TOMLINSON RESEARCH

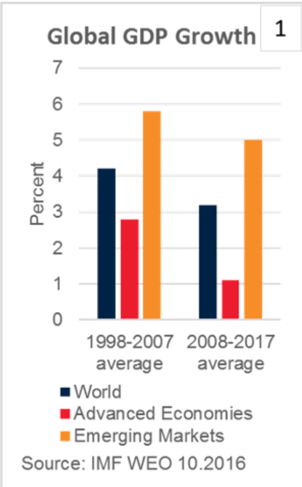
JANUARY 2017 COMMENTARY

A MERCANTILIST JOURNEY, BUT TO WHERE?

London offers tremendous theatre, from marquee West End shows to excellent fringe venues, including my favourite the Finborough. But even these pale in comparison to the political theatre of 2016.

"Brexit" and "Trump" both seem to offer a kind of 21st century mercantilism, seeking to gain national advantage, though not necessarily global benefit, by ripping up existing trade agreements and starting all over again.

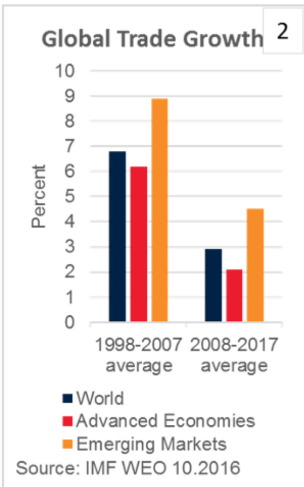
Global economic and trade growth has fallen off a cliff since the 2008 crisis (Charts 1 & 2). Advanced economies barely grew in 2016, up 1.6%, whilst emerging market growth is just 4.2%, according to the IMF.[1] A rotten economy has driven US and UK voters to political extremes.



In our view, investors should beware policies which are likely to become self-defeating.

EMINENT PERSONS

In George Bernard Shaw's play *The Apple Cart*, a popular monarch outdoes his prime minister by threatening to abdicate and run for office himself as an anti-democratic royalist. Cabinet blinks and the king wins the day. The play was banned in places as a "blasphemy against democracy". Shaw's narrative explores our "idolatry of eminent persons", set against the apparent inertia of bland policy makers.[2]



President Trump, a former reality TV star and real estate developer, has never before held high political office, but reached out directly to disgruntled voters and won. His widely followed Twitter account breaks all the rules.

Trump's purported tax cuts and infrastructure spending looked at in light of global stagnation are interesting initiatives. House Leader Paul Ryan's tax proposals may be indicative. His idea is to do away with the absurdity of US companies piling up foreign earnings in offshore banks while borrowing at home to pay dividends, thereby avoiding relatively high US corporate tax rates. But these changes are expressly intended to favour US exports and punish imports.[3]

Large tax cuts and a large infrastructure package this late in the business cycle, with unemployment already low, will likely boost the dollar and balloon America's current account deficit, but create an economic and investment boom. So far, so good. The trick is to combine this with Trump's protectionist rhetoric. The appointment of Reagan-era trade representative Robert Lighthizer suggests a far more aggressive approach.

US trade battles with Japan in the 1980s over cars are instructive. Initially, Japanese car makers agreed to "voluntary" restraints, eventually shifting significant production to the US. By the 1990s, the global sales of foreign affiliates, the result of foreign direct investment (FDI), vastly exceeded global trade volumes.[4] This notion of a global value chain (GVC) is exemplified by Apple's iPhone.[5] But it also highlights that economic anxiety stems as much from technology as globalisation.

A BRITISH CREATION

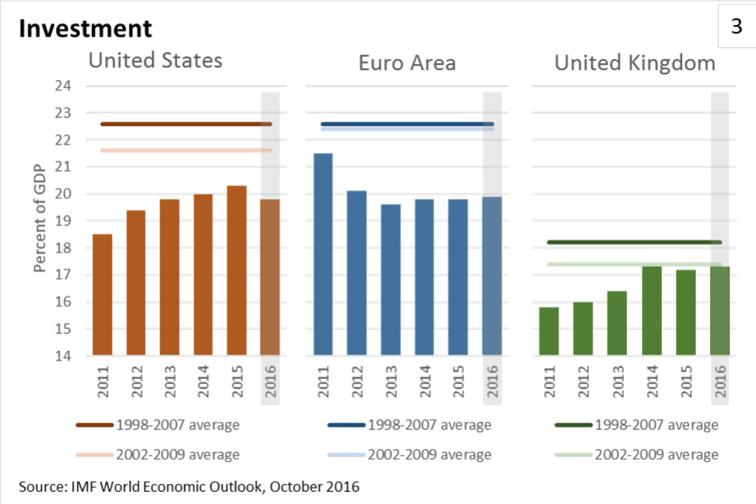
One of the key figures in the UK's Brexit campaign was former London mayor Boris Johnson (now Foreign Secretary), whose wit and persona provided good sound bites about supposed EU rules on tea bag recycling and the proper dimensions of a banana. The campaign ultimately turned on immigration, where the benefits of skilled EU workers were conflated with Europe's refugee crisis and presented as a threat.

The UK's departure from the EU, is a relatively bigger shift than anything contemplated so far in Washington. If the UK leaves the EU's single market, it will be replacing a deeply integrated trade and investment model with one focused primarily on trade, as the UK itself lacks a large domestic market as a basis for inward FDI. A recent World Bank paper found the UK's services trade more than doubled, on the back of physical trade, whilst backward and forward participation in GVCs rose over 30% each, because of EU membership.[6]

The EU's single market, where all 28 member countries trade tariff-free within a customs union, subject to one set of enforceable rules, is a British creation. Today, the EU is the world's largest economy and most integrated market. It's creator, Lord Arthur Cockfield, built his idea around mutual benefit rather than national advantage.[7]

A CERTAIN PITCH OF GREATNESS

Economist John Maynard Keynes' *Notes on Mercantilism* offers clues about where we may be headed. Ultimately, the adversarial nature of *mercantilism* reduces the "inducement to invest", as he terms it.[8] Adam Smith's *Conclusion of the Mercantile System* warns of the primacy of producers over consumers, also echoed by Keynes, as *mercantilists* struggle to generate trade surpluses.[9]



Consumption is the ultimate point of production, yet in absence of an integrated market, favouring producers is a temptation for cornered policymakers, particularly where high profile employers reach, in Smith's words, "a certain pitch of greatness".[10]

Table 1: Interest Rates	2015	2016
US Treasury 10 Year	2.3%	2.5%
US Investment Grade	2.8%	2.8%
US High Yield	8.8%	6.2%
US High Yield CCC or Below	18.2%	11.5%
European High Yield	5.4%	3.3%
Global Emerging Markets	9.0%	6.7%
Source: US Federal Reserve FRED, 31.12.2016		

Japanese car maker Nissan recently received undisclosed written assurances from the UK government in the wake of Brexit, thereby increasing its UK investment. But the UK is vulnerable as it attempts to win new markets in a slowing global trade environment, characterised by relatively few new trade deals and rising protectionism.[11] And corporatism, like currency manipulation, is zero-sum as it garners reciprocal responses.

Table 2: Global Equity Valuations	P/E Ratio	Dividend Yield
MSCI World Index	21.9x	2.5%
MSCI Europe Index	21.9x	3.4%
MSCI Emerging Markets Index	14.3x	2.6%
Source: MSCI.com, 31.12.2016		

These new uncertainties will hardly help UK investment performance (Chart 3), where the US and Euro Area both have large domestic markets supporting relatively high investment. It is not surprising that UK productivity lags both by around 30%.[12] Future employment and income depend on investment spending, which is trending below long term averages in all three. Globally, gross capital formation is at 50 year lows with minimal productivity growth since 2007.

AN EXPEDITION TO THE SOUTH POLE

Our investment conclusion is simply to beware these seismic shifts. Investors should look selectively in the US, Europe and emerging markets but perhaps be mindful that the world now appears less co-operative and more adversarial. At the same time, stock and bond market valuations are not particularly attractive (Tables 1 & 2).

Global trade and monetary policies are set to become highly divergent in 2017. A low growth world flirting with deflation has driven interest rates to generational lows. Policy rates in the US are below headline inflation and negative in the Eurozone and Japan. We expect rising US interest rates will prove to be a headwind for global stock and bond markets, given low growth expectations.

Ideally, alternative investment strategies replace market risks with idiosyncratic or investment specific ones. One of the key areas we are focused on is private equity and debt investments. These emphasise current cash flow derived from areas such as capital equipment leasing and trade finance. These are sectors where banks have withdrawn funding because of regulatory changes and higher capital requirements. There is less reliance on global growth but a greater need for thorough due diligence and risk measurement.

The world changed in 2016 and investors will have to contend with new uncertainties. Global trade has helped sustain growth for more than 50 years, based on specialisation and the global division of labour. The IMF counsel advanced countries to avoid fragmentation and act at the multilateral level. Trump and Brexit by definition are the opposite.

Keynes once described an entrepreneur's decision to invest as based on precise calculation, "only a little more than an expedition to the South Pole."[13] Trump's stimulus plans may well outweigh his protectionism and provide a big boost. Britain could end up maintaining essentially the same arrangement with the EU, minimising Brexit disruption. But we are betting that this *mercantilist* journey out of today's demand deficient, loose-money world is a bumpy one.

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1 http://www.imf.org/external/pubs/ft/weo/2016/02/ (p. 2)

2 George Bernard Shaw, *The Apple Cart* (Edinburgh: R&R Clarke Limited, 1930), 2.

3 http://www.economist.com/node/21711885/print

4 IMF, *World Economic Outlook*, 93.

5 https://www.adb.org/sites/default/files/publication/156306/adbi-wp451.pdf (p. 4)

6 http://documents.worldbank.org/curated/en/853811484835908129/pdf/WPS7947.pdf (p. 3)

7 http://blogs.ft.com/david-allen-green/2017/01/06/what-the-uk-could-learn-from-lord-cockfield/

8 John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan, 1936), 208.

9 Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations, vol. 2* (London: Oxford University Press, 1923), 277.

10 Ibid., 265.

11 IMF, World Economic Outlook, 80.

12 https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/internationalcomparisonsofproductivityfirstestimates

13 Keynes, *The General Theory*, 208.