Global Strategy

Thematic Report

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A Vision of the Future

Our strategy work has always tried to integrate three different time windows.

1) ***Secular Trends*** in asset prices driven mostly by structural change in the world economy and the long term valuation cycle. Timeframe: years to decades.

2) ***The Global Cycle*** in production and trade, which drives intermediate trends in equities. bonds and investor risk appetite. Timeframe: 36-40 months from trough to trough.

3) ***The Flow of News:*** dominated by economic data, policy shifts, elections, positioning - which re-shapes market expectations. Timeframe: days to weeks.

We call this process ***Cycling Down the Secular Path***: secular swings in asset prices tend to be surprisingly persistent and often surprisingly linear, but the global production cycle usually produces large fluctuations around the secular trend – as well as overshooting of investor risk appetite at cyclical peaks and troughs. In our view, shorter-term data surprises and policy events usually affect the path more than the ultimate destination of the medium and longer-term cycle. And that can be true even for giant shocks like the current pandemic.

Naturally, we all spend much of our attention on the short run, but the great investors typically think across all three time frames at once. And while no one can forecast the future with any precision, this multi-time frame approach can help make the future less surprising. Or at least make us better prepared for the surprises.

The underlying methodology can be described as follows:

- Understand the Past
- Imagine Possible Futures
- Identify Key Drivers and Events
- Choose and Quantify Most Likely Outcomes
- Update or Amend (based on incoming evidence)

In broad terms it's very similar to the approach described by Philip Tetlock in his book *Super Forecasters*. By definition it's always a work in progress, and can never be "finished". And oddly enough, it often more important to get the broad narrative right than to grasp all the details. (That way confusion lies).

Below we summarise some of our current thinking about key themes – short, medium and long.

The Shorter-Run

Seems even more important than usual at the moment, given the latest COVID concerns and politics.

We expect the Trump administration to be replaced by a (moderate) Democrat Presidency enjoying a very slim majority in the Senate. A Biden Presidency will focus on trying to address inequality and climate change at home, while rebuilding America's traditional alliances abroad to counter the rise of China. Anti-trust issues - and specifically much more intense scrutiny of the largest technology companies will be another theme.

We expect there to be a big focus on extending the Democrat majority in the Senate in the mid-term elections of 2022, likely meaning that some of the more radical proposals on income distribution or business regulation may be delayed in favour of measures to boost growth in the shorter run.

The net effect should be slightly positive for global growth and trade over the next few years, compared with the status quo, but there will over time be a substantial shift in cash flows between US sectors and between the richest and poorest members of society. Fiscal stimulus will be larger and more focussed on green infrastructure, while inflation risks and long-term interest rates will likely be higher than otherwise. We expect S&P 500 revenue growth to be higher but after-tax profit margins to be lower, and a rotation in equity market leadership is likely initially.

We also expect a Brexit trade deal to be concluded by around mid-November. This should give a modest boost to both Sterling and the euro and help to unlock some of the dormant value in UK equities, which have underperformed global equities massively since the UK voted to leave the EU. The UK is also better placed than most other nations to deploy one or more vaccines, beginning late this year or early next.

The Global Cycle

Our system for tracking, monitoring and forecasting the cycle in global industrial production growth (Global IP) has been especially useful during the COVID shock.

We revised our global growth forecast sharply downwards in late January, two to three weeks ahead of the peak in global equity markets, and soon realised that the COVID shock to output would be larger and more sudden than the GFC in 2008/9.

We set out our "Rolling Recovery" forecast on March 20th, just as global equity markets hit their panic lows. This was followed a few days later by a detailed forecast which called for a record-breaking V-shaped rebound in global industrial production, followed by a sharp deceleration in Q4: 2020 and a (small) outright decline in global production in Q1:2021. We expected a re-acceleration in global output to begin in the Spring of 2021, enabled by a gradual return to more normal social distancing as better treatments and testing made it easier to live with the virus and vaccine deployment began to ramp up. We envisaged a period of strong growth in global production and GDP from mid-2021 to late- 2022 taking global production and GDP roughly back to trend and possibly slightly beyond.

Though the details have changed, the basic shape of our forecast has not. Global IP is now slightly above its pre-COVID level and should rise a bit further this quarter. Global IP momentum will be falling from an unprecedented high of around 45% per annum in September to around 10% in December, but will likely turn slightly negative in early 2021. COVID and the policy response to it has had the effect of "pulling forward" certain types of expenditure, notably in the technology sector (from Netflix to Zoom to Logitech to Cloud Computing and Semiconductors). It has also boosted short-term demand for autos, as well as immediate and longer-term demand for housing outside city centres with enough space to facilitate working from home - and hence the demand for household appliances, home renovations and extensions. Some of these expenditures are one off purchases that will not be repeated over the next 6 months or so. At the same time, bankruptcy risk among small and medium sized businesses is likely to increase substantially over the winter.

Meanwhile, we note that China continues to lead the global production recovery, has been very successful in containing COVID infections and is now forging confidently ahead with development of multiple vaccines, a new five-year plan, ambitious climate change goals and massive funding to develop its own semi-conductor industry. And unlike the West, major EM countries such as India and Brazil are seeing a steady downtrend in new COVID infections, which should facilitate recovery.

For global equities, we think the main theme over the next several months will be rotation away from US and technology leadership rather than significant further upside progress in price levels, or for that matter a new COVID bear market. We expect US and global equity markets to make significant further gains in 2021/22 as global growth reaccelerates, but with an even greater emphasis on ESG investing and the impact for different companies of reducing their long-term carbon footprint.

In other markets, we expect steeper yield curves, more differentiated credit spreads, a modestly weaker US dollar and increased demand for inflation hedges, including gold and crypto currencies. Commodities associated with the switch to electric vehicles are likely to be well supported.

Secular Themes

"Productivity isn't everything, but in the long run it's almost everything" Paul Krugman

Despite the obvious challenges and dangers, our working assumption about the long-term outlook for the global economy is "fewer, richer, greener - and more Asian".

We expect global population growth to continue to slow and then go into slight reverse, a radically more productive economy and a huge shift towards lower carbon emissions and more sustainable lifestyles.

Specifically, we expect that the next few decades will bring perhaps the biggest leap forward in productive potential ever experienced, even as western democracies struggle to address climate change, inequality and the rise of China.

If anything, the current pandemic will accelerate these changes and challenges rather than the opposite.

The Great Transformation

We see five core themes driving this remaking of the global economy.

AI Everywhere: the detailed application of machine learning and AI techniques, (and eventually quantum computing) will drive major efficiencies in virtually all aspects of manufacturing, distribution, energy consumption and research/innovation. Government services, education and healthcare are likely to be revolutionised by this process as well. So will warfare and weapons. Finance too, especially as blockchain solutions becomes more tractable.

While cloud computing is democratising access to computing power, large companies and large countries will have an inherent advantage in the commercialisation – or the weaponization - of AI. Whether the latter reduces or increase the risk of "hot" wars remains to be seen.

The location of global production, retail outlets and office work is likely to change slowly but radically. Real estate values are already being affected and world trade in goods may eventually decline outright, while trade in "services" explodes. And the global super-cycle in semiconductors looks to have many years to run as demand for cloud computing and AI applications escalates.

New Energy and Transport: the shift away from fossil fuels as the world's primary energy source will take decades, but eventually the real cost of energy will be much lower than it is today. The shift to electric and fuel cell powered transport, autonomous vehicles and micro-mobility will run in parallel - and also lead to much lower real costs per mile for both freight and personal transport over time. The speed of the transition is still uncertain, but fossil fuels are likely to be a significant – and more expensive - component of the global energy mix for at least two decades.

Smarter Healthcare: better use of information, understanding of the human genome, CRISPR techniques for gene editing and robotic surgery etc offer the potential for massive improvements in prevention, in diagnostics and in drug and vaccine design. Anti-ageing therapies will probably extend our active lifespans much further. Treatments for the most common cancers, heart disease and management of Alzheimer's are likely to improve substantially. Again, in the long-run the real cost of healthcare should decline significantly.

Connected Cities**:** despite the accelerated shift to a hybrid model of working from home and working in an office, urbanisation will continue, especially in Asia and sub-Saharan Africa. All the world's mega-cities will need to become smarter and greener to cope with pollution, congestion and crime. Digital connectivity to their own hinterland and the world economy will likely reduce the need for physical meetings and international travel. The future of Central Business Districts is not clear, but is likely to be profoundly altered by the COVID shock.

The Future of Food*:* much of food production will move from the farm to the factory, becoming less energy and water intensive in the process. And potentially healthier. Despite the growing world demand for protein as GDP per capita rises and the world's population grows towards a peak, a significant portion of current farmland may be rewilded, becoming a carbon sink rather than a source of emissions. In the process, rural communities are likely to be transformed and the value and use of agricultural land will change radically. Over the long-term, the cost of food is also likely to decline in real terms for those on lower incomes.

Going to War on Climate Change

Over the past couple of years there has been a decisive shift in the global zeitgeist on climate change. Millennials already see this as the most important challenge facing the world, and now virtually every large business on the planet is starting to think about how to make their business carbon neutral in the long-run (with a few notable exceptions). The EU, China, Japan and the UK have set zero carbon goals for 2050 or earlier. This shift of global opinion is ultimately more important than any Climate Change treaty. So far, the Trump administration has been the global anomaly, but many US states and most US companies take a different view. Under Biden we would expect the US to set similar climate goals.

The devil is of course in the details of how to get there, and whether we can do it quickly enough to prevent catastrophic effects on bio-diversity, sea levels, regional liveability and migration. Success would require many trillions of new investment (creating many millions of new jobs) and a major re-direction of economic activity to low carbon solutions. Addressing inequality is even more challenging in this context since those on lower income spend a high proportion of their income on food, energy and transport, and raising the cost of carbon emissions immediately would penalise the poor much more than the rich.

The single most powerful policy change to mitigate climate change would be a deferred carbon tax, which rises slowly at first and then very steeply from about 7 to 10 year's out, creating a very strong incentive for all businesses and individuals to innovate and plan for the low carbon future. Such a deferred tax should be complemented by selected subsidies and regulations to accelerate changes in behaviour.

While a deferred carbon tax is not likely to happen explicitly, it is already implicit in - for example - the German government's approach to this issue. And for global equity and debt markets, it is already clear that future profitability, brand value or even solvency of individual firms will depend on how quickly they can move towards a zero carbon standard, and what the cost will be. As better information becomes available on companies' environmental impact and mitigation strategies, we expect the markets to re-price virtually all major businesses as if they had to pay a meaningful tax on their Scope 3 emissions.

This will help to drive huge inflows into passive ESG products but should also be a huge opportunity for active equity managers. We also expect it to re-define the concept of "value" investing, in that many of the most carbon intensive businesses will show up as value stocks on traditional metrics, at least initially.

Inflation and Inequality

Even before COVID, academic thinking about monetary and fiscal policy was changing in profound ways. Inflation in the US and Europe has effectively been below official targets for over a decade. And longer still in Japan. Official policy rates have been near or even below the zero bound for most of that period and QE or other forms of unconventional monetary policy have become a semi-permanent feature of policy, rather than a temporary expedient. That in turn has fuelled various concerns, from artificially prolonging the life of zombie companies to fuelling asset price inflation and hence amplifying the rise in inequality - of wealth and political influence especially.

That the world's major central banks now see their primary mission as guarding against deflation and financial instability, rather than keeping inflation low would be an exaggeration. But that is the direction of travel. After a year-long strategic review the Fed recently adopted a form of price level targeting, and signed up to a socially desirable "maximum employment" goal, which implicitly assumes the Phillips Curve is permanently flat. The ECB has recently announced that they will conduct a similar strategic review with the *de facto* goal of reducing deflation risk.

Ideas about fiscal policy have also shifted in the face of worries about secular stagnation concerns, the global savings glut and a decade of low levels of private and public investment. Academic debate has ranged from Olivier Blanchard's paper on *Low Interest and Government Debt*, which argues that high debt to GDP levels are a less binding constraint on fiscal policy than previously assumed; to proposals that the Bank of Japan should retire all or most of Japan's government debt, which it now owns; to the more extreme versions of Modern Monetary Theory, which effectively argues that fiscal deficits financed by central banks can and should be increased up to the point where unemployment is eliminated and inflation returns. In Germany, the once sacrosanct fiscal brake was loosened slightly to accommodate climate change related spending. And of course, populist governments – without appeal to theory – are everywhere and always associated with higher fiscal deficits and reductions in long-term fiscal sustainability.

All this is a sign that social preferences are changing. The 1970s stagflation has faded from our collective memory and it is now assumed that inflation takes care of itself in a free market system with globalised trade and capital flows. Or even that there is a bias towards deflation as a result of successive booms, asset bubbles and busts - as indeed we argued back in the early 1990s when explaining our view that long-term bond yields would trend back towards their all-time historic lows.

But when central banks and governments stop worrying about inflation, should investors start?

That slightly depends on your time horizon. Large supply shocks – especially food or energy supply shocks – normally cause short-term spikes in overall inflation, but these are typically reversed as supply responds to higher prices. The current pandemic is both a large negative supply shock and a huge negative demand shock: as and when demand fully recovers one should expect some upward pressure on inflation for a period.

Beyond that major inflationary episodes are associated with excess money growth and large budget deficits. But if you take the long view nearly all the major inflations of the past were the direct result of major wars – when large budget deficits were indeed financed by money printing, trade was disrupted and large amounts of capacity was destroyed or had to be urgently re-deployed for the war effort. Or the indirect result of war (eg – the Weimar inflation in Germany which was the result of huge social and political tensions brought on by the excessive WW I reparations demanded by France).

More broadly, history suggests that (global) inflation moves in longer cycles of acceleration and deceleration punctuated by war, but that the organic outcome of free market capitalism in peacetime is to produce very low inflation or even slight deflation – see figure 4 below – but that inflation is likely to be higher when society cares more about redistribution than wealth creation, especially if fiscal and monetary policy enable sustained conditions of excess demand.

In the early 20th century – a period of rapid growth and innovation – inflation was running around 1% per annum (after averaging about -1% per annum from 1870-1900) even before WWI drove prices sharply higher. It was a period when resentment about extreme inequalities of wealth was running high, which manifested itself in both anti-trust action directed against the "robber barons" and in legislation to facilitate the growth of unions. This period is sometimes called the decline of laissez-faire in the history books.

Societal preferences were also changing in the late 1960s and early 1970s even before the twin energy shocks of 1973 and 1979: budget deficits were running high under the twin burden of fighting the Vietnam War and funding Johnson's Great Society program, unions were strong, labour market flexibility was declining and workers were winning much more generous pension and health care benefits. Inflation trended gently but steadily higher through this period, laying the foundations for the great burst of stagflation in the mid-to late-1970s once the oil shocks hit. So although inflation is always about excess demand, and usually facilitated by rapid money growth, the secular cycle in inflation is perhaps best viewed as the result of a dialectical social process in which rising inequality and a rising profit share lead to a change in society's preferences which pushes the system in the opposite direction. And as with Reagan and Thatcher in the 1980s, the US and the UK are likely to be the leading indicators for the rest of the developed world.

At one extreme you could argue that a triple blue outcome in the US elections means something like the following: the US will indeed be going to war (against climate change, against inequality); will have to prepare itself for a hot war against China (to deter them from actually invading Taiwan, the source of many of the components that drive our digital systems); will raise corporate taxes as well as minimum wages, increase business costs for health care - and impose, or reimpose, a mountain of costly regulations. Against that, there will be effects of the Great Transformation which we think will lead in time to (much) lower prices for food, energy, transport, health care and probably high quality education too. Capitalist innovation on steroids you might say. The disruption to existing business models and asset values will be huge, with the risk of high frictional unemployment and deficient demand (more inequality) but the prospect that those on lower incomes eventually stand to benefit the most from the lower cost of living (less inequality). In the interim, easy monetary and fiscal policy and some degree of income distribution may be exactly what the economy needs.

We can't really know where this epic contest will leave inflation. Time frames matter though. The drive towards zero carbon will raise business costs initially; so will higher corporate taxes and higher minimum wages; so will a measure of de-globalisation resulting from tensions between the China and the US. Outright war is not impossible if China can build its own advanced semi-conductor industry, or if it feels compelled to invade Taiwan. Neither is likely any time soon, but that would lead – like WW I – to a big spike in inflation and huge wealth destruction everywhere. In the interim our working assumption is that we will see (moderately) higher inflation on a 5-10 year horizon, as part of the transition to a radically more efficient economy. Global bond yields will drift higher (in the US, 30-year yields back to 2.5 to 3.0%) initially as break evens rise, later as real yields recover somewhat. Expectations for nominal GDP growth will stop falling and the demand for inflation/disaster protection will increase. And there will be big implications for sector leadership and stock selection within the equity market.

All this feels eerily like the early 1900s to us, but then as we know, history never repeats itself exactly.

The Rise of China

For most of the post WWII period there has been only one true superpower. Now there are two. Pre-nuclear history is not encouraging. Of 15 cases in which a rising (global) power threatened the dominant nation, 12 ended in war. In the post-nuclear world we have one example: it led to the Cold War between the US and the Soviet Union – which ended when the Soviet economy collapsed under the weight of its own internal contradictions. Arguably that one example is more relevant than the other 15.

Millions of column inches have been spent on the fractious future of the US/China relationship. We claim no special insight but for what it is worth we think that the following few things are what really matter.

The logic of Mutually Assured Destruction (MAD) still applies between major nuclear powers. Paradoxically, to keep the peace both sides must be – or credibly appear to be - willing to risk a nuclear conflict they cannot win.

As things stand China and America are co-dependent strategic rivals - far more economically and financially inter-dependent than the Soviet Union and the US ever were. So outright conflict anytime soon would also lead to mutually assured economic destruction. Among many other dependencies the US relies on China for many critical ingredients for drugs, and China lags a long way behind in semi-conductors.

Moreover, for China to "win" in this type of Great Power competition is not really about achieving military dominance, but to pull ahead in the economic and technological "arms" race, to gain influence and standard setting power within the international arena, to develop its own capital markets and to reduce the role of the US dollar as the world's major reserve currency. This is a marathon not a sprint, and time is probably on China's side. Their political system and heritage is geared to long-term planning in a way that the US is not.

Within this multi-sided rivalry, national security concerns mean that neither side can afford to depend in future on the other to supply or maintain critical elements of their civilian or military digital infrastructure. And multi-national companies from all nations will need to diversify their supply chains away from China to achieve greater resilience.

This is economically inefficient and will raise costs to some extent, but it is unlikely to reduce the aggregate level of global investment and may well have the opposite effect. It may even accelerate the trend to more automated production systems within global manufacturing. Meanwhile, growth within China itself is already much more driven by internal demand (for services) than it by manufacturing exports.

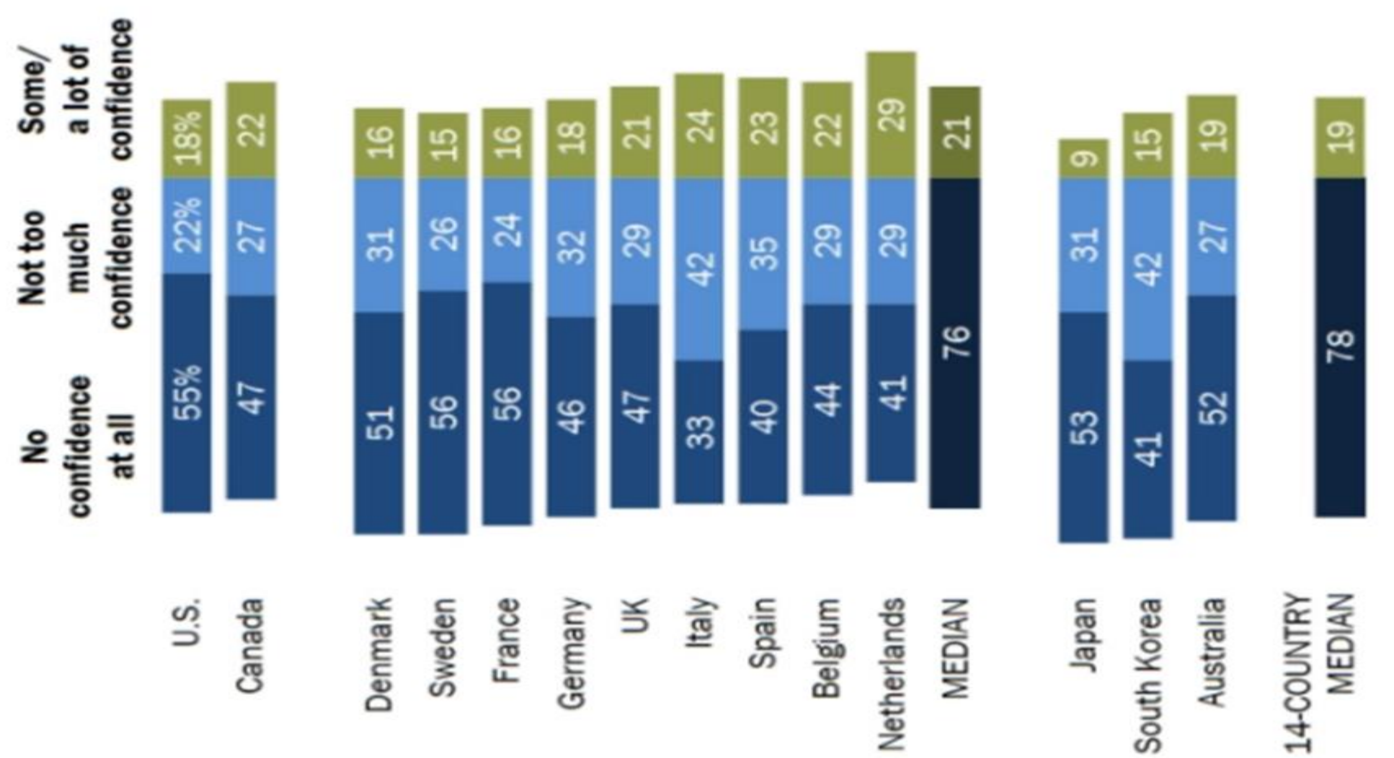
China will never accept that Taiwan can be an independent nation and maintains an active plan to invade/annex the island. President Xi refers to it regularly. So would they try to kill two birds with one stone, so to speak? At the same time, there are many who think that China will never catch up in semi-conductors, no matter how much money it spends. The best it can do is to recruit as many engineers and designers as possible from the leading global manufacturers.

China certainly has the manpower, aircraft and missiles to invade Taiwan, but whether it would be able to take and hold the island as a whole without encountering massive guerrilla style resistance is an open question. In the meantime, the likely economic fallout and likely loss of overseas markets and trading relationships would be somewhere between very large and enormous. In terms of nationalist rhetoric Taiwan will always be a military target. In terms of economic and political cost benefit, it is almost certainly a losing proposition. In the foreseeable future, the risk of China actually invading Taiwan is extremely low: but political logic dictates that the threat must always be maintained. And for that matter that the US must do it's best to deter an invasion, by whatever means it thinks fit.

There is no doubt that China's relationship with the US and the rest of the world will remain ambiguous for many years to come, combining rivalry with cooperation and friendly words with aggressive warnings not to interfere in China's internal affairs. But in the end the logic of MAD – whether seen in economic or military terms will keep the two powers from direct military confrontation in our view.

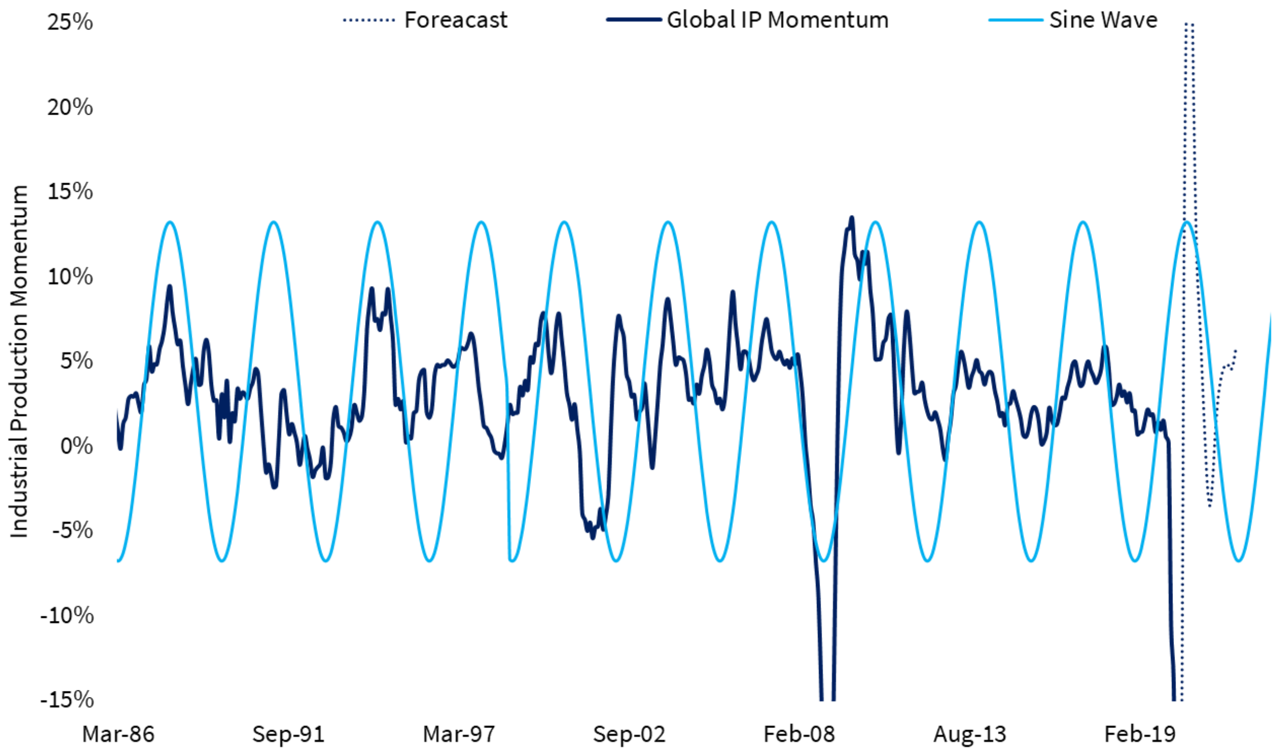
The one caveat is the degree to which President Xi has centralised power, and become the potential President for life. If there is one lesson about power from history it is that the longer a single individual enjoys supreme power, the less well they govern and the greater the risk that they might sacrifice the economic benefit of the nation for the sake of their ego or continued hold on power. That is after all what happened with Chairman Mao. The longer-term question mark, therefore, is not about the Chinese people: it's about the President Xi himself. At the moment China is leading the world in controlling COVID, developing vaccines and putting the economy back on its feet. Xi has consolidated his position even further through the crisis and China has been notably assertive – over Taiwan and many other foreign policy issues. The evidence is that the rest of the world doesn't trust him -see figure 1. And that should be no surprise.

FIGURE 1: GLOBAL TRUST OF XI'S ACTIONS



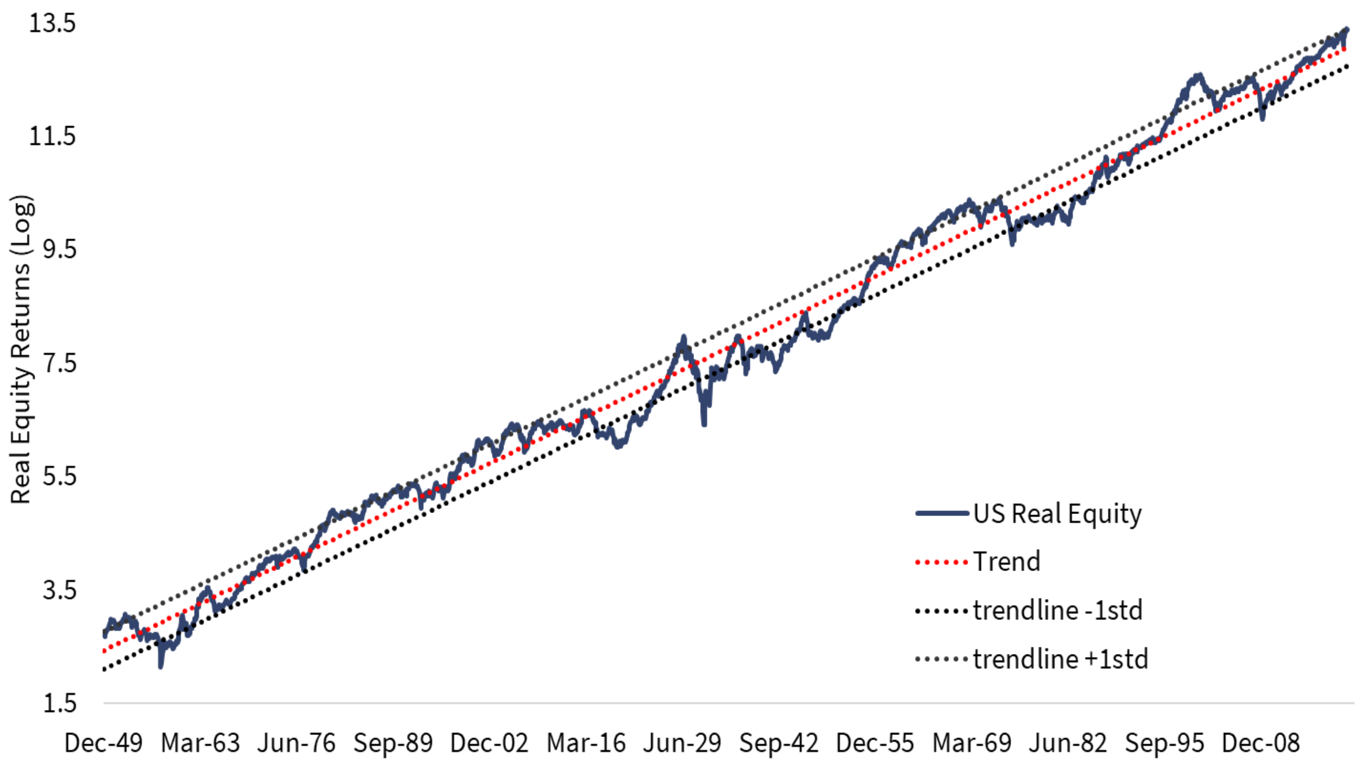
Source: Pew Research Centre

FIGURE 2: GLOBAL INDUSTRIAL PRODUCTION VS STYLISED PRODUCTION CYCLE



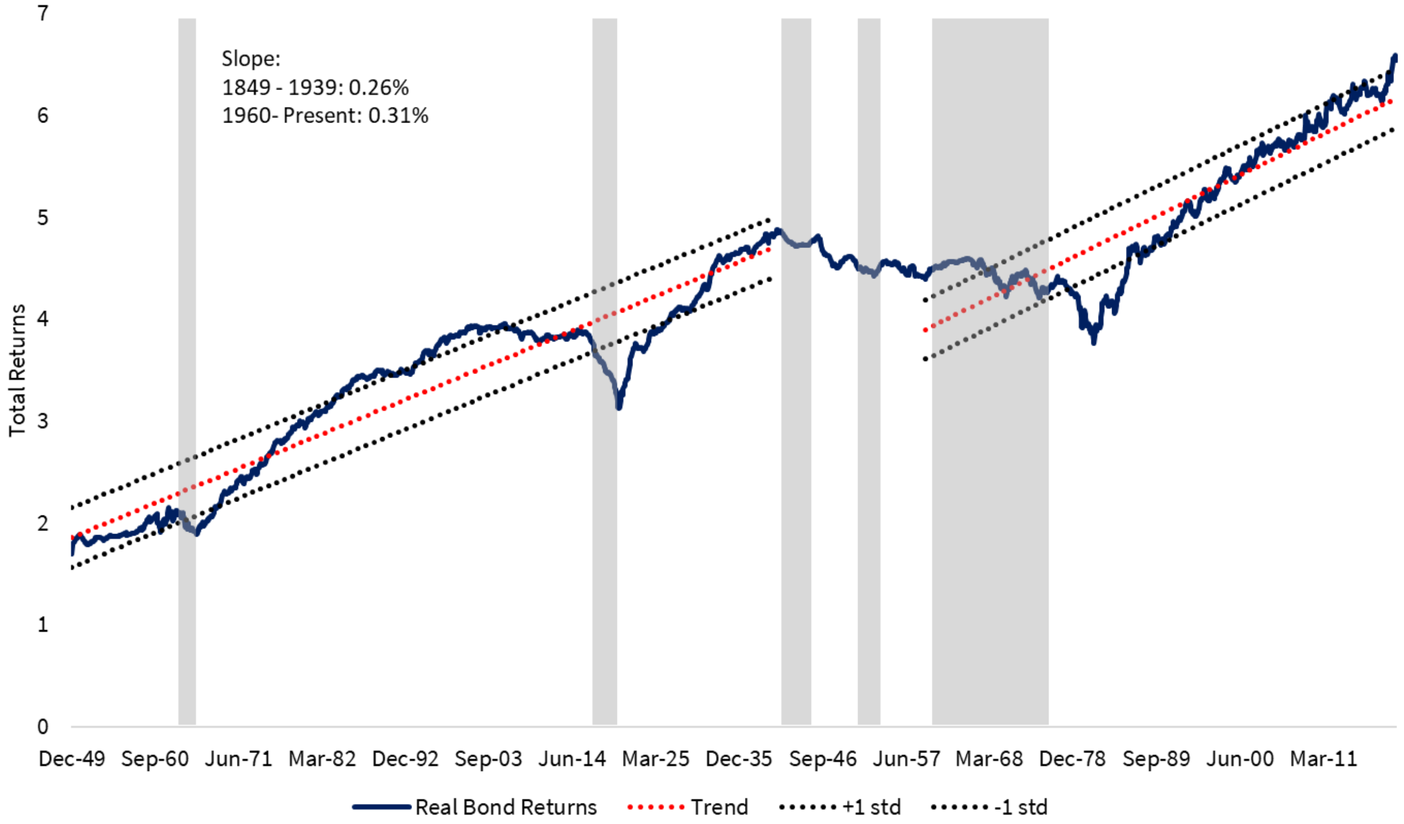
Source: WilmotML, Refinitiv

FIGURE 3: REAL EQUITY RETURNS VS TREND (1850 – DATE)



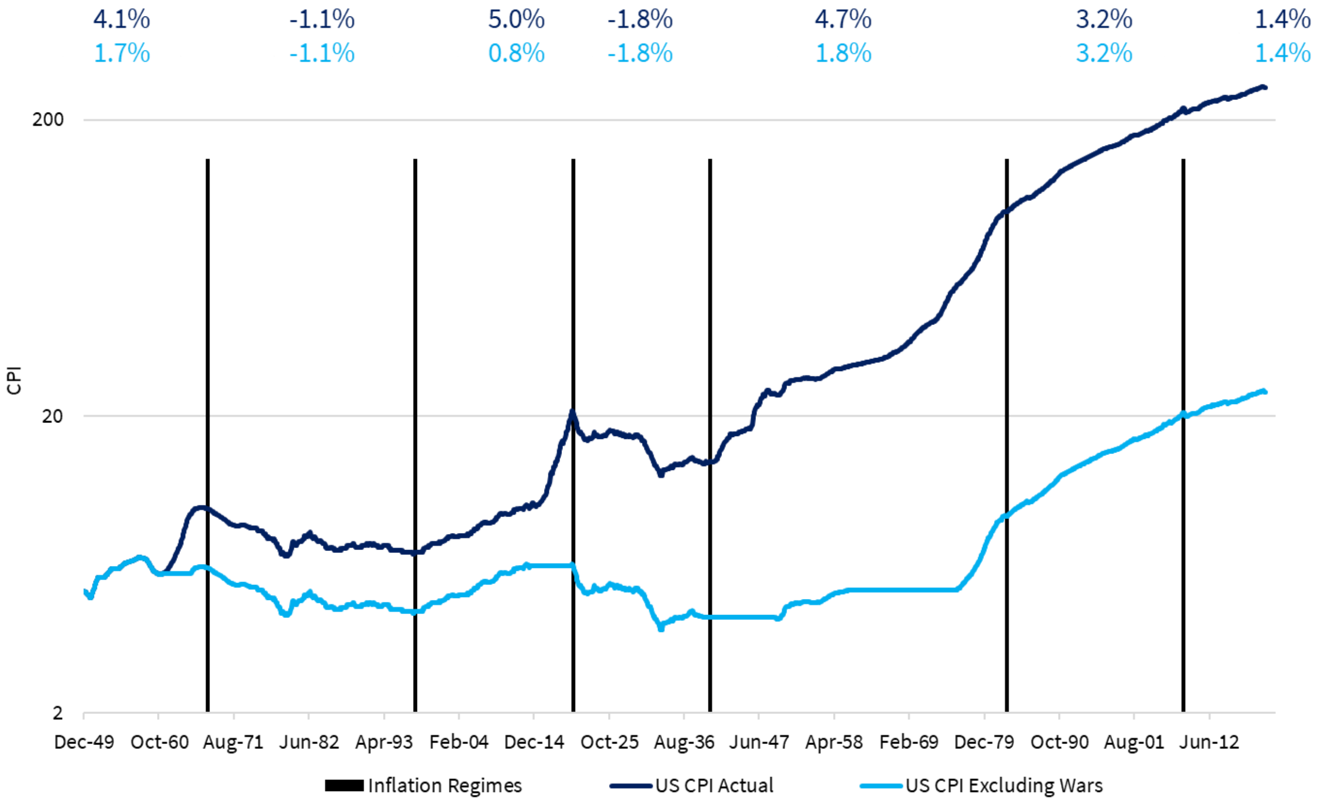
Source: WilmotML, Refinitiv

FIGURE 4: REAL BOND RETURNS VS TREND (1850 – DATE)



Source: WilmotML, Refinitiv

FIGURE 5: INFLATION REGIMES WITH ANNUAL GROWTH RATES: CPI (1850 – DATE)



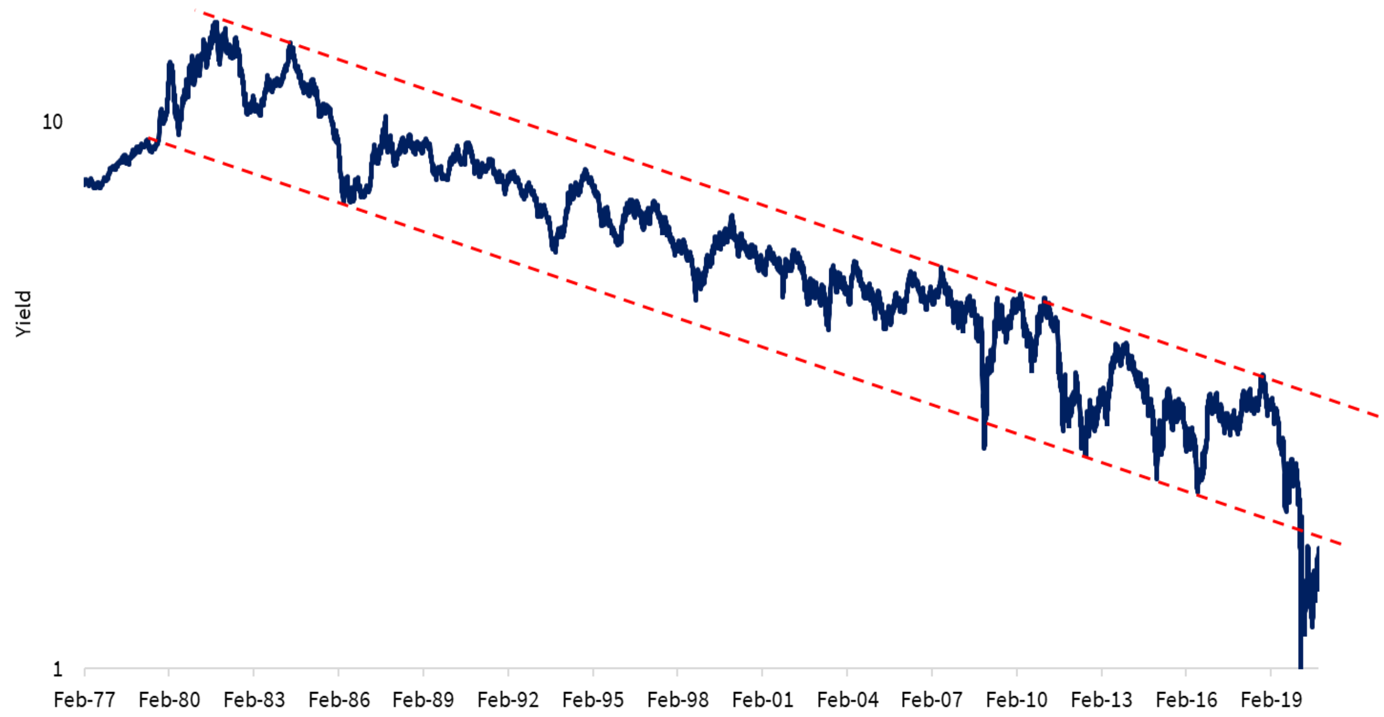
Source: WilmotML, Refinitiv

FIGURE 6: US INFLATION REGIMES – TABLE OF ANNUALISED GROWTH RATES

Dates	Dates Excluded	CPI Growth Rate (Excluding Wars)	Real Bond Returns (Excluding Wars)
31/12/1849 – 01/08/1867	30/04/1861 – 30/04/1865	4.1% (1.9%)	1.0% (0.8%)
01/08/1867 – 01/11/1897	None	-1.1%	4.2%
01/11/1897 – 01/05/1920	31/07/1914 – 30/05/1920	5.0% (0.8%)	-1.6% (0.1%)
01/05/1920 – 01/02/1940	None	-1.8%	4.0%
01/02/1940 – 01/12/1982	30/09/1939 – 30/09/1949 31/08/1960 – 31/12/1975	4.7% (1.8%)	-1.5% (0.5%)
01/12/1982 – 01/08/2008	None	3.2%	3.8%
01/08/2008 - Present	None	1.4%	1.8%

Source: WilmotML, Refinitiv

FIGURE 7: US 30Y TREASURY (LOG SCALE)



Source: WilmotML, Refinitiv

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