his last contribution as IMF Chief Economist, Maurice Obstfeld has added an interesting but not very uplifting Foreword to this World Economic Outlook, analysing 10 years after the Lehman crisis against the backdrop of the pre-crisis economics.

In this Foreword, he highlights the fact that for the first time since the 1980s, growth patterns of the developed world on one hand and of the emerging economies on the other were strongly diverging since the year 2000, even during the financial crisis (see graph below).

Figure 1. Real GDP Growth, by Country Group
(Year over year)



Source: IMF, *World Economic Outlook*, October 2018.
Note: Grey area denotes projections.

And although everybody suffered from the financial crisis in similar ways, the emerging markets still post relatively high post-crisis growth levels.
Obstfeld analysis points at the main differences between the following groups:

- *developed economies* with their ageing workforce, slow productivity growth, significant government interference and relatively high public debts, versus
- *emerging economies* with their young dynamic labour-force, improved policy frameworks and flexible responses to changing environments.

In the context of today's outlook, it brings also to the fore that the emerging economies will face increased vulnerability to negative world trade developments. This is illustrated in the IMF summary table above which shows that since earlier this year, growth forecasts in some countries in Latin America Africa and the Middle East have been slashed by up to 1% point of GDP!!

That is not good news for the world as a whole.
Lower emerging markets growth resulting from trade restrictions and anti-globalisation sentiment, will certainly not slow down the migratory movements of people looking for a better life elsewhere and the lack of growth will not help to establish sustainable policies aimed at protecting the world against climate change and natural disasters.

It is therefore not surprising that Obstfeld's last Foreword concludes with a stark warning: "*Without more inclusive policies, multilateralism cannot survive. And without multilateralism, the world will be a poorer and more dangerous place.* "

2. It is however amazing that in a world with so many disturbing threats and risks, the world economy continues to grow albeit at a slower pace, and that financial markets -volatile though they may behave not (yet) crashed.
   Look at today's nightmarish list of world developments below: Each of those could in itself seriously de-rail the world economy and financial markets, and who knows what their cumulative effects could be ....

   - Brexit
   - Trump 's trade wars
   - Populist movements in central and eastern Europe
   - Potential new Cold War with Russia
   - China's economic/tech imperialism
   - Italy's new populist government
   - Fed rate hikes
   - Asset pricing bubbles
   - Multiple Middle Eastern conflicts

   Traditionally macro economic models predict that after 7 to 10 years of economic growth, a slowdown and possibly even recession is unavoidable.
   Today's pessimists point out that national and international policy makers currently have hardly any instrument left to avoid/mitigate the impact of an upcoming economic down turn.
   A recent special issue of The Economist (13-19th of October 2018) under the title: "*The next recession. How bad will it be?",* argues that most policy instruments (fiscal, monetary, micro-economic, regulatory) have been (over)-used following the financial crisis of 2008/2009.
   So not much room to maneuver for policy makers left and gloom and doom are prevalent.

3. Time for a more nuanced view.

   If economic cycles are determined by a combination of *endogenous* factors (e.g. running inflation, drop in effective demand, underinvestment, falling employment, lower wages, etc.) and *exogenous* factors (for example technological shocks, policy changes, trade wars, taxation, etc.), it might be important to look at the current status of these factors in the major economies a bit closer.

The following table tries to summarize some cycle-relevant developments for the four biggest economies in the world: the US, the EU, China, and Japan, since the financial crisis of 2008/2009.

4 Biggest World Economies	Out of recession since	Current cyclical momentum	Non cyclical and structural factors	Short term cumulative effect
United States	Q2 2009	Downturn imminent	Tax relief Trade wars FED's interest rate hikes Asset mispricing	+++ -- - --
Euro Zone	Q1 2009 *and* Q2 2011 *and* Q1 2013	mid cycle	EU tensions: *- Italy (Greece?)* *- Brexit* *- Poland/Hungary/Czech Rep.* Trade wars Consumption/investments ECB monetary policy	 - - - -- +++ +
China	NA	growth slow-down expected	Trade wars Debt levels Tech/hacking war Strategic investments	- -- - ++
Japan	Q1 2009 *and* Q2 2011 *and* Q3 2012	mid cycle	Trade wars Debt levels Ageing population Fiscal stimulus BoJ monetary policy	-- - - ++ +

The picture that emerges is one where the major economic players are not at the same stage of their economic development.
We should not forget that the US were the first to enter in a severe recession in 2008. And since it re-emerged from its recession in 2009, the US has continuously shown positive economic growth (for now almost 10 years).

Japan and the Euro-zone countries followed a similar first crisis in 2008/2009, but were then hit by two more recession -"after-shocks". Their most recent recessions only ended late 2012/early 2013.

China (and many other non-commodity based emerging economies e.g. India) did suffer economic slow down during and after the crisis but none had periods of negative growth/recession (see IMF graph above). However, oil and commodities exporting emerging countries such as Brazil, Russia and Argentina suffered significantly worse due to depressed commodity prices in the aftermath of the crisis.

So let's not forget: not all major economies are in the same stage of their economic cycle and that their outlook for the short term is therefore different. And with all the other issues impacting the economic outlook (see table) we could see opportunities knocking here and there.

4. It may thus not be all doom and gloom everywhere.
   Even a sensible economist (optimist?) can even see opportunities arising in the divergence between the major economic blocks.
   If one dares a few tentative observations, they resemble this:

   - Time is ripe for a cyclical softening of the US growth machine. However, despite all the upset over trade wars, interest rate hikes and high valuations, corporate America and US citizens have sweltered in the sunny climate of lower tax rates since the 1st of January 2018. The short-term impact is strongly positive with (although the bill in the form of higher public deficits is for the next generation).

   - The Euro-zone is lagging behind the US in terms of business cycle by at least 3-4 years. A cyclical down turn is therefore not immediate.

     However, there are serious non-cyclical factors affecting the Euro zone economies.
     First and foremost, the new Italian government's expansionist budget which conflicts with EU strict budget rules.
     Some ask whether this is this a new Greek crisis in the making?
     No, is my answer!!

The "*End to austerity*" has become a wider European battle cry (even conservative UK Prime Minister Theresa May announced it at her Party's conference in October).
In France, president Macron needs to mobilize support from the political left and right for his continuing structural reforms. This can only be done in the context of a more expansionist and less austere policy setting.
And in Germany, the traditional puritan austerity policies are being further undermined after the recent CSU Bavarian election flop. The current CDU/CSU–SPD coalition can only survive by softening its own policy approach in order to please the new political force of the Green Party and keep the nationalist/populist AfD at bay.
And tensions with some populist, central European governments in Poland, Hungary and the Czech Republic (anti-immigration, democratic and civil rights) will need to settle themselves before next years' European elections. Otherwise those forces may spill over in a swelling populist tide in many European countries.
This will require re-arranging the traditional European table-setting with less dominance of the original Treaty of Rome signatories; painful for some but unavoidable, certainly after Brexit.

Brexit, although a big political issue in the UK, it has become "old news" in many other EU countries. Most of them have moved on and current opinions on the negative impact on the other 27 EU countries vary significantly. Undoubtedly a compromise with the EU 27 will be found at the last moment with one clear outcome: *the UK will suffer*.

Let us not forget, sixty years of European economic and political cooperation since the Treaty of Rome of 1958 have produced a long and sometimes painful history of problem-solving.
All the mechanisms for political compromise are in place and are constantly fine-tuned (most critics use "Brussels" as the collective label for this process).
Without any doubt "Brussels" will find solutions for the Italian Budget, for the rise of populist agendas in central European democracies, for the unresolved migration drama and for

Brexit. In the best EU traditions, none of these will be clear, transparent, inclusive, and swift.
They all will smell of accommodation and compromise.
But they create a way forward for all parties involved.

So weighing all the pros and cons I do not believe a downturn is in sight and expect that the economy of the Euro-zone will continue to deliver around 2% GDP growth per year. Which in the context of the last few decades, is a decent performance.

- The growth outlook for China is clouded by serious economic imbalances. The current "Plan" will however continue to bring investments in infrastructure, education and health for the Chinese population (also in rural areas?). In accompanying reform measures capital markets will step-by-step become more open with more equity stocks becoming tradable on onshore and offshore Stock Exchanges. The expectation is that growth levels will continue around 6-6.5% p.a. for the coming years.
  Threats could come from an aggressive trade war with the US.

  Furthermore the international response to some of the perceived Chinese IT hacking activities as part of their industrial espionage could trigger serious counter actions harming the Chinese economy in the longer run.
  But for the short term, balancing these elements it is expected that the Chinese economy will continue to grow at substantial rates of around 6% per year.

- In Japan, the Abe's economic stimulus policy would seem to be bearing fruit after many a difficult year since the financial crisis. The Japanese economy experienced a series of recessions with the last one only ending late 2012. Economic growth has been low and fragile since then with even some negative quarters into this year. Contrary to the US there is no cyclical downturn on the horizon soon.

  Consumption driven growth drives investments and exports continue to contribute to Japan's reasonable growth rates. The ageing workforce leads to tighter labour markets and thus wage drift, which in turn creates new consumer demand. Trade conflicts could derail the Japanese recovery as exports drive an important part of GDP but overall the Japanese short term outlook is relatively benign.

5. As said, there are too many gloomy thoughts around.
   However it should be acknowledged that the different phases of development in the world's main economic blocks could create opportunities for investing in diverging market segments.
   It will however require an active approach and such a recipe would entail:

   - Analyse economic diverging closely
   - Accept higher levels of volatility
   - Look for value; avoid overpriced assets
   - Hedge for significant tail risks
   - Accept FED rate rises and enjoy ECB and BoJ continued easing
   - Do not increase overall risk but do not significantly de-risk either.

   So investors should not hide but also suppress any wish to play the hero!

   Bart Le Blanc, October 2018.