Economic Update July 2017

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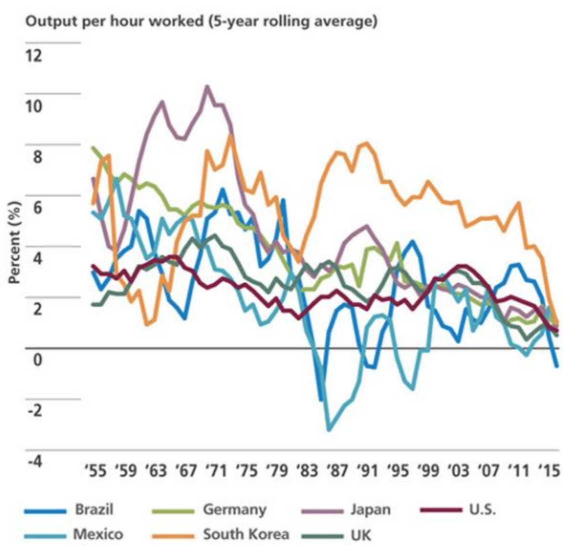
"If you have one economist on your team it's likely that you have one more than you'll need."

Warren Buffett

The Global Economy

Figure 1: Annual labor productivity growth – select developed and emerging countries



Source: The Conference Board Total Economy Database™, November 2016

The above chart shows how the amount of productivity or output per hour worked has declined across the board over several decades. The global economy has been slowing down.

The Economic Interim Review is (should be) a succinct update on the global economy, although of late, it has expanded to a similar size of the quarterly economic updates that offers a lengthy and more in-depth review of the global economy. As an interim economic update therefore, this one is succinct and may look brief.

Productivity is a critical factor for the global economy and indeed every economy on earth. Productivity has declined (as the chart above demonstrates), with the ongoing grip of deflation around global economic growth remaining tight. That is despite the trillions of dollars of quantitative easing and other macro-prudential tools currently at play, not to mention interest rates that in some parts of the world remain at all-time lows. Also, as we know, the world is in general, awash with debt.

Productivity is very important. Economists tell us that there are basically two main ways to grow an economy: (1) boost productivity, or (2) grow the labour force. As you probably know, developed economies increasingly appear to receive little help from favourable demographics in the future (a slightly different story for emerging economies).

Just in case you were in any doubt, the liquidity bubble is the result of struggling economies, whose growth has continued to slow down over the last 50 years or so. There are numerous theories around where things are at economically and how things might go in the future (that's economists for you!).

Some argue that deflationary pressures have hurt productivity growth and that the absence of real demand and investment, is to blame. Others argue that innovation today is less useful for productivity as much of the technology being developed is for lifestyle purposes rather than productivity gains in business. For example, the significant number of iPhone Apps that can be downloaded are not all about business or improvement.

Then, there is the current hot topic of technology and robots taking over our jobs, using clever, complicated algorithms that replace much of the need for humans to be involved in some tasks.

On the other hand, the cost of some of this technology is rapidly declining, which is partly why humans are being replaced. In other words, the hourly rate of a robot with clever algorithms will soon be similar to a manual employee. If we take today's pay rate, it is somewhere around $20-$40 per hour for many low-skilled jobs. In my opinion, this will just mean that humans will be able to be retrained in other areas, where they can add more value in a way that robots and algorithms cannot.

Recently, a notable economist commented that we can now project technology developments and innovation ahead for 50 and 100 years because the rate of innovation appears to be slowing down. To me, that sounds a bit like a comment from someone with global notoriety (the name escapes me at the moment) who commented maybe 70 - 80 years ago that all inventions known to man have been invented and that (back then) what was invented was all there would ever be. We all know how that's worked out.

I'm old enough to remember the discussion around population growth and the world running out of food. We have all seen so called 'peak population' come and go. There is plenty of food in the world for everyone; the problem is how food is distributed.

A couple of things we know for sure: (1) Making predictions can be difficult, especially about the future. (2) Science, calculations and highly intellectual rationales have a way of convincing us why something is so. Often it just isn't so. Take for example, the simple household budget. For those with tight cash flows at home, if they only ever used an Excel spreadsheet to add up their expenses and compare with their income, then all they have is some simple mathematics that tells them that there isn't enough money. It is only when they step back and get some perspective, they realise that the math around the budget is only a snapshot. What really matters is their spending patterns and that is all about their underlying habits and attitudes around money - their spending behavior.

Science and math can sometimes do no more than tell us why things cannot be done!

Whilst it is difficult to see a return to global economic growth above 4% per annum consistently, despite the multitudes of internet jockeys and "permabears" extolling, quite convincingly in many cases, why economic Armageddon is a certainty. I suggest that we do not hold our breath for that outcome – it is possible but unlikely.

Markets can be fickle, neurotic even, however humans are innovative and adaptable. Markets recover and move on.

Longer term, there is what some call the inevitable threat of the coming debt crisis, demographic changes and geopolitical tensions that will all conspire to strangle economic growth.

Why is it that people give their undivided attention to (fake?) news and clever sounding explanations wrapped up in mathematical calculations? Most of us know that the popular media is less about pure journalism these days and much more about 'creative, entertaining content'.

The Contingent Threats

The contingent threats are those events that may or may not eventuate but if they did, could cause significant upheaval across global markets.

Growing levels of debt would fit into this category, although they appear manageable at the moment.

There is also the shadow banking industry in China, which is large enough to at least temporarily destabilise the global economy in a significant way if interest rates rise too fast or another event caused loan defaults a that in turn lead to a contagion / flow on effect. In my view, the Chinese government *might(?)* step in and contain it. I say this because the Chinese government is currently vigorously managing economic slowdown in China.

Then, there is always the so-called 'weapons of mass destruction', which are derivatives. This is something that no one can control and if it does get out of control, things could get interesting. Nothing that you or I can do about it.

A missile exchange between North Korea and someone else – the real problem here in my view is that North Korea is a wealthy economy with lots of resources, even though the population generally appears poor. I imagine if they do not have nuclear technology already, it will only be a matter of time before they do.

We could add to this list with things like rising interest rates, the rise of the machines (the robots) and the changing shape of the workforce, if this were to happen too quickly and so the list can go on. In fact, I imagine that you could add a few items that you can think of too.

In my view, whilst these contingent threats exist, the world continues to revolve around the sun and the global economy continues to grow, albeit at a slower pace than we might prefer. Whilst it is possible that unforeseen innovation in technology could in the fullness of time boost economic productivity and growth, it is difficult to see that happening soon.

I believe we are in the so-called 'muddle through' economic environment and economic growth will likely be sub-4% globally for the foreseeable future (I am very happy to be wrong about that).

Anyway, the global economy and market conditions provide us with a ready reckoner for short-term pricing. As investors (I'm not an economist), let's keep an eye on our big picture goals, our strategy, review the action and the planning that we undertake and maintain the resolve to stay the course with quality, productive assets and not get distracted by the noise of economies and markets. That is because economies and markets naturally heave to and fro, move up and down and don't progress in a straight, even line.

To Summarise …

Economic productivity has been slowing down for over 50 years, which is less than ideal.

In the meantime, global economic growth still looks to be in the range of around 2.7% over the next 12 months, which isn't spectacular but okay for a global economy continuing to struggling with that deflationary grip.

What does this mean for investors? In short, expect returns to be lower as the market wrestles with the realisation that asset prices at some point are linked to economic growth. I hasten to add that the market is never that logical. However, when an unexpected event occurs and upsets the market, it is when prices are stretched like they are at the moment that asset prices can fall a long way. Providing we have invested in productive assets that are quality, a decline in asset prices is likely a signal to buy more…

"*Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. If it stops moving, subsidise it."*

Ronald Reagan