Markets struggle with political risk

October 2016

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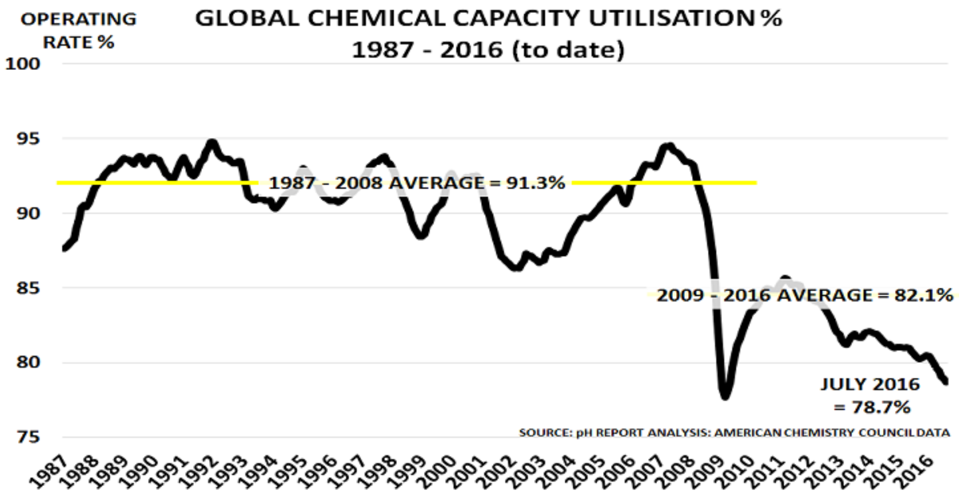


Chart 1: Global chemical Capacity Utilisation continues to fall

> *Central banks have destroyed price discovery by flooding markets with endless supplies of free cash*

Markets have one main function in life – price discovery. If I want to buy, and you want to sell, the existence of a market allows us to discover the price at which the market will balance in terms of supply and demand.

History, however, provides many examples of times when rulers decided they knew best, and destroyed market economics. The Soviet Union was one example, where the Central Committee of the Communist Party would decide what was going to be made and where, and the price at which it was being sold. That system of course collapsed with the Berlin Wall in 1989, but the collapse took decades to happen.

Today, we have another central organisation which is attempting to carry out the same manoeuvre – the main central banks in the West. They have also destroyed price discovery by flooding markets with endless supplies of free cash. The evidence for this statement is in the first 3 charts shown here.

Chart 1 shows capacity utilisation (CU%) in the global chemical industry – the best real-time indicator that we have for the global economy. New data from the American Chemistry Council shows CU% fell yet again in August to 78.7%, nearly 2 percentage points below August 2015:

- ❖ This pattern has only been seen before in 2001 and 2008, which were not good years for the industry or the global economy

The market is being completely rigged by the central banks

- It has now fallen every month this year, and the 2009 – 2016 average is nearly 10 percentage points below the average seen before the Financial Crisis began in 2008

Chart 2: Earnings in the FT 500 Index have halved over the past year

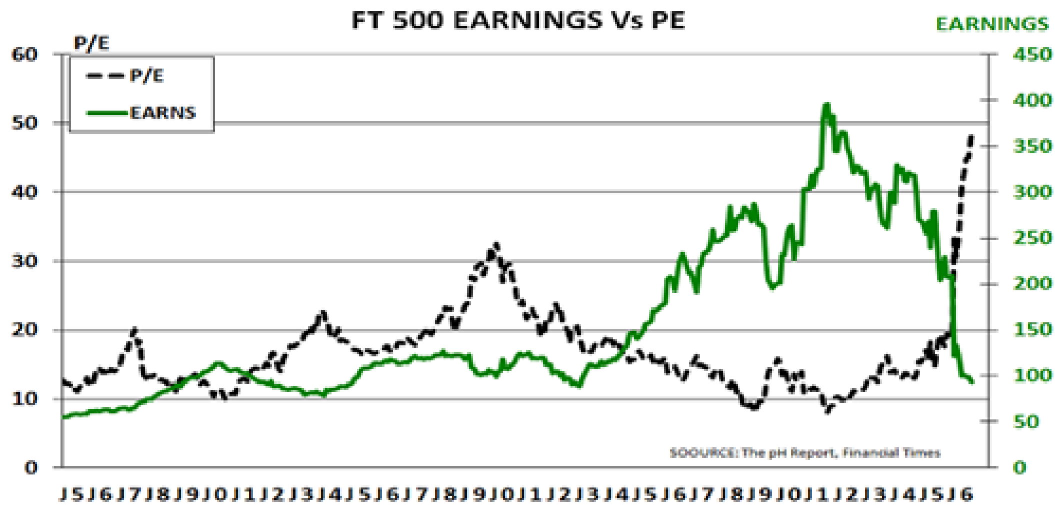


Chart 2 confirms the downturn underway. It shows earnings for the UK's FT 500 Index since 1985, set against the price/earnings ratio. As one would expect, given the CU% decline, earnings have been tumbling in the past year:

- They peaked near 400 in mid-2011, and eased to around 200 by mid-2015
- Since then, they have more than halved to just 93 on Friday

Normally, of course, this would mean that market prices also fell, as the outlook for earnings worsened.

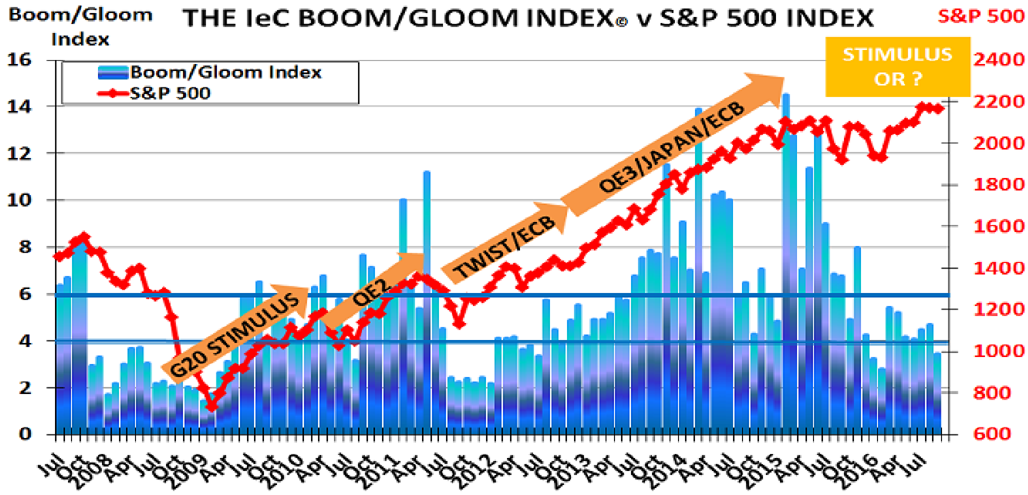
But the opposite has in fact happened, as the central banks have simply pumped out more and more free cash. They have even taken interest rates to negative levels in many major markets such as Japan, Germany and the UK.

Investors, increasingly desperate to try and meet their target returns for paying pensions etc, have responded by bidding up the price/earnings ratio from 18 a year ago to 49 today – easily the highest level ever seen in the period. This takes us to Chart 3, showing the IeC Boom/Gloom Index. It measures sentiment versus the US S&P 500 Index, and shows this has fallen back to danger levels once more.

Investors all recognise that the market is being completely rigged by the central banks. But, they say, "What can we do? We cannot go into cash, as it yields nothing, and benchmark Western government bonds also yield nothing". $15tn of developed country sovereign bonds even have negative yields. The fact that some of the best performing US$ debt markets in Q3 were El Salvador, Mongolia and Zambia highlights how desperate the "search for yield" has become.

Markets have forgotten how to price political risk

Chart 3: Stimulus has had much less impact on the S&P 500 this year



How long will the central banks be able to keep markets artificially high and defy economic reality? We cannot know. But we do know they are providing a fertile breeding ground for populist politicians.

2. Markets struggle with political risk as populists gain

Chart 4: Populists such as Jeremy Corbyn, Marine le Pen, Donald Trump and Bernie Sanders are entering the mainstream

Markets have forgotten how to price political uncertainty in recent decades. They have become dependent on central bank handouts, and assumed that globalisation and trade agreements are permanent features of the economic landscape. Today, they need to relearn, very quickly, what has been forgotten. As we noted a year ago, the rise of the populists highlighted the paradigm shift underway. We argued that outsiders such as Trump and Sanders would probably play a major role in the US Presidential Election, and that this political development would have economic impact:

"The economic success of the BabyBoomer-led SuperCycle meant that politics as such took a back seat. People no longer needed to argue over "who got what" as there seemed to be plenty for everyone. But today, those happy days are receding into history – hence the growing arguments over inequality and relative income levels.

Many readers were amazed at our suggestion last year that Trump could become the Republican nominee

"Companies and investors have had little experience of how such debates can impact them in recent decades. They now need to move quickly up the learning curve. Political risk is becoming a major issue, as it was before the 1990s".

Perhaps unsurprisingly, many readers were amazed at our suggestion that Trump could become the Republican nominee. They were also somewhat shocked by the idea that populism might start to have a major impact on trade agreements. Yet last month's presidential debate featured Trump as the nominee, and both candidates argued for major changes on trade policy, as the New York Times reported:

"That neither candidate came to the defense of trade and trade agreements underscored a remarkable feature of this presidential election: Both major parties' nominees are running against such pacts, despite the long pro-trade tradition of the Republican Party, and Mrs. Clinton's past endorsement of the signature trade agreements of her husband and her former boss, Mr. Obama".

More recently, our suggestion in March that a Brexit vote "was becoming more likely", also surprised some readers. But today, many companies and investors are becoming uncomfortably aware that the Brexiteer demand for immigration controls make it likely that the UK is heading for a "hard Brexit" in Q1 2019 – where it leaves the Single Market and maybe even the Customs Union.

It is, of course, difficult to envisage a world where populists rule. But the Brexit result highlights that "business as usual" is no longer the only Scenario that needs to be considered:

- Even though Sanders did not win the Democrat nomination, he is still a very powerful figure, and a Clinton presidency would no doubt be far more radical in certain areas as a result
- A Trump presidency would almost certainly be very different from the Reagan-Bush-Clinton-Bush-Obama continuum of the past 35 years, with major policy changes – such as the renegotiation or scrapping of many trade agreements and a possible withdrawal from NATO
- Similarly, Europeans and others need to consider what might happen in Italy if premier Matteo Renzi loses his December referendum and resigns; or in France if Marine le Pen becomes President next year; or in Germany if the Alternative für Deutschland does well in next October's national elections. They might well gain enough seats to make a continuation of the current "Grand Coalition" between the CDU/CSU/SDP impossible.
- Even in the UK, where most pundits regard the populist Labour Party leader, Jeremy Corbyn, as unelectable - due to his radical socialist and pacifist agenda - it would only take a breakdown in the Brexit negotiations for his chances of gaining power to rapidly improve.

The key conclusion is that we are living in very uncertain times.

People with assets have got richer, people without have not

Companies and investors therefore need to prepare very carefully for every possible outcome – even if these seem unlikely today. For example, most investors today assume that the Federal Reserve will always support US stock markets. But if Trump were to win next month, it is likely that this policy would change very quickly.

3. Political risk rises as voters feel only the populists are listening

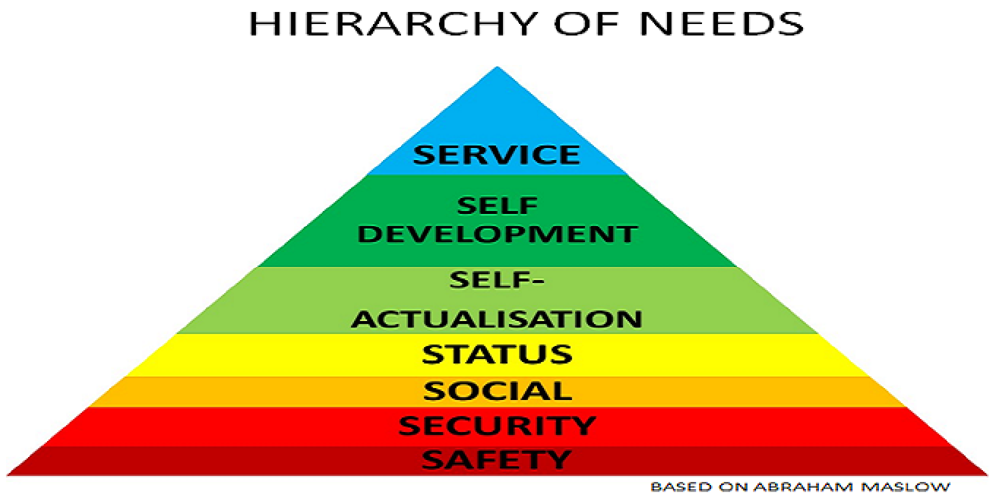


Chart 5: The Hierarchy of Needs highlights how basic needs are currently not being met

New UK premier, Theresa May, chose her high-profile Conservative Party conference speech to highlight how the central banks have encouraged the populists' rise:

"We have to acknowledge some of the bad side-effects. People with assets have got richer, people without have not."

The problem, of course, goes wider than this. The continuing failure to recover from the 2008 Financial Crisis is one of 3 major policy errors of recent years, along with the disaster of the Iraq War and its aftermath, and the seemingly uncontrolled growth in immigration. Collectively, these have undermined confidence in the Western political system.

In turn, this loss of confidence has led to the rise of the populists. The chart above, based on the insight of American psychologist Abraham Maslow, highlights why this has happened. Maslow's research showed that people are motivated by a range of needs:

- The most basic needs are for Safety and Security – if people are worried about possible dangers, or their ability to earn a living, they will become frightened and insecure
- Social standing and Status are also critical – people want to understand their place in society, and be recognised for their role within it
- Less tangible needs then develop, if these needs are being met – Self-actualisation, Self-development and Service
- These focus on realising one's own potential, developing new skills, and on helping others and serving society

Policymakers need to stop sheltering behind the fig-leaf of the central banks

This analysis makes it easy to see why the comfortable certainties of the SuperCycle are now history for an increasing number of people in the West.

The rise of terrorism, and the seeming inability of governments to respond successfully to domestic and international threats, worries ordinary people and makes them uncertain. Similarly, the rise of the "gig economy" has meant tens of millions of people are now dependent on temporary work and zero-hours contracts – often juggling several jobs in a day to earn enough to eat and pay the bills.

Equally important is that the seemingly inevitable "rise of the middle class" has ended. People are no longer confident that going to college will provide them with a steadily rising income, along with healthcare and the prospect of a comfortable retirement. Many Millennials have large tuition fee debts, and find it hard to believe that their generation will end up doing better than their parents. As Fortune magazine has reported:

"The vast majority of American workers expect to have less money at the end of their careers than their parents did—and that fear is highest among 20-something millennials"

This trend has been developing for some time, as a Forbes report in 2013 on a survey in Montreal and Vancouver confirms:

"Somebody with the same degree, the same job and the same demographic profile is earning less today than they were in the 1980s"

And yet, despite the growth of social media, policymakers are not even listening to these concerns, let alone responding to them, as the Wall Street Journal noted last year:

"The biggest thing leaders don't do now is listen. They no longer hear the voices of common people. Or they imitate what they think it is and it sounds backward and embarrassing. In this age we will see political leaders, and institutions, rock, shatter and fall due to that deafness."

Fortune, Forbes and the Wall Street Journal are not revolutionary media, keen to stir up unrest and incite social disorder. They are simply reporting facts. And yet, these facts have continued to be ignored – to the point where populists have a real chance of gaining power – if not this year, then perhaps next year or the year after.

As the Real Clear Politics poll confirms, nearly two-thirds of Americans feel their country is headed in the wrong direction, and their views are widely shared across the West.

It really is long past time for policymakers to stop sheltering behind the fig-leaf of the central banks, and the absurd idea that these can stimulate economic growth by creating more and more debt. The voters simply want straight-talking about the issues in the Hierarchy of Needs that concern them.

If today's leaders continue to refuse to listen to them, they will inevitably find populists who will.

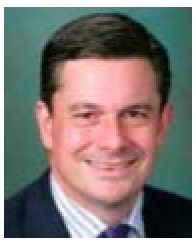
About IeC

IeC is a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.

Paul Hodges

Is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.
Paul is Chairman of International eChem (IeC) and non-executive Chairman of NiTech Solutions Ltd. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business. Paul is an appointed member of the World Economic Forum's Industrial Council, a Freeman of the City of London, a graduate of the University of York, and subsequently studied with the IMD business school.

Daniël de Blocq van Scheltinga



Was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO.
He has lived in Hong Kong for 16 years, and continues to spend much of his time in China, advising both international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University in the Netherlands, holding a Master of Law degree with a speciality of International law.

James Gruber

Is a 14-year veteran of financial markets, having covered them as a leading fund manager, stockbroking analyst and journalist. Most recently, he spent 20 months as the founder/publisher of the widely-followed investment newsletter, Asia Confidential, which focused on key macroeconomic issues facing the Asia Pacific region. Prior to this, he was a Portfolio Manager for Asian Equities at AMP Capital, managing Asian and China A-share funds totaling US$1bn, for two years.
The performance of the China A-share fund was ranked no. 1 globally over one and two years during his time there. For five years prior to this, James was a senior research analyst at leading Asian brokerage, CLSA, where he covered multiple sectors in Hong Kong, Australia, Malaysia and Indonesia. He began his working life as a news journalist at the Australian Broadcasting Corporation.