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PRESCIENT & SUCCINCT ANALYSIS OF WHAT'S OUT THERE

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- Today's world is threatened by many a ticking time bomb. Some, like immigration, financial crises or terrorism, tend to blow up suddenly; but the majority - including rising inequalities, ultra-low or negative interest rates, technological change, over-indebtedness, fading productivity and so on - are defusing slowly but surely. So **slowly as not to create the feeling of an impending crisis.** And yet as in a hall of mirrors, they conflate with each other, contributing to the rising global sentiment of populist angst and to the feeling that we live in a regressive era.

- 23 countries accounting for roughly 25% of global GDP have now central-bank policy rates of zero or less. A further six, including the US, have policy rates of 1 percent or less, meaning that **in 60% of the world economy, the scope for monetary stimulus using conventional** (policy-rate cuts) **or unconventional tools** (QE) **is exhausted**. NIRP (Negative Interest Rate Policies) in Japan and the Eurozone seem inevitable, like insulin injections for diabetics: they do not constitute a cure, entail undesirable side effects, yet without them the patient will die (i.e. the economy will enter into depression). As they won't succeed in lifting aggregate demand, **"helicopter money"** ("monetary finance" in the economists' jargon) **is next**.

- At the end of April, sovereign debt with negative yields amounted to $9.9 trillion ($6.8tn in longer-term bonds and $3.1tn in shorter-term ones). **Their impact on (1) banks, (2) insurers, (3) pension funds, and (4) money market funds is devastating**, costing investors about $24 billion annually (according to Fitch). Insurers and pension funds are the hardest hit. If ultra-low or negative interest rates persist for too long, they will ruin the retirement of all those on defined benefit pension schemes that run the risk of insolvency.

- The odds of tighter US monetary policy increased after the Fed indicated that it foresees an interest rate rise in June. The mere mention of such a move was enough to (1) trigger a stronger dollar, and (2) bring to an end the reprieve that emerging markets (EM) had experienced in March and April. **For a variety of reasons, the fortunes of EM are contingent upon Fed policies.** A rise in US interest rates will fast reveal which EM countries and companies are 'naked'.

- For the first time in 30 years, **productivity is receding in the US**, with GDP per hour projected to drop by 0.2% this year. The rest of the rich world is doing little better (+0.3% in the Eurozone and + 0.4% in Japan). Nor are EM immune from this receding trend (productivity growth almost halved in China: from 7% in 2013 to 3.6% today). When change and innovation seem to be accelerating everywhere, declining productivity is a puzzle. Even accounting for measurement problems, the productivity performance is dismal. It explains in part the feeble or non-existent growth in real wages and living standards. If it endures, **the endgame of the productivity crisis could be the breakdown of the democratic order**.

- A related puzzle for investors is why Western corporations are sitting on so much cash (among non-financial companies: $1.7tr in the US, $2.2tr in Japan, almost a trillion in the Eurozone and more than half a trillion in the UK). This not only explains in part why productivity is so low, but also **reflects a lingering sense of uncertainty about the future**. It's not far-fetched to imagine that sooner or later governments will start penalising retained profits to encourage firms to spend.

- Trump's nomination, violent demonstrations in France, the Leave campaign's tone in the UK, the quasi-victory of the far-right in the Austrian presidential elections – all these disparate manifestations possess one commonality: they are triggered by the **increasing sentiment of economic and social insecurity provoked by the digital revolution and all the changes it entails.** Despite the considerable long-term benefits innovation can bring, it also fuels societal upheaval for those least able to adapt. Some policy implications are: **progressively, governments around the world will turn away from openness and will implement policies that "force" redistribution**. This will entail greater taxation for business and wealthy individuals, the closing of tax loopholes, etc. Escaping the tax net, legally or not, will become impossible.

- In Europe, **economic risks are receding while political risks are mounting**, with substantial disparities between countries. Average economic growth (fuelled by consumption more than exports: a sign of resilience) is close to 1.6% while unemployment is falling across the region. **On a <u>relative</u> basis there is every reason to remain bullish about Europe**.

- The latest polls on the British referendum send conflicting messages, with the "Remain" vote slightly ahead of the "Leave" (45-40), and a large portion of voters still undecided (10-20% of the total). In recent years, and despite their over-powering media presence and ability to shape public opinion, polls have had a dismal track record. They are arguably a waste of time: beset by different heuristics and generating more noise than signals. **Prediction markets, by contrast, give more accurate results.** They currently discount the risk of a Brexit, signalling that the "Remain" vote will win with more than 70%.

- Saudi Arabia has embarked on an exceptional and treacherous journey. "Vision 2013" may be the Saudi equivalent of Mao Zedong's Great Leap Forward: aiming to overhaul an entire country (an agricultural into an industrial economy in the case of China, from an oil to a non-oil economy in the case of Saudi Arabia). Can a non-oil economy be built using oil revenues? A tall order. **Transforming an economy is "easy" compared to the considerably harder task of reforming institutions and changing social norms.**

- In the coming weeks, "must-watch" issues include: (1) the prospect of higher US interest rates and its wide-ranging collateral effects, (2) China, that remains at the epicentre of global economic and financial stress, and whose corporate debt woes continue to grow; (3) continued pressure on overleveraged EM; (4) the extent to which structurally lower commodity prices are affecting resource-rich countries, from those collapsing (Venezuela) or in dire straits (Nigeria) to those trying to adjust (Saudi Arabia); (5) the vast array of growing geopolitical and societal risks, with a focus on US elections, Brexit and the "policy unpredictability" in countries whose fate depends on "strongman leadership" (Putin, Xi, Erdogan, Sisi, Modi, Orban, Duterte, Trump? etc.). **For real-time and in-depth analysis on any of these, or if you are interested in prediction markets to better forecast some of the risks, please contact us.**