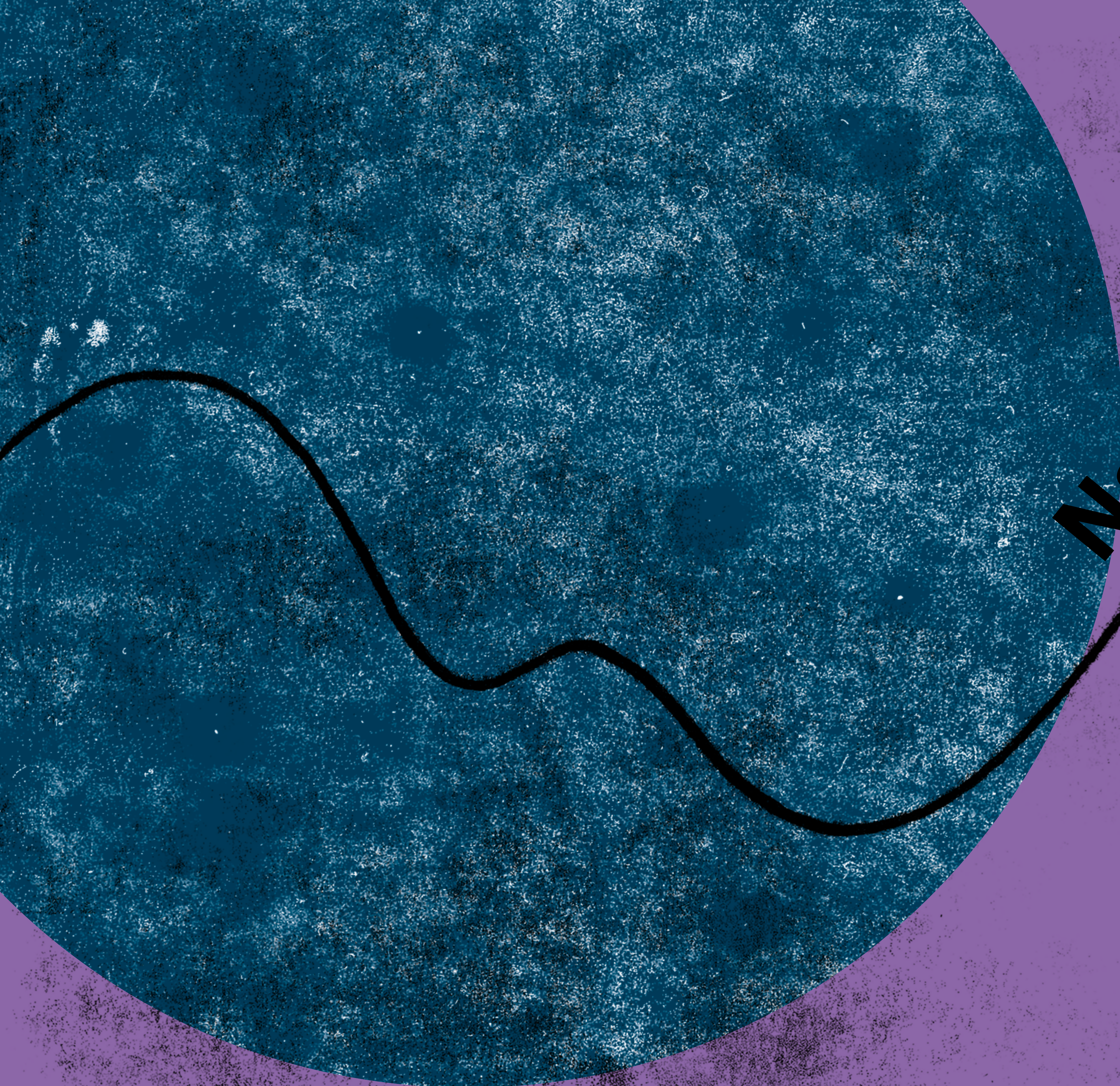

Navigating the Cycle

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2017: Problems remain under the covers

2017 was an exceptional year. The post-crisis recovery culminated in a synchronized pickup in growth around the world. Financial markets performed very strongly: not only stock markets surged by around 20 percent but almost all other asset classes clocked up attractive returns, too. At the same time, volatility was extremely low. All this was underpinned by rising corporate profits boosting share buybacks, dividend payments and investments.

This great synchronization in 2017 was quite surprising. Political challenges were plentiful. The newly elected US President Donald Trump left no doubts about his intentions to smash the rules-based trading system; Europe remained in policy paralysis over Brexit, Eurozone reforms, and refugees; and geo-political tensions, notably in North Korea and the Middle East, kept rising. But the cyclical upswing was strong enough to cover all these problems.

2018 and beyond: Problems come to the surface

2018 has proven to be quite different, and so will the following years. On the one hand, the cycle enters its last stage and loses steam, on the other hand, the political risks may become even more daunting. As a consequence, growth differentials are set to emerge again, reflecting differing fundamentals as well as diverging economic and monetary policies.

The great withdrawal of monetary policy

To start with monetary policies. Monetary normalization in the US is already well advanced. The Fed, the US central bank, had not only stopped its bond purchase program (QE) but also started to reduce its balance sheet. Interest rates are back at levels last seen before the financial crisis. In contrast, the ECB, the European Central Bank, has barely begun with normalization; it just announced to end QE by the end of this year. The first rate hike is at least still one year off. And the other systemic relevant central bank, the Bank of Japan, has still to drop any hint on normalization. These different stances have repercussions in financial markets, first and foremost in currency markets: After years of weakness, the dollar is back and might strengthen further. Coupled with higher rates in the US, the dollar strength has had a profound impact on global capital flows: Capital left emerging markets for a couple of months, in particular poorly managed ones like Argentina or Turkey, causing their currencies to flied further against the dollar. These market turbulences have calmed down in the meantime but could quickly resurface with further monetary tightening.

Financial markets in advanced countries are neither immune to turbulences. The actual or expected withdrawal of central banks has changed market sentiment. Whereas during the post-crisis years market participants were quite confident that policymakers would respond to market disruptions – building the "buying the dip" mentality –, this is no longer the case. In that respect, the recent episode in the Italian bond market – where spreads surged briefly at the prospect of a constitutional crisis in Italy – was instructive: The ECB did nothing to calm markets; on the contrary, shortly thereafter came the announcement that the time for policy normalization has finally come, given the rise in inflation. The upshot: The era of policy suppressed volatility has ended, markets are in for a rougher ride, compounded in many cases by already stretched valuations.

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The fiscal policy mess

There are also sharp differences in fiscal policies. The US have embarked on grand-scale policies to stimulate growth, in a pro-cyclical way: Huge tax cuts, deregulations and ambitious spending plans add fuel to an already booming economy in 2018. In Europe fiscal policy has become gradually less restrictive in recent years. But it is still miles away from boosting demand in a meaningful way. What is even more: Structural reforms have more or less come to a standstill, be it at the national or supra-national level. The result is political impasse in Europe slimming the chances for a higher long-term growth. Last but not least China: After years of unconstrained debt-fueled growth, doubling the total debt pile to 300 percent of GDP in just ten years, the government has finally started to reign in the borrowing binge. Although overdue, slamming the brakes on corporate leverage, forcing banks to write down bad loans and curbing shadow banking will undoubtedly weigh on growth.

De-synchronization and three recession risks

These diverging policies speak for a more uneven and less dynamic economic development, with a temporarily widening growth differential between the US and Europe, slower growth in China and periodical "accidents" in emerging markets. However, this describes the benign outlook for the world economy.

There are mainly three, mutually reinforcing risks that have the potential to push the world economy into recession over the course of the next three years: a US recession, a trade war and a populistic backlash.

The US economy is currently experiencing – thanks to highly pro-cyclical fiscal policies – a sugar-rush. The resulting hang-over could be nasty and exacerbate the cyclical slowdown. Most likely, the price for pro-cyclical policies will have to be paid in 2019 or 2020: the revaluation of the Dollar and necessary steps to rein in excessive deficits will slow the economy down. If the overheating forces the Fed into raising policy rates faster and higher than expected, a recession seems inevitable. A possible trade war would make a bad situation worse denting sentiment of consumers and companies.

The rest of the world would be hardly immune to a US recession as the room for maneuver to revive demand and fight spill-over effects is (very) limited: Interest rates are still relatively low almost everywhere – and rock bottom in Europe and Japan; balance sheets of central banks are bloated; and public debts and/or fiscal deficits are too high to allow for more than cosmetic measures.

If the world economy slips into recession, it becomes quite probable that recent trade tussles turn into a full-blown trade war. In the way the post-crisis years of low and insufficiently inclusive growth have fueled public anger and led to the rise of populism, renewed economic hardship would further erode trust and reinforce economic nationalism.

But even without a recession, the probability of a trade war is uncomfortably high. This would be a fatal hit for the global economy. Although the direct impact of tariffs on trade flows might be at first glance minuscule and hardly detectable in an environment with still strong growth, their effect is nonetheless poisonous: Protectionism creates uncertainty. And uncertainty saps corporate animal spirits leading to less investment, in particular cross-border investment; global value chains get strained. With the confidence in rules-based, global economic governance badly shaken, trade and capital flows will eventually dry up. Rather sooner than later, growth and productivity take a blow.

It is easy to see how a recession cum trade war would add fuel to the flames of populism. But the rise of populism is (no longer) dependent on economic malaise. It has become a force of its own. 30 years after the "end of history", the supposed victory of Western liberal and open democracies over autocratic and closed societies in the East, the West looks exhausted. Its inability to cope with a new, polymorph world offering new challenges – the rise of China, climate change, migration – makes it vulnerable to attacks on its values. After years of frenetic globalization and social as well as cultural change many people feel uprooted and look for new identities: the working class, for example, turns to right-wing parties as it sees the (traditional) Left as part of the new liberal and global elite – and no longer as the advocate for the "normal" people. Populistic movements – on the Right as well as on the Left – exploit this void and promise to create a new sense of social affiliation by turning inwards. In economic terms, they stand for economic nationalism attacking global markets, the most important source for growth and prosperity in the aftermath of World War II.

THE DANGER THAT THE CURRENT UPSWING ENDS IN TEARS IS REAL.

To sum up: Despite strong growth in the last two years, the outlook for the world economy shows more than just a few scattered clouds. The danger that the current upswing ends in tears is real. Markets and policymakers seem to have ignored that risk for some time. For sure, such an outcome is not inevitable. If policymakers act comprehensively and in concert, and turn around in trade policies, the slowdown can be managed and a hard landing can be avoided. But they have to change course now.

THERE IS A WILDCARD THAT COULD CHANGE EVERYTHING: TECHNOLOGY.

The wildcard: AI

So, all hope is lost? Not really. There is a wildcard that could change everything: Technology. In particular AI (artificial intelligence) holds the promise to usher in a new era of high and rising productivity. After years of sluggish productivity growth lowering potential output, such a technology-driven push would be more than welcome. The question is: How fast can these productivity gains be realized? Undoubtedly, examples of super-efficient companies abound. But to make a real difference, these new technologies have to diffuse into the broader economy as well. And this transition takes time and creates adjustment costs. Also higher market concentrations and increased market power of incumbents hinder the diffusion of new technologies as the transfer of resources from less to more productive competitors is slow downed. Somewhat paradoxically, it would require a little more regulation to accelerate the adoption of new technologies – especially upgrading competition policy to the needs of the data economy of the 21st century.

Thinner cows are coming up

What are the implications for investors? One thing is crystal-clear: They have to prepare for a more difficult environment, to put it mildly. Since the crisis, financial assets have significantly outperformed the real economy: This happy constellation is over. The backlash of many years of expansionary policies and the risks of a trade war might make the opposite come true. In any case, returns will be lower and volatility higher than in the post-crisis environment. For successfully navigating such an environment, investors need "cautious flexibility": a resilient balance sheet and an agile investment process to exploit temporary opportunities. But most importantly, an open mindset will help to find the right path between all the potholes of potential disruptions, be they technology-driven or political-induced. The calm years are coming to an end. Investors are likely to face rougher times – but hopefully the downward leg of the cycle will be short.