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Winter Is Coming: The Geopolitical Recession Begins Now

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Executive summary

I expect to see a significant global economic slowdown in the next 12 months, with a high chance of a recession around this time next year. I'm not concerned whether we see back-to-back negative quarters; a recession is defined as a significant slowdown in aggregate demand, which is highly likely in the next year in my view. While I believe the direction is set, the pace and severity will remain very policy-dependent. The primary driver of the slowdown is what I am calling a "geopolitical recession" (term borrowed from Eurasia Group) that is creating a permanent state of endemic uncertainty and instability in the global political economy. It is a shift from four decades of increasing globalization to one of deglobalization and collapsing global governance. The escalation in the global tech and trade wars will drive a decoupling of global supply chains and significantly lower economic growth. I expect the negative impact on earnings to be significant, as decades of increasingly complex interconnectivity cannot be unwound without unintended consequences.

Monetary policy cannot undo the trend. It may cushion the impact but cannot reverse it. For a decade, monetary policy has been the solution to financial tightening-driven slumps, and hence all backward-looking correlation algorithms will buy the U.S. Federal Reserve (the "Fed"). They forget 2007 when the reason the Fed was cutting interest rates was because the economy was tipping over. The market bought that one, too. It did not end well.

This is not just about U.S.-China trade. China's economy was already slowing from deleveraging efforts aside from trade, and while we expect further policy easing will offset a drastic slowdown, the Chinese are not looking for a big reacceleration. Europe and Japan cannot drive global growth as they are merely warrants on global trends with limited ability to set an independent direction. Add in Brexit and Italian/populist movements and Europe is also a contributor to the geopolitical recession concept. It is not just the U.S., its president and China. It is the new global normal.

As rates everywhere go to zero, investors who require a positive real return will ultimately have to own more risk assets, and with rates in the 0–2% range, a price-to-earnings (P/E) range of 15–20+ makes sense. The reason for our cautious positioning today is that I expect to see a significant market correction as earnings estimates for 2020 get slashed. That would be a time to buy.

The takeaway from a geopolitical recession is that elevated political uncertainty will drive slower economic growth, lower earnings and elevated market volatility. Active allocation through the cycle with a strong understanding of potential policy outcomes will be required. The past decade has been all about monetary policy. Today you need to add fiscal, trade, technology and geopolitical policies into your repertoire.

Winter is coming. My 2019 target for the S&P 500 Index was 3000. We are there. Fade the rally, watch the policy space, watch the hard data, watch earnings announcements. Buy risk assets when investors fear winter will never end, not when they see sunshine in Fed invincibility.

Perspective and fund positioning

I have been structurally bullish on the U.S. and the global economic outlook for most of the past decade, notwithstanding a few tactical challenges, such as the euro crisis of 2011–12 and the 2015–16 energy/emerging-markets crisis. Since 2013, we have been in a period of monetary policy normalization as the Fed sought to reverse the extraordinary policies of zero rates and quantitative easing implemented in the wake of the 2008–09 financial crisis. It was doing so because the economy was returning to health. Given the strong economic backdrop and low interest rates, at Signature Global Asset Management our mantra has been: Engage Risk Assets.

Only in 2015–16 did we get defensive as the pace of normalization threatened to tip over the global economy. But just as Fed tightening was the cause of the downturn, the quick relent on tightening by then-Fed Chair Janet Yellen in early 2016 was the solution to the slowdown. As credit channels reopened in response, we returned to our overweight equity positioning from mid-2016 onward.

In the past year, with U.S. policy rates rising above 2% and approaching the expected neutral level, we became more cautious and began to tactically pull back our positioning from overweight to neutral. Our view was that the economy should remain in good shape. We did not expect the Fed to continue tightening excessively in the absence of building inflationary pressures, which have remained subdued. This fear led to a market correction in the fourth quarter of 2018, but was quickly reversed as the Fed in January clearly reiterated, in line with our view, that it had no intention of driving the economy into a recession, the so-called “Powell Pivot.”

Through April, my base case continued that the U.S. and global economies would remain in a slowing, but stable, growth trajectory. As the stimulus from the 2018 tax reform and budget bill faded, I expected the U.S. economy would decelerate from its recent 3% pace towards a more sustainable close to 2% growth rate, supporting earnings growth in the 5–10% range for 2019 and 2020. There was no fundamental case for a recession. The broad trajectory of the U.S. would, by and large, be mirrored in the overall global economy. A key component to this view was that the U.S.-China relationship would remain on track despite lots of tension and headline noise, but we did not expect that it would deteriorate to the point of threatening the stability of the global or U.S. economies. In other words, we believed the geopolitical backdrop would remain rocky but stable, high-profile trade talks would keep both sides at the table, while in the background the budding tech war would remain on a separate low-boil track. I was wrong.

In May 2019, trade talks collapsed, and the tech war became the key relationship driver. May was a tipping point. The world has entered a geopolitical recession. There is no going back as we have entered a new tech-centric cold war that will drive a deglobalization process and an unplugging of global supply chains. There will be supply-side-driven economic consequences that the Fed and monetary policy will be unable to offset.

The geopolitical events in May have caused me to become more structurally bearish on the global and U.S. economic outlooks than I have been in a decade. With markets drifting complacently at all-time highs, Signature Global Asset Management has shifted its fund positioning to a defensive stance, with lower equity exposures and higher bonds, cash and gold weights across the portfolios.

Global geopolitical recession

It is important to understand that while the U.S. and China take centre stage, it is not just the escalating U.S.-China economic and tech wars. We are moving into a truly global geopolitical recession: rising populism across European Union (EU) countries and Brexit in Europe, America First-led trade battles with just about everyone from Mexico, Canada and Europe to India, rising tensions between Japan and South Korea – all are contributing to an elevated geopolitical volatility that will spill over into a significant global and U.S. economic slowdown and a significant earnings recession for global equity markets in the coming 12 months.

While I believe the direction is set, the actual pace and severity – and hence market behaviour – will be very policy-dependent. In the coming decade, the battles will ebb and flow, but in the coming year I do expect to see further escalations on the China tech front, on the U.S.-Europe tariffs front and, ultimately, I expect the U.S. to also “weaponize” currency policy and the U.S. dollar (i.e., use the currency’s heft as a tool of foreign policy). Be prepared.

From globalization to deglobalization

Long-term investment strategist Jan Loeys at J.P. Morgan defines globalization as the fading of national borders and the increasing flow of goods, services, capital, people, companies and ideas across national borders. For the past 70 years since the end of WWII we have arguably lived in a period of increasing globalization. Ever more people and countries have been joining the U.S.-led rules-based system of global governance norms as institutions such as the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO) were built to help establish and enforce a set of global rules of engagement. The objective was to prevent the beggar-thy-neighbour protectionism and trade wars that led to the great depression of the 1930s and a precursor to WWII. Following the collapse of the Soviet Union and an end of the last cold war in the late 1980s, globalization went into hyperdrive in the 1990s with the creation of the EU single market and the euro, followed by the entry of China into the WTO in 2001. The past four decades have been some of the most politically stable and prosperous times in recent history, lifting billions above the international poverty line (which today is US$1.90 per day) and into the global market economy. For investors, globalization and new technologies opened up both significant new global market opportunities and the ability to optimize supply chains at a global level. In the process, globalization helped drive corporate profits and margins to ever-higher levels. Deglobalization will work in the opposite direction.

For investors, the broadly stable and benign geopolitical backdrop meant they could broadly ignore politics from an investment perspective. Politics was fun to discuss at dinner parties but largely irrelevant, and often detrimental, from an investment perspective. As the geopolitical recession drives more deglobalization, that is no longer going to be the case. In the coming decade, investors will have to develop their political risk assessment tool kits. As Ian Bremmer, founder of Eurasia Group, recently wrote in a newsletter emailed to me:

"When I started Eurasia Group in 1998, the economic impact of political risk was largely contained to emerging markets (countries I accordingly defined as "those where politics matter at least as much to the markets as economics"). In developed economies and in the global economy as a whole, political developments only mattered at the margins. But now that we're experiencing an unwind of the U.S.-led global order, it's a different story. Today, geopolitics have become the principle driver of global economic uncertainty."

The three critical events of May

May 2019 may well go down as one of the key pivotal months for the global economy in recent decades. There were three critical events in May that changed the trajectory of the world for the coming decades. The first was the collapse in the U.S.-China trade talks and the unilateral escalation of tariffs from 10% to 25% on US$200 billion worth of Chinese imports. This was followed by the threat of tariffs on the remaining US$300 billion. China duly retaliated with higher tariffs on US$60 billion of U.S. goods. The implication of this move was that the two sides stopped talking. The real issue between the U.S. and China has never been about trade, in my view; it is about technology and ultimately the rise of China as a challenger to the U.S.'s hegemonic status. U.S. President Donald Trump believes it is about trade and that bilateral deficits matter. But as long as trade talks continued, communication between the two sides was occurring at the highest level and there was a forum to address the broader issues such as technology, Huawei Technologies Co. Ltd., etc.

The second event was the placing of Huawei on the U.S. entity list and effectively banning U.S. firms from buying or selling to Huawei, the largest telecom equipment maker in the world. This was an outright declaration of economic warfare from the U.S. and sent a clear message that the objective of U.S. policy is not to get a trade deal with China but rather to contain China and destroy its technological capacity to challenge the U.S. As Steve Bannon, Trump's former chief strategist, mentioned in a *Washington Post* article, "We're in an economic war with China. It's futile to compromise." This is the sentiment that underpins the new modus operandi between the U.S. and China. It is not constructive.

While Huawei may be the global leader in 5G technology, it still relies on U.S. semiconductors to build its equipment, without which they would be out of business. By the same token, China's dominance of rare earths (a group of scarce metal chemical elements important for technology and manufacturing) production means that if China shuts off sales of rare earth to the U.S., the U.S. could not produce the semiconductors. Given a few years, both sides will be able to reduce or eliminate much of their interdependence for critical components. This is at the heart of deglobalization, the unplugging of supply chains and the fragmentation of the global economy into regional, and less efficient, trading blocks. The objective of placing Huawei on the entity list was to destroy one of China's leading and largest tech firms. This was the launch of a new technology-centric cold war between the U.S. and China. There is no going back.

The third element of the May trifecta that sealed the trajectory toward a new trade cold war was Trump's threat to impose escalating tariffs on all Mexican goods if they don't deal with the immigration issue. This weaponizing of economic sanctions for non-economic objectives occurred before the ink on the new NAFTA deal between Canada, the U.S., and Mexico was even dry! The clear message to the world was that the U.S. was willing to tear up and disregard an agreement at any time. The government feels no obligation to honour its commitments. The message I have heard from trade negotiators in other countries is that they no longer believe the U.S. is negotiating in good faith. Any agreements reached can be ignored. No country is willing to make significant concessions in a negotiation under such conditions. Mistrust has replaced trust.

The net result of the events in May is that as trust evaporates, the world is moving toward a state of endemic uncertainty and instability. It is the start of the collapse of the institutions of global governance. Following 70 years of building up the institutions of global governance and the tearing down of walls and borders, the world is heading back towards protectionism and fragmentation. It will force the decoupling of global supply chains as large countries seek self-reliance and companies are forced to protect their businesses from the ebbs and flows of economic sanctions and tariffs. But unplugging interconnected supply chains after decades of increasing interconnectivity will have significant unintended consequences. Nor can it be done overnight:

"This contest will be a drawn-out process that will likely last our careers. We as investors and analysts need to pace ourselves, and try not to just follow the latest news. We need to understand the economics and the cultural differences."
– Stephen Jen, former economist at the IMF and Morgan Stanley[1]

Ray Dalio, founder of Bridgewater Associates, the world's biggest hedge fund manager, expressed a similar view:

"The conflict goes well beyond a trade war. As China emerges as a world power capable of challenging the U.S., the countries will clash in all sorts of ways because of different approaches to government, business and geopolitics. They can't negotiate these more fundamental issues."[2]

Welcome to the new normal. Winter has come!

[1] As quoted in Bloomberg News article, "Investors Brace for a New Cold War That Will 'Last Our Careers,' posted May 30, 2019.
[2] As quoted in Bloomberg News article, "Investors Brace for a New Cold War That Will 'Last Our Careers,' posted May 30, 2019.

Conclusions

At its core, this is about a rising superpower challenging the hegemonic stature of an existing power. It will last the rest of our lifetime. We need to develop the tools to understand potential investment implications and to navigate portfolios through what will be a very different and more volatile geopolitical backdrop compared to any previous times in our careers. Our immediate concern at Signature, as reflected in our cautious positioning, is that the rising uncertainty, tariffs and decoupling of supply chains will curtail corporate capital expenditures and hiring, driving slower economic growth. It will lead to significant unexpected negative earnings impacts in the coming few quarters. We are only at the starting line of these events, and the full implications are inherently unknowable, and we want to respect that. With the S&P 500 Index hitting a new high of 3000, and 2020 earnings estimates still in the double-digit range, we do not believe these risks are appropriately reflected in today's equity markets. Rather, markets today are reacting to the Fed's signalling that given the deteriorating economic outlook, it will be lowering interest rates later this year. But lower rates will not, and cannot, reverse the growing endemic uncertainty and geopolitical instability behind the deteriorating economic outlook.

While I believe the efficacy of rate cuts will be limited in halting the slowdown, it is important to emphasize that I see no inherent need for a severe recession. There are no significant imbalances in need of correcting. The driver is an exogenous shock, not an asset bubble collapse as in 2008 and 2001. We should see a more shallow downturn in the economy. For equity markets, my concern is they still imbed much higher earnings growth than I expect, but once markets begin to price an expected decline in 2020 earnings, I will be a lot more interested in re-engaging with equities. Given our expectations that interest rates will stay glued to the floor in the next few years, investors will absolutely have to hold more equities if they want positive returns, and valuations are not at all scary. If interest rates remain in the 0–2% range in coming years, I would expect that equities can easily trade between 15–20+ PE levels. But the riskiest time to hold equities, and when I expect to see markets correct, is when earnings growth is moving into negative territory, a reasonable possibility in the coming few quarters.

Sources: Bloomberg L.P., World Bank and Signature Global Asset Management, as at July 8, 2019.

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