Anti-Globalization

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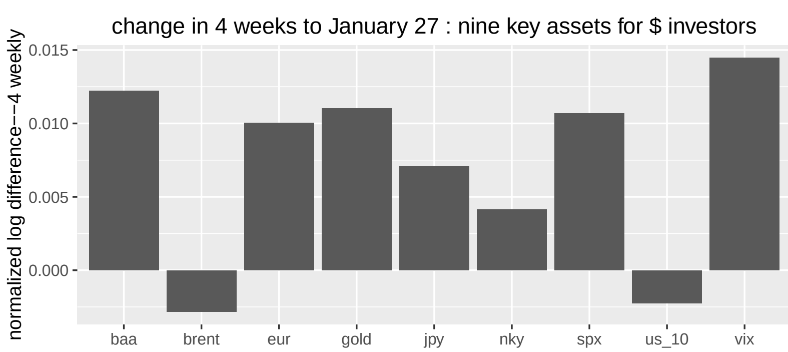
A stronger global cycle and the still-unknown impact of Trumpist fiscal policy together pushed risky assets up in value. Monthly gains were unusually uniform across all risk assets: stocks, credit, and foreign currencies as seen from the US.

In the last week these gains concentrated on stocks and credit, while gold tumbled as a now-superfluous store of safe value.

Lastly, oil prices stopped their rise, which had been mostly due to Saudi output cuts. Increasingly it seems that Saudi Arabia's financial vulnerability is forcing it make the main cuts in oil production.



European bonds sold off hard while US yields paused for breath. Early indications are stronger all over Europe, and particularly in the UK, hinting that Brexit, whatever form it takes, will not destabilize growth.

Striking has been the collapse in Turkish asset values. An aggressive democratic dictatorship may not be so good for asset values after all, particularly when businessmen start to be arrested.

Meanwhile, the general relief that growth seems solid and hopes for a Trump presidency lifted emerging market equities more than others. Mexico and India saw the biggest gains. Both had suffered recently, from US risk in Mexico and from demonetization risk in India.

A new tribalism. Globalization means open trading among the world's burgeoning 7.5 billion people, allowing each person to achieve the best he can. As a practical matter, that actually means allowing each corporation to do the best it can by competing fiercely in highly specialized markets. Survivors gain a potentially vast market for some precisely worked-out and world-class product that no smaller national market can support. Recognizing since Adam Smith that trade was the way toward real wealth, we have the potential today for powerful globalized growth taking advantage of humanity's great numbers and potential for specialization.

Is it painless? No. Any one successful business can flounder suddenly with changing technology or new competition. Ask the Finns, who once dominated global cell phone sales but suddenly lost that market. Intense global competition forces up the value of export industries, but at the cost of disruption and sudden shifts in fortune. Making it work requires recognition that there will be losers, but we have the resources to support and retrain the necessary, periodic, temporary losers in the process. Unfortunately this vital, social support, part of a coherent globalization program has been largely overlooked, to the profound political cost of globalization's credibility.

By comparison, anti-globalization is mainly a politician's claim that the limited nation state can deliver economic wellbeing with less risk by limiting the freedom of global markets. Certainly that is an attractive campaign argument, but is it actually credible? In fact, decades of experience with Latin American populists who dramatically declaim about how their "action steps" to stop imports will produce domestic growth say otherwise. In fact, some protected return for a handful of favored companies has always been bought at the expense of higher import costs for millions.

Ad-hoc protection creates rents, discourages investment, and accumulates damage over time. One dramatic "action step" after another is called for as the promised improvement in growth remains elusive. For a small country that will eventually lead to nearly complete closure to trade and a miserable outcome: consider Myanmar, Cuba, and Venezuela. Small markets without global trade collapse more deeply than you can imagine with this medicine. But it works anyway for the government that stays on, trumpeting one new step at a time.

Immigration control is much the same. The idea is to bolster welfare for those on today's voter roles at the expense of immigrants, rather than imports. But immigration control creates just as many perverse outcomes by limiting freedom. If our problem is an aging population, why would be not want young and able immigrants to come and work effectively in our system? But no, the essence of anti-globalism is to find a subset of the world and argue that it needs defenses against the great Other. What divides those protected from those not favored? Some original birthright, some tribal membership. Sad.

Trump the protectionist. Anti-globalism was the ideological backbone of Trump's campaign, and it turned up with force in Trump's inaugural address. *"Protection will lead to great prosperity and strength."*[1] We still do not know how deeply anti-globalist views are shared by the Republican establishment or the business leaders who populate Trump's cabinet. And Republicans may coax him into a needed tax reform, and an equally needed infrastructure program is possible, if ill-timed, but Trump and his ideological advisers are certainly going first for tariffs, walls, and immigration control.

This is a colossal retreat from what was a US focus on defending a global system, with economic gains for all. Now the idea is to prevent disruption at home rather than help others or even to seek excellence in our own leading global companies, most of which run vast global supply chains. We will protect manufacturing but ignore new technologies and possibilities. Worst of all, Trump seems to think correcting each individual bilateral trade balance is like achieving a business profit by individual

[1] Trump, D. (January 2017) *Inaugural Address* Washington: White House Website

business unit.

Trump comes into office with a gift from the Obama years of a surge in GDP growth. Consumption was strong in December, partly out of enthusiasm for the potential of the new administration. But investment, on which the second stage of this drawn-out recovery depends, has lagged so far. Partly this was due to the collapse in shale oil drilling, and in fuel-saving new aircraft deliveries. Some promise for a cyclical recovery in investment remains, fueled by potential enthusiasm for tax, infrastructure, and protectionist policies. But on balance, growth should level out at the pace of underlying demand less some inevitable cyclical deterioration in the trade account, or about 2%.

Reacting to potential tax and spending initiatives, Yellen gave a detailed outline of how she thinks about the pace of rate hikes and end point for this rate hike cycle. She gets 3% as the terminal overnight rate, but given the room for error in these rough calculations, one could easily get 4% instead. As she clearly said and is worth repeating: getting there slowly but surely will avoid the biggest shocks to today's extended asset prices.

Brexit at any cost. Its not only the US that is losing its way on globalization. In the UK, Theresa May has made immigration restriction her first priority in exiting Europe. For her immigration, a perceived threat to working class incomes, is the great complaint and source of "silent revolution" against the globalist status quo.

Her main concern might better be aimed at how dropping out of Europe will interfere with the UK's trading opportunities. As part of a customs union, UK goods are now free to trade anywhere within a vast economic area. Exactly as free global trade creates opportunities and wealth, so the nearly zero cost trade within Europe has supported a revived car industry and other UK business across a million invisible opportunities. May can yet discover that the loss of this perfect freedom of trade is a bigger set-back than she thinks and a bigger price to pay for national immigration control.

As in the US, longer-term risks from anti-globalization are not evident in the UK at the moment. Initial fears that the UK's heroic trade deficits, due to its long-permitted independent fiscal policy, would collapse with Brexit amid a sharp drop in sterling and in confidence have not materialized. UK and European growth remains on a solid footing in late 2016. New German capital goods orders to China, in particular, seem to have recovered with the rebound there from the trough in late 2015.

Meanwhile, at the ECB, Draghi is fighting a retreating action against tighter policy. He may hope that a prolonged weak euro and low rates will do enough to restart Italian growth and defuse a natural popular inclination to find out if exit from the Euro can be worse than endless stagnation and staggering youth unemployment. Not just Italy is at risk, The Netherlands will vote in March, France in April-May, and Germany in September. Each could bring another populist surprise adding to the anti-globalist experiment.

United States

ACTIVITY	CREDIT	POLITICS
Car sales hold up 2H inventory pop underway Underlying car sales, exports wobbly Construction is weak	Fed hike likely Dec14 Trump mentions infrastructure spending Investors jump back into equities, HY Funds were withdrawn ahead of election HY car loans and P2P credit problems	Trump made it to the White House?? Policy uncertain, but unconventional

Europe

ACTIVITY	CREDIT	POLITICS
Higher EU CPI with oil prices up Italian stagnation and deflation	BoE sees higher inflation ahead Monte dei Pasche debt-equity swap	Court needs Parliamentary vote on Brexit Dec 4 Italy referendum on its Senate May Presidential election in France

China

ACTIVITY	CREDIT	POLITICS
ISM-type indicators are all up Electricity use is up Car sales remain very strong Social Credit growth slows Home sales dip and prices stabilize Early retirements start in steel	Chinese company buying in DE, PT FinMin out who favored RE tax Debt-equity swaps involve third parties Ban on finance for RE developers Several new capital flow controls	China pushes its Free Trade Agreement

Can Xi picks up the pieces? China's Premier Xi spoke out for globalization at Davos, as you would expect. Of course China has been granted a vast opportunity to grow through globalization. Early growth depended on allowing foreign companies to set up low-cost assembly operations in China for export into world markets. A prohibition of moving assembly operations to China, or a blockade of exports from China back to the US would have been a massively unfriendly but feasible act ten to twenty years ago. But by now China has seen most of the the new global manufacturing investment for decades and is hardly dispensible to the rest of us. What is more, a long appreciation and big real wage gains at home have already begun to drive down China's trade surplus amid local complaints that business cannot compete globally.

Globalization involves trade across goods and assets. Any US attempt to block Chinese exports would find scarce alternative supplies here, and could easily see Chinese expropriation of extensive US direct investment assets in China. It could also cripple leading American companies, like Apple, with their vast supply chains accross the global system. This may not be fully understood, amid the Trumpist confusion of a trade deficit with a commercial loss as the guiding principle of international relations.

With or without a protectionist shock, China's economy is cooling off from an inventory-charged recovery. Car sales, which surged in 2016, should slow as sales taxes are reimposed. Housing construction could plateau as rules on leverage has been tightened up. Government rail construction is proceeding at a heated pace but can hardly accelerate, and can add little more to demand. And, lastly, exports have been decling steadily since 2014, and appear weak even into a recovering global economy.

Meanwhile, Chinese credit is one place in global markets where higher US interest rates could have a big dislocating effect. The PBOC's medium- term lending facility rate was moved up last week as sign of tightening credit terms, at least partly to quell a weakening yuan. Higher rates may hurt China, where a headlong rush into corporate bonds has created a vast pool or corporate debt to be repriced. Holders of these bonds are often wealth management products subject to losses, and forced sales as depositors seek alternatives. Globalization works in mysterious ways, when we allow it.

I skipped last months' monthly partly because of the profound unknowns of how Trump would impact markets. Initially investors focused on potential infrastructure spending and on Reagan-like tax cuts financed with deficits. These might mean more investment, growth, and profits. But to me, such measures were more useful five to eight years ago when the US recovery was in doubt, not now.

So the real question for investors is whether an unneeded fiscal expansion is coming. Or, and this seems more likely, we could get an ideological push into the tribalism of protection, immigration control and the search for enemies abroad and at home. We know for sure that protection is deeply corrosive of long-term productivity and growth because it limits choices. It is as simple as that. Protection, then, poses a completely new long-term risk to US growth that may not be apparent to equity investor at the moment.

Amid this completely new uncertainty we still have oversized global asset pools rotating between promising sectors. This is most obvious within China, but it is going on in global markets, too. Recently rotating flows have added unexpected force to an equity advance as money came out of bonds, where losses appear increasingly inevitable, into equities. The resulting Trump equity boom takes us to very high valuations given any prospective normalization of interest rates. It is a remarkable development and certainly worth shorting.