

A tale of two worlds

A global view from Michael Power, Strategist, Ninety-One

“It was the best of times, it was the worst of times”. So begins ‘A Tale of Two Cities’, Charles Dickens’ classic novel set against the backdrop of the French Revolution in 1789. Although written more than 150 years ago, these poetic opening lines may appear highly analogous to today’s economic situation and, like the French Revolution, I would argue that we are at an extraordinary point in history. Like most great turning points, it is obvious, yet no one saw it coming.

Using the next six couplets of Dickens’ opening words from the same book, I would like to walk you through the current predicament and explain how several already established trends have been accelerated by the pandemic. All of them point to an imminent changing of the guard as far as global economic leadership is concerned. The decline of the West has been hastened, whilst the rise of new powers in the East has been given fresh impetus.

Changing of the guard

“A very tough decade faces the West. Ever-increasing debt burdens will be viewed as the norm until it’s too late. The demographic vice is slowly but surely tightening. Against this backdrop, the focus of capital markets and currencies will swing decisively from West to East. China, and indeed Asia at large, will become much more influential in the world of capital.”



It was the age of wisdom, it was the age of foolishness

For me, one of the real big issues for the West at the moment is the poisoning of the monetary system that is currently taking place. Huge amounts of debt are being created, as consumer demand continues to be subsidised by democratic Western governments. We are told there is no alternative and are forced to live with negative real interest rates, which gradually erode the real value of people’s savings. In effect, the bond market has been poisoned, as has the price of risk. Savers find it hard to retire on a yield-based income, and we are starting to see the zombification of the industrial and service sector landscapes, as companies that would normally perish are sustained – not truly alive or dead – by borrowing at almost zero cost.

The logic that is given is that if everyone does it, then everyone can get away with it. But in this context, ‘everyone’ only refers to the West and largely excludes the countries of the East, who are generally not following the same set of policies. The result will be that the short-term wisdom of Modern Monetary Theory (MMT), where government deficits are financed by money printing, will be revealed as longer-term foolishness.

It may take five to ten years for this to happen, but I believe it is inevitable sooner or later. The way this will materialise is in currency markets, with the decline of the dollar and other Western currencies. We have already started to see the dollar fall – the Chinese renminbi was very strong in the second half of 2020. However, I think this will at some point spread into the euro, the pound, and the Japanese yen as well. The result will be imported inflation and, in turn, MMT will turn from being saviour to villain, and its positive effects will prove to be as illusory as a magic money tree.

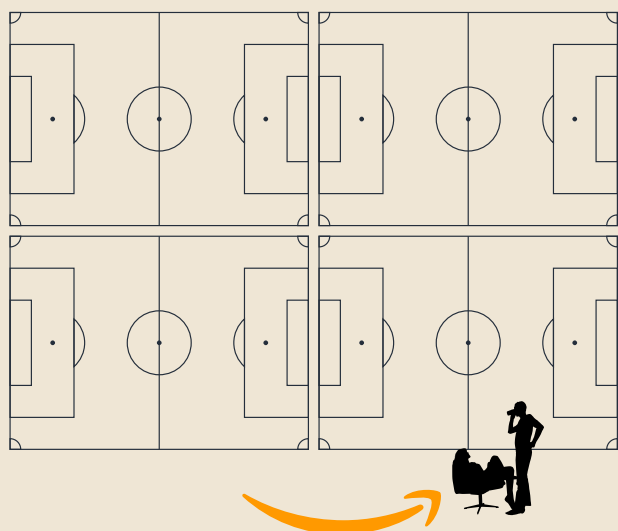
It was the epoch of belief, it was the epoch of incredulity

This has everything to do with technology and the breathless optimism that currently surrounds it. There is talk of technology bringing about a fourth industrial revolution and, alongside, digital technology, we have some extraordinary advances being made in medical research through the race for a COVID vaccine. But it is important to remember that technology breakthroughs can be destructive as well as creative.

Unemployment in traditional retail is rising as a result of disruption. For example, Amazon has a fulfilment centre in Ohio which is the size of four football fields. It is run by just two employees – the rest is done by robots. Automation and artificial intelligence are destroying huge numbers of blue, and even, white collar jobs. This is an environment in which populism may continue to fester, with disillusionment among those whose jobs have been displaced. Meanwhile, in a wider context, it is worth remembering that China leads the world in terms of spending on research and development.

Technology as a destructive force, as well as creative

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It was the season of light, it was the season of darkness

Climate change is forcing all sorts of changes on the way that we live. Necessity is the mother of invention. And what we are beginning to see now is that environmental degradation is forcing science to deal with the consequences. I have long believed that the true essence of the fourth industrial revolution is not digital – it is about renewable energy. Energy is the most fundamental thing on our planet. It is the essence of thermodynamics, which is basically the set of rules that governs us all, and we are now seeing an incredible transformation taking place in this space.

Green hope, which for a long time was the main force driving environmental ideas forward, has now been supercharged by green profitability. New solar and wind technologies are far cheaper to install than coal-fired or oil-fired power stations. These old sources of energy are being de-emphasised and whole industries are being transformed, with electric vehicles leading the way.

China's role in advancing renewable technologies is understated. China has revolutionised long-distance electricity distribution, which makes this green transformation possible. The demand for new energy commodities is likely to soar – indeed, perhaps this has already started.

It was the spring of hope, it was the winter of despair

Demographics are an underestimated force in the world of investment. Demographic changes are too slow burning to be factored into the everyday thinking of many investors, but they are now starting to weigh very heavily on the economic outlook of the West. Pension systems, both private and state, are increasingly underfunded. The emergency monetary conditions prompted by COVID have crushed interest rates, meaning the bond component of household savings is now largely devoid of income.

Meanwhile, healthcare budgets are being increasingly directed towards looking after the over 60s, and dependency ratios in the West are declining as the state must pick up the resultant financing burden. The contrast with economies enjoying better demographics could not be more stark, although the Japan-like problems still threaten China, Korea and Taiwan by 2030. Asia more broadly, however, is entering the savings phase, just as the West moves towards dissaving. The consequences for the financial markets of the East and West will be profound in the coming decade.

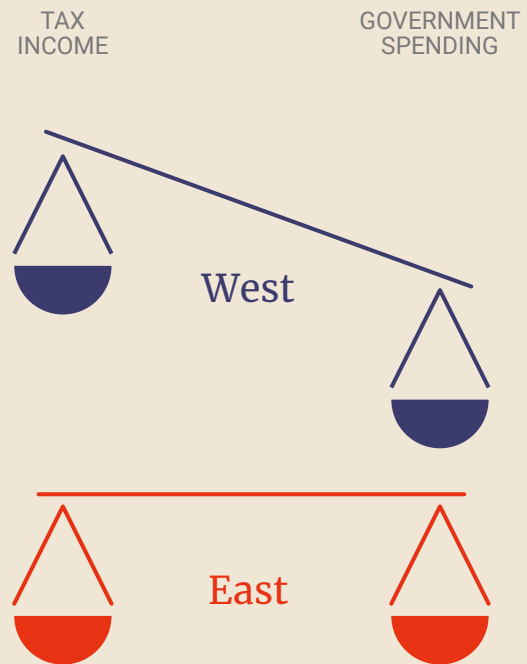
Don't underestimate demographics

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Money printing adds risk in the West

“Huge amounts of debt are being created, as consumer demand is subsidised by democratic Western governments. In effect, the bond market has been poisoned, as has the price of risk. This really only applies to the West and largely excludes the countries of the East, who are generally not following the same set of policies.”



We had everything before us, we had nothing before us

It is time for Asia to move to the centre of the economic stage. This process has been fast-forwarded by the pandemic, because East Asia has coped with COVID much better than the West. China will become the world's largest economy by the middle of the coming decade. It has just announced its new plan, China 2035, and one of its key ambitions is to double its GDP per capita. Another commitment relates to its R&D efforts, which are now being redoubled following the exclusion of Huawei from much of the West.

The rest of East Asia is quickly centring itself upon China. The new free trade zone, RCEP (The Regional Comprehensive Economic Partnership) is a good example. RCEP countries represent about 30% of global GDP but within ten years, that will likely have risen to 50%.

Asian consumption is driven by the rapid raise of the younger generations, at a time when the West struggles with its ageing demographics. The political systems of the West are grappling with the rights of the individual, versus those of the collective, which tend to be more respected in the East. Meanwhile, financial markets in the West are rewarding financial engineering much more than they are rewarding R&D spend. All this spells risk for the West, opportunity for the East.

We were all going direct to heaven, we were all going direct the other way

I believe we have reached a crossroads. I think that COVID has acted as a catalyst to all the themes mentioned above. Global investment decision making is at a turning point. Home bias, which the Americans are particularly guilty of, is increasingly a costly cop-out. The risks of a domestically focused strategy do not appear to match the potential rewards. Western investors generally must take a more globalised approach to their portfolios if they want to meet their various goals.

Broadly speaking, investors must embrace higher risk globally in pursuit of better returns, accessing Eastern growth driven by more favourable demographics. Avoiding China and its bloc will likely be an increasingly costly choice. You cannot really think about Asia without thinking about China as well.

A tale of two cities

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Longer-term investment conclusions

A very tough decade faces the West. The hangover from COVID is going to be difficult to shake off. In the West, under Modern Monetary Theory, ever-increasing debt burdens will be viewed as the norm until it is too late. Then the currency crises will hit, after which higher inflation is likely. Inequality exacerbated by technology is going to continue to trigger a backlash from those whose jobs and livelihoods have been displaced. The demographic vice is slowly but surely tightening.

Against this backdrop, the focus of capital markets and currencies will swing decisively from West to East. China, and indeed Asia at large, will become much more influential in the world of capital.

To close on an optimistic note, one further quote from A Tale of Two Cities is, "Nothing that we do is done in vain; I believe with all my soul that we shall see triumph". Wherever there is risk, there is opportunity. It is simply that the geographic source of that opportunity may be changing.

Ninety-One is a fund manager for St. James's Place.

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