Strategic Portfolio Advice Team – October 2024

Interpreting signals
from the global economy
and financial markets

Decoder

In Focus

- **We visited the IMF/World Bank Annual Meetings in Washington, DC, to take the pulse of the global economy**
- **The Fund's projections are benign in the short run, with inflation under control. There are worries further out, about mediocre growth and debt sustainability**
- **We may be close to the start of a new Trump government – the election is too close to call. Deregulation, oil exploration and tariffs are coming if he wins**
- **Globalization and multilateralism are in retreat, as is fiscal conservatism. Though that may very well upset market fundamentals, risk premia remain small**
- **In summary, the institutions that got us through the previous shocks did well; more shocks are likely, and it looks like we will have to face them with smaller buffers and not always with the best tools for the job.**

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Bracing for Trump

"It's like a music festival for economists." That is how the new Dutch representative to the IMF characterized the Annual Meetings of the Fund and the World Bank that took place this week. Though that slogan may not appeal to everyone, we made use of the fact that many of the world's policymakers, opinionmakers and investors were gathered in Washington to update our views on the state of the (economic) world and its many risks. Below we discuss our most important insights.

The economic outlook

Forecasting was hard in the last five years, we heard one of the authors of the IMF's World Economic Outlook complain. The world was buffeted by unpredictable events and almost as soon as the WEO went to press, the Fund's economists were running to update the numbers, because of lockdowns/container shortages/a war in Europe and any number of other shocks.

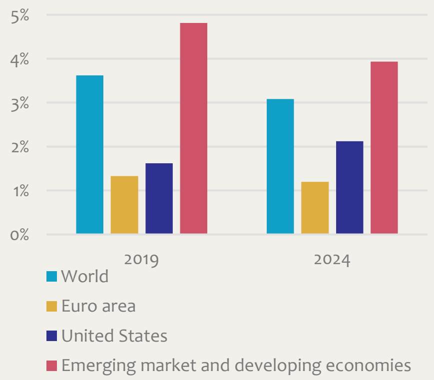
Compared with those hectic times, this year's outlook is calmness itself. The ripple effects of past shocks are fading and the numbers are returning to normal. Most importantly, the inflation forecast is now confidently closing in on target in most regions. Attention can be directed elsewhere, and the Fund recommends "three pivots" to policymakers: a less restrictive monetary policy, paying increasing attention to fiscal sustainability and—lest we forget—growth-enhancing reforms.

The success story of inflation is dissected and the verdict is that price shocks (goods during Covid, energy and food after the Ukraine invasion) spread through different sectors but did not reach the labor market, avoiding a spiral of wage and price increases. We have decades of predictable monetary policy to thank for the anchored expectations that paid off in the past few years. The concerted tightening worldwide also signaled central banks were determined to fulfill their mandate, which helped control the inflation outbreak.

Among the investors we talked to, there was some skepticism about the rosy inflation projections that the IMF is serving this time. The mechanism for wringing the last excess price growth from the economy is unclear (core inflation is still 3.3 percent in the US and 2.7 percent in the euro area) now that interest rates are coming down. One of the underpriced risks, they say, is a "higher for longer" scenario in which expectations of further rate-cutting are dashed once again.

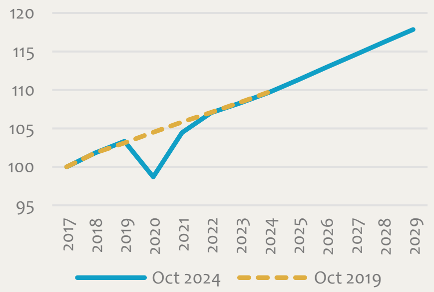
In Figures

Long term growth downgraded



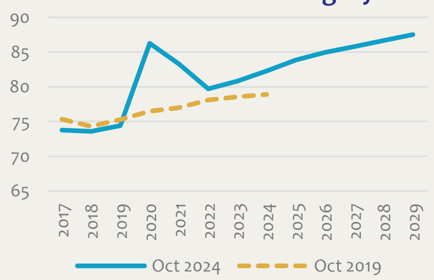
GDP growth 5 years ahead in the IMF's World Economic Outlook from October 2019 (*i.e.*, pre-Covid) and in the latest edition from October 2024. Total expected growth is down more than half a percentage point. With the US upgraded and the euro area downgraded, the expected growth gap between the regions is now almost a full percentage point.

Covid did not leave a GDP scar…



GDP in advanced economies (index number) from the October 2019 World Economic Outlook and the 2024 edition. In retrospect, the 2019 estimate for this year was exactly right. This is not the case for EM however; for EM 2024 GDP is 7% below the 2019 projection.

… but there is a Covid debt legacy



General government net debt as a percentage of GDP for advanced economies, from the 2019 and 2024 WEO. For EM, gross government debt as a percentage of GDP in 2024 is 7.5% higher than projected in 2019.

Data: IMF.

The IMF is more optimistic about the short run but stresses the risks in the medium run – this is economists' speak for the next 3-5 years. Productivity growth forecasts have been downgraded since the Covid crisis. Where the 2019 WEO had world potential growth at 3.6 percent, the current issue puts it just below 3.1 percent. Some of this is demography, but relatively low investment and disappointing productivity growth also play an important role. Low growth ultimately means low expected returns. An important caveat is that forecasts do not yet include the productivity effects of AI, which cannot be estimated with any certainty.

Inescapable fiscal arithmetic

Sustainability was a word we heard a lot, but only in the context of the fiscal outlook – not in the context of a green transition. Governments have splashed out over the past few years – and mostly for good reasons – but that has deteriorated the fiscal position. There is limited room to maneuver should a new pandemic or energy crisis occur. A worry is that debt levels have reached levels where the impacts get non-linear. Because of this, a shock could easily add 20% of GDP to the global stock of public debt. The problem is that well-behaved countries will suffer as well, because of global factors and systemic spillovers.

In the end, governments will have to deal with an inescapable arithmetic. As long as the debt stock is growing in keeping with nominal growth, we are looking at stable debt-to-GDP levels. When economic growth falls behind the interest rate – or in math terms $g < r$ – we need primary surpluses to stabilize matters. The only two alternatives are a bout of inflation that pushes up nominal GDP more than the nominal interest rate, or a restructuring of the debt. If we do the math for the US, a considerable fiscal consolidation is necessary. By some estimates the US primary deficit amounts to some 3.5% of GDP now. Growth has had a good run the last few years, fueled by stimulus cheques, immigration and perhaps a one-off productivity boost from working remotely. But the economy has been running above potential. With trend growth at 1.5-2.0%, inflation at 2.0-2.5% and 10y bond yields north of 4%, the government deficit should be consolidated by some 3-4% of GDP to stabilize the debt ratio.

To consolidate such a large amount is no easy task. A divided government will not make it easier. Arguably, a 'trifecta' government will make it harder still: both parties have plans that further distort the balance between government spending and tax income. It is obvious that politicians won't solve this problem on their own initiative. It will take external pressure from the markets. No one knows at which point the 'Liz Truss moment' will be reached for the US, or other countries. Obviously, when interest rates go up to price the risk of trouble, that will by itself increase the risk of trouble. In the end, the bond market can – as Bill Clinton's political assistant James Carville had it – intimidate everybody.

Although some developments will push both r and g in the same direction – demographics and labor productivity growth – other developments can push them apart, like more prevalent supply shocks. The inflation experience of the last few years pushes up inflation risk premiums. The fact that bonds were not as good a hedge for equity risk over the covid years may also push up their required return. Obviously, simple supply and demand dynamics matter as well. A fiscal outlook clouded by spending for ageing populations, defense and the energy transition will increase the supply of bonds.

For the eurozone as a whole, the IMF thinks only a limited fiscal consolidation is necessary. For China, it is not necessarily the level of the debt that is a worry, but the structure of the debt. Recent steps to move debt from local governments to the national level are a step in the right direction.

The shadow of Trump

With the elections in the US just over a week away, the elephant in every room in Washington was the uncertain policy of the next US government. The election itself is seen as uncallable: the margins between the two candidates are so tight that odds are indistinguishable from 50-50. If anything, momentum seemed to be favoring the return of President Trump.

A second Trump government (an “orange swan event”) would be exactly the thing that could disturb the tranquil forecasts we were handed by the IMF. We were told the priorities of such an administration would start with a tax cuts and jobs act, a deregulation offensive and a reassertion of US power abroad. The longer term goals are summarized by the three 3’s: 3 percent real growth, 3 mln barrel/day equivalents of new American fossil fuel production and a 3 percent deficit by 2028. The first and last of these three would be powered by efficiency gains in government and the economy at large, spearheaded by the Elon Musk efficiency commission.

More upsetting to the delegates of multilateralism gathered in DC were the proposed trade measures of Trump II: a 10 percent blanket tariff on imports and a 60 percent special tariff on Chinese imports, the latter to be achieved in steps of 2,5 percent per month during 2 years. The intended effect is to rebuild American capacity in, for instance, the pharmaceutical and electronics sectors. Tariffs are negotiable in the sense that a deal can always be struck if Trump likes the terms.

Trade experts doubt whether tariffs will indeed have the intended effect of rebuilding American industry. More likely they will benefit “friendly” countries that will gain the final assembly step of production before products enter the US. Many also doubted a 60 percent rate would be legal, even if phased in. The degree of difficulty in getting the tariffs in place would vary with the composition of Congress, which is also still in limbo.

A game of tariffs and counter-tariffs would probably lead to some strong currency movements. Trump II is widely seen as dollar-positive and euro-negative; the Chinese would need to devalue the Yuan by some 15 percent to cushion the tariff blow, a move that was seen as conceivable.

Would such a trade policy also reignite American inflation? Reasoning in the Trump camp is that a 10 percent rate in a country that imports 10 percent of GDP[1] would cause a 1 percent CPI increase at best. But such macro reasoning surely underestimates the much larger effect on certain business models and the damage that the resulting turmoil would do.

A win for the other party would mean a smaller move in roughly the same direction. With more cooperation with allies and without tax cuts and abrupt tariffs, sure, but the deficit will still go up and China will remain an adversary, not a trading partner.

Economic policy

The world is topsy turvy now. In politics, who would have thought a Kennedy would endorse Trump and the Cheneys would endorse Harris. The Democrats are now the party of free trade, of sorts, while the Republicans have turned isolationist. A number of shocks have brought us here: political ones like Trump’s victory in 2016 and Brexit, the Covid-pandemic and the Russian invasion of Ukraine. Economic policy nowadays is not only about economics, but about national security too, opening the door to industrial policy – a dirty word until not so long ago. The implication is that the global economy will look less like a level playing field and further shocks are more likely, whether they stem from natural disasters or conflicts. In a fragmented world, shock absorption cannot be shared so much with other countries and knee-jerk policies might actually aggravate shocks (e.g. when crop failures lead to export bans and national hoarding of food supplies).

With fiscal positions already stretched, it will be harder for governments to let the deficit work as an automatic stabilizer, and fiscal policy could turn pro-cyclical. Fortunately, there is more ammunition available from monetary authorities. That increases the likelihood of more action from their side. Conventional policy only targets short term rates, while the more important long rates could prove sticky and on the high side (as explained above). As a consequence, the crisis tool of QE could be necessary earlier than thought (“inescapable QE”). This comes with several

[1] Actual imports are closer to 15 percent of GDP.

worries. Could the reliance on easy monetary policy bring about a rebound in inflation? Another concern is that fiscal and monetary policies influence the economy in different ways. Does leaning on the latter not lead to a lopsided economy in which activity is focused on sectors like the financial industry and real estate? This does not particularly stimulate potential growth and the misallocation could sow the seeds for the next crisis.

Investment implications and risks

So the remedy for short term problems may only add to long term issues. The IMF warns there may be a mispricing of risks. There is a lot of risk out there, but risk premia are very low. There is talk of a macro-market disconnect and about the discrepancy between geopolitical risk metrics and financial market volatility. The IMF worries that when risks do materialize, massive last minute hedging activity may actually exacerbate the turmoil.

Other concerns are around multi-strategy hedge funds with concentrated bets and high cross-asset correlations. And the trend of passive investing , as well as too high levels of illiquid 'level 3' assets. The risk is that this ultimately increases the vulnerability of the financial system. Especially against a backdrop of a shock-prone economic environment, whether from trade, FX, conflict or climate, accidents cannot be ruled out.

Investors fear that ignoring geopolitical risks can only work for so long, and that a possible Israel-Iran conflict would be the start of a serious repricing. Even if we are spared another hot war, the industrial policies that follow from geopolitical risks have investment implications. Debt sustainability is an issue that will only be addressed by governments when markets force them.

Unheard of in DC

Sometimes you can learn as much from what is said, as from what is not said. Compared to previous editions, there was little attention for ESG-related topics, like climate change and blended finance. We expected to hear more about the challenging public finances in France. When France was mentioned, it was in a list of countries with fiscal challenges, starting with the United States, or together with growth challenged Germany, but never really by itself.

We would have loved to get more insight into the September stimulus package in China. But with Chinese presence in DC at such a low in the last few years – they have their own BRICS 'festival' now – this was a challenge. Investor interest has also declined, now that many (mostly American) parties have cut their exposure. The simultaneously held BRICS summit was ignored for the same reason, except in discussions with journalists.

Bracing for chaos

Even though the short term outlook is not bad, there was an uneasy feeling in Washington about possible change ahead. Trump was clearly in the air. Some Trump fans – and potential future policy makers – took the podium to downplay the risks, but the overall mood was on tenterhooks. If there is an unpredictable President who is willing to play with fire when it comes to economic policy, institutions and international affairs, things could get quite chaotic – even without considering the reactions of other countries.

Against that backdrop, it looks surprising that risk premia are so low. But then again, what's an investor to do? There is nowhere to hide. With the fiscal challenges ahead, traditional safe assets may not be your refuge of choice. With macro shocks equity could be in for a wild ride, but tax cuts could ease the nausea, at least in the beginning. All that remains is to be watchful of the news, and remember the lessons from the past.