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2019: A YEAR OF LIVING DANGEROUSLY IN THE WORLD

- By Dawie Roodt

Once again, it's that time of year when economists and other enchanters toss the bones to predict the future. We at the Efficient Group go through a similar exercise albeit without real bones. Despite the absence of this millennium-old ingredient in our endeavour to see into the future, we are confident that the results of our predictions will be of comparable quality. So, there you have it, dear reader. After trying for decades to peer into the future, we know that we don't know what the future holds — but that doesn't mean we shouldn't try!

Thus, I will share with you a few comments on some opportunities and potential risks that 2019 hold for the world, South Africa (SA) and your portfolio. In this note we look at the international environment; a follow-up note will focus on the SA environment.

Broadly speaking, two trends are well established. After more than a decade of global economic growth and a record-breaking bull run on most financial markets, tighter monetary policy from the major central banks (notably the Fed) and disrupting political developments in recent years could derail this streak of happiness. With regards to political developments, the escalation of the war on trade between especially the United States (US) and the rest, as well as other political events like Brexit and a swing to the right in many countries in the world come to mind. Sure, Trump's trade charade has the potential to do significant harm to global growth. However, and usually underreported by the mainstream media, there are many examples where trade has, in fact, become freer. With some luck, we could see a world with less protectionism than what the current narrative suggests but beware, the danger of protectionism remains.

The second international trend, which is of more concern to me, is the current and future tightening cycle of monetary policy by the world's major central banks. I am concerned about two aspects of the reversal of easy money by, especially, the Fed.

Firstly, there is a real danger that central banks can get their timing wrong and overdo their tightening. Remember, central bankers also have difficulty seeing into the future and there are many examples where monetary policy tightening exacerbated an economic downturn.

A second concern that I have is that the Fed, and the others like the European Central Bank and eventually also the Bank of Japan, are using two monetary policy instruments to tighten policy, namely interest rates and quantitative tightening (QT). Interest rates are the traditional instrument to conduct monetary policy but after many years of quantitative easing (QE; buying of financial instruments by central banks after the financial crisis), the Fed is now of the opinion that these transactions should be reversed. In effect, massive amounts of liquidity will be withdrawn from the world's financial markets and that should not be good for financial markets.

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Getting interest rates right is difficult enough, now they are raising interest rates and draining liquidity through QT! This is potentially the biggest danger to the world's economy and financial markets. But there are many other dangers and opportunities out there. Brexit can go catastrophically wrong or some other political developments in the European Union (EU) could affect politics and hence economic stability. Think Italy, Hungary and more recently, France. Anyway, as far as the EU is concerned, little by way of economic growth could have been expected although they have fabulous companies to invest in, especially those that do business internationally.

The US economy, bar an overreach by the Fed, is likely to continue doing surprisingly well. Here are a few factors that stand out for me in the US: Unemployment is probably as low as it can go, yet inflationary pressures are surprisingly mild. Why is that? My theory is that productivity growth in the US is much stronger than what official data suggest and hence that the economy is probably growing faster, especially in the so-called gig economy and tech-related activities. That is why inflation remains low; strong production growth prevents demand from "overtaking" supply with the result that inflation remains low — for now.

There is, however, a lurking crisis waiting to happen in the US: unsustainable state debt. After Trump's recent tax reliefs, the US's fiscal accounts have become totally unsustainable (although these trends were already well established long before Trump). That means that, unless state spending is cut dramatically, the day will come when the US will not be able to service its debt anymore. Remember, many more future obligations that needs to be financed and not only the official debt.

However, if I am right in my theory that actual productivity growth in the US is underreported, then, relative to the size of their economy, state debt may not be that concerning. Anyway, after a bit of a meltdown last year, US companies are quite attractive at current valuations.
Japan is an interesting case study. Their capital market has basically been nationalised after massive QE, their population keeps on getting smaller and they are one of the most technologically-advanced economies in the world. Although all the factors mentioned above are not normally seen as positive, the combination of these factors result in a relentless increase in the per capita wealth of the average Japanese person and the existence of world-class companies to invest in.

Chinese growth is likely to keep on slowing down in coming years despite a weaker renminbi and huge local fiscal and regional (belt and road initiative) spending. Additionally, politics seem to be getting more authoritarian and a possible credit crisis is waiting for a trigger. We continue to monitor China closely.

I close with a quick view of a few other places in the world: Brazil could be interesting to watch with their recent political changes. The same goes for Argentina. But stay clear from the rest of Latin America except for Mexico. A couple of Eastern European countries sound exciting but beware of Russia. Africa is mostly having a difficult time with one or two exceptions.

That, in short, is our summary of the world. Keep a lookout for the follow-up note for a closer look at SA.