Neoliberal Globalization, Deflation, the Rise of Populism, and Investment Implications

By Michael Underhill

Galton’s problem, named after Sir Francis Galton, is the problem of drawing inferences from cross-cultural data, and it is due to the statistical phenomenon now called autocorrelation. Autocorrelation leads statisticians and scientists to infer that events may be independent when they may be related. The problem is recognized as a general one that applies to all nonexperimental studies—and to experimental design as well.

Nowhere is this problem more evident than the most recent British election, Brexit, and the U.S. election of President Donald Trump. At first glance, these events may seem independent, but they may actually not be independent; they may be indicative of larger forces at work in the global economy driving us toward an era of neonation- alism. This new trend has appeared with modern-society electorates’ rejection of neoliberal globalization, even though the structures and tools of globalization will continue to flourish in a changing environment.

In the Organisation for Economic Co-operation and Development (OECD) countries, neoliberalism established itself as an alternative to democracy, due to a withdrawal from politics (especially among younger people), and to a surge in far-right and anti-systemic political movements. These types of issues have been fueled in part by marginalization among more-vulnerable citizens (i.e., the poor, the working class, the disenfranchised) in society, owing to the decline of the traditional left.

Neoliberalism as economic politics was birthed in 1973 in Chile during the coup against a socialist dictator as a means to implement Milton Friedman’s political economics. The implementation of neoliberal policies and the acceptance of neoliberal economic theories in the 1970s are seen by some academics as the root of financialization, with the financial crisis of 2007–08 as one of the ultimate results. The antecedent to the neoliberal model can be traced to 18th- and 19th-century policy on free trade. This thinking fueled the race toward less cost-intensive commodity production, trade, commercialization, and commoditization of global assets (i.e., capitalization/liquidation by monetization). Since the 1970s, leaders worldwide have shaped policies so that global economic interests are emphasized over national economic interests. This emphasis has led corporations to position themselves beyond community and national levels, to compete on a global playing field where small and mid-sized players are driven out of the market due to lack of scale. This neoliberal globalism mentality has led to a global ecological, economic, monetary, social, and political slide toward total collapse. We are left with a hole in the ground next to a garbage dump filled with used commodities, and the subsequent deflationary trend of recent decades.

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Trend Reversal: Brexit and U.S. Elections

Nowhere has the trend away from neoliberal globalization been more evident than the 2016 Brexit vote and U.S. elections. These two events highlighted the issues of disenfranchised citizens: their desire to “take back” their countries’ economic policies, and their populist hopes of implementing more protectionist trade policies to address income inequality and upward mobility.

Political leaders have been forced to confront this rise in populism, because it affects the way leaders govern on both a regional and global level. Consider that Confucius regarded material inequality and political instability as interdependent:

The ruler is not concerned lest his people should be poor,
But only lest what they have should be ill-apportioned.
He is not concerned lest they should be few,
But only lest they should be discontented.
And indeed, if all is well-apportioned, there will be no poverty; if they are not divided against one another, there will be no lack of men, and if there is contentment there will be no upheavals.

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Pew Research Center conducted a post-mortem of the election of Donald Trump:

Overall, Trump won small towns and rural America easily on November 8, claiming 62% of the votes while Democratic candidate Hillary Clinton received 34%. By contrast, Trump won a more modest 50% to 45% victory in the suburbs while losing handily to Clinton in urban areas 59% to 35%.2

Pew also reported that income and equality trends across the United States over the past 10–20 years became more pronounced due to globalization:

The public sees threats to jobs coming from several directions: Eight in ten adults say increased outsourcing of jobs to other countries hurts American workers, and roughly the same share (77%) say having more foreign-made products sold in the U.S. has been harmful. Significant shares also cite increased use of contract or temporary workers (57%) and declines in union membership (49%) as trends that are hurting, rather than helping, workers. At the same time, global markets for U.S.-made products are seen as helpful for workers by 68% of adults.3

The desire to “make America great again” has led to this rise in populist sentiment and laid the foundation for policies that focus on U.S.-centric manufacturing and production. Populism for these voters means pivoting away from quantitative easing and financial engineering (i.e., leveraging up, corporate mergers and acquisitions, stock buybacks) and investing in the real people in the real economy with real assets. The United States has not seen such an opportunity for strategic reversal since Ronald Reagan’s administration. The opportunity can be realized, however, only if the incoming administration adheres to the principles that won it the election and avoids the compromises that the bureaucratic base of government will try to force on it to avoid disrupting the status quo. The OECD stated in its twice-yearly report on global economic prospects that “while the exact form it would take is uncertain,” it does expect Trump to offer some fiscal stimulus from the early months of his presidency, and that its likely scale would boost U.S. economic growth to 2.3 percent from 1.9 percent in 2017, and to 3 percent from 2.2 percent in 2018.4 A report from the World Economic Forum estimates that every dollar spent on a capital project in utilities, energy, transport, waste management, flood defense, or telecommunications generates an economic return between 5 percent and 25 percent—making the case for an additional $70 trillion to be spent on global infrastructure by 2030.5 Figure 1 shows how infrastructure spending evolves from meeting basic to more advanced human needs based on a region’s economic growth.

Investment Implications: Volatility, Uncertainty, Complexity, and Ambiguity. As economists and investors continue to dissect far-reaching policy implications of Brexit and the U.S. election, asset allocators are faced with a brave new world in which to recalibrate allocation models to incorporate volatility, uncertainty, complexity, and ambiguity.

Take a look at Trump’s policy proposals, which include fiscal stimulus, trade tariffs, restrictive immigration policies, and a hawkish tilt in Federal Reserve (Fed) policy.
Fiscal stimulus has positive global spillovers because stronger U.S. demand boosts imports of foreign goods and services. Dollar strength reinforces positive spillovers to OECD economies with floating exchange rates but limits gains in non-OECD economies. Spillovers to China, for example, depend on the extent to which the renminbi appreciates with the dollar; net effects are less positive for non-OECD economies that rely heavily on dollar-denominated debt.

The other components of Trump’s agenda—tariffs, immigration, and the Fed—have negative global spillovers because they prompt rising U.S. inflation and slower U.S. growth. The growth drag is generally muted for OECD economies with floating exchange rates but significantly negative for some non-OECD economies including China.

Trump’s policies might act as a modest drag on global growth. OECD growth may receive a brief boost from fiscal stimulus but then weaken, and spillovers into non-OECD economies would be negative throughout. Moreover, the risks appear asymmetric. A larger fiscal package could boost global growth moderately in the near term, but a more adverse policy mix likely would act as a significant drag on world growth in subsequent years.

Global equities were surprisingly resilient in the weeks after the U.S. election as many investors discounted Trump’s victory due to the president-elect’s personal behavior. Investors have viewed Trump’s surprise victory as a pragmatic shift to pro-business policies that will influence law given the support of both houses of Congress. This expectation should translate into a net positive for the U.S. economy and provide some challenging scenarios in various foreign countries over the next four years.

There also is an opportunity for monetary reform, compliments of the House Republicans’ economic reform legislation, as detailed in their 2016 policy paper and excerpted here:

“... our economy would be healthier if the Federal Reserve was more predictable in its conduct of monetary policy and more transparent about its decision-making. ...”

Legislation sponsored by Rep. Bill Huizenga and approved by the House—the Fed Oversight Reform and Modernization Act (the FORM Act) does the following:

• Protects the Fed’s independence to chart whatever monetary policy course it deems appropriate, but requires the Fed to give the American people a greater accounting of its actions.
• Requires the Fed to generate a monetary policy strategy of its own choosing in order to provide added transparency about the factors leading to its monetary policy decisions.
• Helps consumers and investors make better decisions in the present and form better expectations about the future. These improvements are important for Americans to enjoy greater economic opportunity. By pursuing this expansion through increased transparency instead of policy mandates, the FORM Act further insulates the Fed from political pressures.5

Some economists and practitioners also appear to support a “strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment.”7

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<th>Table 1: The Consequences of Populism—Policy Consequences by Country</th>
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<td>Country</td>
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<td>Rising inflation</td>
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<td>Expanding debt</td>
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<tr>
<td>Real exchange rate over-appreciation</td>
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<td>Low productivity</td>
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<td>Economic distortions</td>
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Data as of 2016 for Argentina, 2015–2016 for Brazil, and the present for Venezuela and Colombia.
Source: Capital Innovations Institute™

Globally, Americans are accused of impatience and ineptitude. We create new businesses and enterprises to address our needs, resisting the idea of “standing in line” and accepting the imposition of doctrines on our country. We call it democracy in its purest form and no other nation comes close. This narrative may seem expository, but our economy demands vigorous examination and, at times, restructuring to instill confidence among the people and reawaken their capitalist roots. Examination allows for debate and reflection needed to restore and solidify the economic basis of our country. Longer term, if Trump is successful in accomplishing his objectives, this election surprise will mark an important trend reversal in the United States: the rejection by U.S. workers, both Republicans and Democrats, of the country’s shift toward socialism (i.e., Clinton and Sanders). Undetected by the press, the citizens’ message was clear: Americans rejected the false promises of a welfare society, which has failed to deliver standard of living improvements.

For those investors who think populism may be the silver bullet solution, a cautionary tale arises from the devastating effects of populism on Argentina, Brazil, and Venezuela. In recent years, in those countries inflation has climbed significantly

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higher, economic systems have become malformed, and productivity has lagged. These negatives have altered the exchange rate and, combined with higher inflation, led to substantial appreciation of the real exchange rate (thus undermining competitiveness) and an increase in public debt (see table 1).

Neighboring Colombia, however, applied a more balanced, prudent approach, shunning populism in favor of short-term pain to position Colombia for a longer term sustained economic recovery, preserving macro and financial stability. Indeed, there are never risk-free solutions to economic growth and stability.

Because of these geopolitical issues and policy shocks worldwide, investors must focus on dynamic asset allocation, where the mix of assets is nimbly adjusted as markets rise and fall, as the economy strengthens and weakens. This dynamic strategy calls for investors to sell assets that are declining and purchase assets that are gaining; it is the polar opposite of a constant-weighting strategic asset allocation. This approach may help to defend against country shocks, currency shocks, inflation, and interest rate shocks.

**Allocations Need to Include Real Assets**

The results of the November election and a December interest rate hike by the U.S. central bank were among the top macroeconomic highlights of the final quarter of 2016. U.S. stocks rose to record highs, driven by optimism that the new administration’s pro-growth policy initiatives (i.e., corporate tax reform and financial deregulation) might become a reality. With the details and timing of any U.S. policy changes uncertain, the manner in which expansion will unfold will be noteworthy. One possibility would be a material acceleration in growth spearheaded by renewed business confidence (figure 2). Another would entail a continued expansion at the 2016 pace. The most probable scenario is a mix of these, with most combinations likely to create inflationary pressures and move the economy closer to the late cycle marked by a rising inflation/slow growth environment.

Fiscal stimulus likely will take longer to implement than other policies. It may take the form of higher infrastructure spending, increased defense spending, lower personal tax rates, etc. Generally, fiscal stimulus tends to favor more cyclical sectors, but this depends on the specifics within the fiscal stimulus program. Investors will need to closely monitor any developments throughout 2017.

Financial deregulation is most likely to be greeted by an increased willingness of banks to lend. If banks are more willing to lend, history has shown that this can lead to accelerated loan growth over the next 12 months. Improved loan growth may benefit the financials and consumer discretionary sectors the most.

Few things influence corporate earnings more than taxes. Historically, corporate tax reform has boosted corporate profits. The benefits typically start the year before reform: Profits and investment spending improve largely due to a corresponding increase in corporate confidence. Historically, lower corporate taxes have benefited energy, materials, and consumer discretionary and staples sectors the most.

Investment spending recovery is correlated with corporate profits, which have been in a recession—but profits are starting to recover now. Starting points matter, and any acceleration in profits could be substantial and durable. Historically, even average investment spending recoveries have resulted in pro-cyclical environments that favor financials, energy, materials, and, to a lesser extent, industrials and consumer discretionary (which are more diversified sectors). But the durable and standout leadership historically has been financials. From a factor standpoint, the market is likely to be sharply pro-value, which historically outperforms 70–80 percent of the time during investment spending recoveries.

Having exposure to a mix of sectors with low correlation to each other can help reduce risk, lower volatility, and increase diversification in an investment portfolio. These benefits can help a portfolio weather the stock market’s ups and downs and ensure its sector allocations do not move in lockstep when market conditions change (see figure 3).
In our view, real assets also should be aligned with a portfolio’s growth allocation, because these growth and income categories tend to respond positively to improving economic growth. Listed real assets, which span the continuum of Treasury inflation-protected securities, global listed infrastructure securities, commodities, global real estate securities, and natural resource equities, are capable of generating a wide range of returns, inflation protection, and potential diversification benefits. Each client must determine which objectives are most important and build the portfolio with this hierarchy in mind. Some objectives cannot be achieved simultaneously. For example, if one wanted to achieve short-term inflation protection while maximizing long-term return potential, one of these objectives would have to be sacrificed to achieve the other.

The real asset allocation of most investors is in the neighborhood of 5–10 percent. But 56 percent of the asset universe, allocations of upwards of 25 percent would not be unreasonable.

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Endnotes