Sunday Wrap

Happy Sunday,

I wish you a happy New Year – and a happy new decade.

I'll use this first Sunday Wrap of the 2020s to discuss five key global "big theme" developments, which started brewing more seriously during the past decade, and which are now about to gain sufficient momentum to start shaping policymaking for the next decade, directly or indirectly, – thereby impacting relative growth and financial markets' performances more structurally.

To set the stage, let's first remind each other of the astonishing decade that has just past:

In economics, following the great recession, the western world has experienced a record-long period of economic expansion, although it came with a widening in income distribution (in the US massively so). Globally, we have enjoyed the greatest reduction in poverty the world has ever seen. Both were – predominantly - the result of globalization and a long period of incredibly accommodative monetary policies.

Meanwhile, but not unrelated, progress in science and technology has also been phenomenal during these past ten years. In medicine, this includes the discovery of an Ebola vaccine as well as huge progress towards preventing the spread of HIV. And, of course, the world has fundamentally changed when it comes to data manipulation and (free) communication across the world.

As a result of it all, the quality of human life – in general – has improved tremendously. Child mortality has continued to plummet across the world, while life expectancy globally has increased by a staggering six years within just these past ten years: From 66.6 years in 2009 to 72.6 years last year.

Yet, in parallel with these wonderful achievements, this past decade has seen a number of very troublesome developments across the world, which can only be seen as warning shots about the future:

The number of terrorist attacks increased significantly throughout Europe, the Middle East and Africa, as did the number of mass shootings in the US (which, for unknown reasons, are not called terrorism). In politics, Russia overwrote the most fundamental of post-WW-II rules of respecting national borders (as well as their own signature of the Budapest Memorandum on Security Assurances of 1994) when they snapped Crimea away from Ukraine in 2014. The year after, the refugee crisis fueled – exponentially - the rise of the far right throughout Europe, not least as political groups milked the tragedy with the help of social media. And as the world, particularly the Anglo-Saxon commentariat and media, got busy predicting the fall of Europe to nationalism, the true political disaster stroke "closer to home". In 2016 the UK voted to leave the EU after one of the most flawed processes in modern history, and the US elected Donald Trump as their next president on a dreadful nativism agenda – an outcome helped by an alarming combination of terrible income distribution, nasty identity politics, troublesome use of data and social media and a candidate uniquely capable of harvesting the resentment in parts of the population.

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So, on that note, these are the five key developments I see from the past decade which I believe will dominate policymaking – and thereby relative growth and investment opportunities – during the next 5-10 years:

- **Income distribution: Expect policies to boost the income of the less-well-offs at the expense of predominantly businesses and capital owners.**
- **Climate change: Expect that "talk" will finally turn into "action", with possibly massive ramifications for relative performance of asset classes.**
- **Gender equality: Expect legislation on quotas – and a more decisive role by the courts.**
- **Social media: Expect legislation to safeguard democracy – with a measurable impact on some of the big tech companies.**
- **The end of negative rates. Expect a return to a "new and sustainable normal" for the European financial sector.**

1. Income distribution: Expect policies to boost the income of the less-well-offs at the expense of predominantly capital owners.

I'm sure you are familiar with recent years' substantial skewering of US income distribution to levels not seen for almost 100 years. In addition to the standard measures, whether percentiles (showing particularly striking gains for the top-1% and generally poor developments for the rest) or Gini coefficients, this is also illustrated by the sharply lower share of national income going to labor, relative to what goes to capital.

In Europe, the skewering of the income distribution has been much more moderate than in the US. In particular, the European middle class has seen a broadly steady share of income (which is still disappointing, to be sure). However, in terms of the share of income going to labor vs. capital, Europe has hardly fared better than the US. In France and Germany, for example, the share of income going to labor has now reached the lowest level in some 50 years.

There are several reasons for these sharply – and troublesome - accelerating trends in income distribution, but globalization is surely the single most important one. While globalization (including free trade and investment) is a clear net positive for growth and income, it comes with winners and losers – and not all "losers" have been compensated fairly. In a nutshell, workers in China and other EM countries, as well as capital owners (and companies) across the world, have benefitted at the expense of the least-skilled workers in the tradable sectors in the OECD. Of course, EM countries did not share their newly won benefits from globalization with workers in the OECD area (apart from providing them with affordable mobile phones and other good gear), but neither have the capital owners and firms in the OECD shared to any significant degree their windfall from globalization with the labor force in their own countries. Indeed, the effective tax rate for the top-20% in the OECD has declined significantly in recent years (while remaining broadly stable for the rest of the population), while many multinational companies have allocated the vast majority of their earnings to tax havens.

I predict – with good certainty – that taxation in the OECD will change towards higher taxation of the top-10% earners (including via higher taxes on real estate) and a clampdown on companies' use of tax heavens. We'll also see the very recent roll-back of globalization continue (to help reduce the negative effects on OECD workers at the expense of overall benefits). Needless to say, the more we get of the former, the less we'll need to fear the latter. The relative winners of this will be lower income groups in Europe (and the US), and the producers and distributors of the goods and services this group of the population consume. The relative losers will be multinational companies with large chunks of taxes allocated to tax havens.

2. Climate change: Expect that "talk" will now turn into "action" with possibly massive ramifications for relative performance of asset classes.

I expect the 2020s to be the decade when "talk about climate change" progresses to "action against climate change". The evidence of potentially devastating man-made climate change has long been clear to the scientific world, but the examples visible to the general population are now coming with a frequency that surely will drive the political agenda during this new decade.

Either the existing parties will adopt the necessary policies, or new political forces will emerge as the population - particularly the young – demands action. (Yes, I'm aware that Trump is still in denial, but I find it inconceivable that the next US president will not accept reality. So, hopefully, it's just a matter of another year, at worst another five years for the US to see the light.)

My guess is that it'll start with some serious carbon taxation broadly along the lines discussed in the latest IMF Fiscal Monitor (here, in case you need a refresher: Fiscal Monitor: How to Mitigate Climate Change).

However, since this is a global issue (or at least not a purely national issue), concerns about level playing fields for businesses will work as a brake on the necessary changes. For example, how can existing tariffs and other trade rules between Europe and the US continue to be okay if Europe imposes costly (for individual businesses) "climate protection" legislation for its industries, while the US does nothing, or even moves in the opposite direction (to the long-term detriment of the world)? This means two things: Climate change considerations will become more important in trade negotiations – and a slower-than-desirable move to appropriate policies.

As a result of the slow-motion of necessary policy changes, I predict three types of "compensating pseudo legislation" in this area, which will impact growth and investment just as much as real legislation:

First, public pressure will increasingly change investment behavior. Most investment funds already have frameworks in place to evaluate their investment in terms of climate change objectives and/or public perception. Recently, Greta Thunberg and 20 other young people have launched a campaign demanding that investment funds dump their investments in fossil fuel companies.

Second, the courts will step in to a larger degree. We saw this already late last year in the Netherlands when the constitutional court ruled that – on humanitarian grounds – the government must reduce greenhouse gas emission by 25% (relative to 1990 levels), and not only by the EU's pledge of 20%, as argued by the government.

Third, as long advocated by Mark Carney and now also hinted at by Christine Lagarde for the ECB, central banks will increasingly design policies to help curb climate change. If you want a flavor of how this may pan out, I recommend Mark Carney's excellent speech to the European Commission in March last year. It's here: A new horizon - speech by Mark Carney

This all means that relative demand for equities and securities will shift towards companies which are "on the right side of future climate change legislation" – and the scale for this will become increasingly quantifiable.

3. Gender equality: Expect legislation on quotas – and a more decisive role by the courts.

I'm sure you are familiar with the still appallingly low share of women in senior positions in politics, public administration, business, media and the arts – and about the many examples of stunning pay differences for what appears to be similar jobs as those held by men. Just this past Friday, a court in the UK ruled in favor of BBC news presenter Samira Ahmed, who had sued her employer for discriminatory pay relative to another BBC news presenter, Jeremy Vine, adding up to almost 700,000 pounds. (As an illustration of how far the BBC seems to have fallen, they had tried to justify the pay difference with an assertion that her male colleague presents the news with "a glint in the eye". I say no more…)

Helped by quotas (some legal, but most of them voluntary) the share of women in senior positions has increased in recent years. Certainly, it's no coincidence that two of the four top European jobs this past year went to women, that the new IMF head is – again – a woman, and that the chief economist jobs at the OECD, IMF, World Bank and EBRD are now all held by (highly qualified) women. That all said, according to the World Economic Forum, the progress in bringing about a more equal representation in top jobs across politics, public administration and businesses has stalled slightly during the past five years.

So here is my prediction: Whether overall progress has stalled or not, it remains too slow for comfort, so we'll see quotas aimed at greater gender equality being introduced across an increasing part of society – and we'll see court cases to an increasing extent address remaining pay inequalities.

A world with quotas for key appointments across society will naturally risk compromising the desired purely merits-based system, and if so, it will lead to a sup-optimal outcome. However, the counterfactual (to a quota system) is not a perfect merit-based system, unfortunately, but something close to the present one – and there is plenty of evidence that this present one is far from a just merit-based one. Consciously (or, more likely subconsciously), we men tend to vote for, appoint or hire "someone like us", unless we are forced to look deeper and think harder before we make such decisions. So, as with all other policy changes, there'll be winners and losers, but the sum of it all, will be a net positive.

More broadly, without a doubt, the more accurate our political decision-making bodies, our businesses and the world of arts represent the composition of society, the better it is for long term sustainability.

4. Social media: Expect legislation to safeguard democracy – with a measurable impact on the some of the big tech companies.

In my opinion, the explosion of unregulated social media – and the use of it by political groups and foreign powers to spread mis-information (or fake news, if you will) – is a key source of recent years' rise in identity politics, hate and disrespect among people, which, in turn, poses a real risk to western democracies. The examples are plentiful, ranging from Cambridge Analytica and its role in the last US presidential election, to the evidence of actual (and attempted) influence by Russian operators in the Brexit referendum, as well as in recent elections in France and Germany.

In defense of their operating models, Facebook's Marc Zuckerberg and others have argued that these platforms simply facilitate "free speech", but such a claim confuses "free speech" with "free delivery of speech". Anyone should be free to stand on a corner and say whatever he or she wants (remember Speakers' Corner in Hyde Park where such historical figures like Karl Marx and Lenin stood to spread their wisdom?) – but everyone must remain accountable to the law of the land. The same thing goes for the established media; imperfect as it is, someone is still accountable for what's being printed or broadcast. But not so on social media platforms – and their attempt at self-regulation has surely proven insufficient.

If you haven't seen it, I highly recommend actor and comedian Sacha Baron Cohen's speech on this topic in November last year to the Anti-Defamation League. The transcript is here: 'greatest propaganda machine in history'

My point is this: I cannot imagine that democratic leaders around the world will continue to accept the use of unaccountable social media by foreign powers and fringe groups to challenge the democratic process that has in the past legitimized their right to govern. I'm confident this holds for Europe and for the rest of the OECD, with the possible exception of the US where the descent into money-based politics might already have gone too far to properly address this issue. We shall see in the post-Trump world.

This – along with the increasing European attention to the handful of big (US) tech companies which channel their European earnings to one or two tax havens – means that past years' strong outperformance (in after-tax earnings and equity performance) of these few companies may well come to an end in coming years.

5. The end of negative rates. Expect policy changes to facilitate a move to a "new and sustainable normal" for the European the financial sector.

Finally, as I have discussed on several previous occasions, the lack of appropriate fiscal policies in recent years (and I refer here more to the composition of spending/investment and revenues, than deficits per se), led the world's central banks to introduce an amazing degree of monetary accommodation (made possible by globally low inflation). In Europe, where fiscal austerity remained longer than in most other OECD countries, and where political and practical complications were associated with QE, this led to experiments with negative interest rates.

However, in combination with a much-delayed restructuring of financial institutions, continued modest economic growth and a massive additional cost-burden of regulation and supervision, the entire European financial sector has been put under huge pressure for the past ten years.

In the simplest form, this is illustrated by the fact that banks have been the second worst performing sector for investors during the past ten years, and that they therefore now trade at barely more than half their book value.

So, asking the obvious question to policymakers and supervisors: As a sector, how do you remain sufficiently capitalized if you have under-performed other sectors (with whom you compete for capital) during the past ten years – unless you can persuade global asset allocators in major pension funds and other fund managers that things will change for the better? My very strong sense is that any such explanation of a better future will have to include more than cost-cutting. It has to include a constructive vision for the operating environment.

Put brutally simplistically, and with a bit of exaggeration for the purpose of illustration, as a result of past performance and the present outlook, European banks are being kept afloat by (non-market based) financing from the central bank. And when they are not, they are being rescued by their governments – from Northern Germany to Southern Italy – because, it seems, for political reasons banks are neither allowed to merge across borders to get big enough to properly fit the world we live in, nor allowed to go out of business. Meanwhile, the level of interest rates and the shape of the curve mean that many pension funds and life insurance companies are now "solvent" only because they are allowed to discount their (presently legally binding) future liabilities with an artificially high discount rates.

Without a doubt, this has to change – and it will. As I have argued before, the most desirable adjustment to the present deeply troublesome combination would be a gradual path back to a purely market-based system, including: (i) interest rates back to at least zero with clear attention by the ECB to the shape of the curve, and probably additional QE, (ii) compensating fiscal adjustment to avoid an overall policy tightening for the economy, (iii) a supervised quantified targeted reduction in banks' cost ratios (including for compensation), (iv) streamlining of the many different angles of bank regulation and supervision, and (v) a clear commitment to encourage cross-border bank mergers to achieve the necessary size for competitiveness and safety. Easier said than done? Yes, but let's get started, maybe with the ECB's policy review.

So, on that note, I wish you – again – a happy New Year. I look forward to hopefully many interesting conversations and discussions about this fascinating triangle of economics, policies and markets in the year (and years) ahead.

Best

Erik

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