Disconnected in a Connected World: Brexit and Beyond

In our March article “It is a Long Road to November” we discussed Brexit as a potentially underestimated source of tremors for the markets. Today as markets adjust to the impact of the British referendum, the regularity of small terrorist events and prepare for the next political event in the US, it is important to frame events such as Brexit. Is it a one-off case or does it fit into the growing theme of “Disconnection in a Connected World”?

Fear of “imitation fragmentation” in Europe might galvanize European leaders to come out of their summer blues and actually seize the opportunity to build a stronger, more pragmatic Europe, which would be a positive.

But the environment for continued slow global growth, unconventional monetary policies unintentionally shaping new consumer and investor attitudes, combined with a growing gap in many parts of the world between “traditional” political leaders and their constituents - at a time where global “connection” (as defined by internet users) has never been as high - is creating new socio-economic characteristics that will support more volatility. Interestingly, this will be combined with fragmentation or disconnection in the global geopolitical sphere as well.

“Disconnected in a Connected World”

Social “groundswell” in the connected world: not de-globalization

Over 46% of the world’s population is expected to be connected to the internet in 2016 versus less than 1% in 1995. In 2014, nearly 75% of all internet users in the world lived in the top 20 countries. Although the rate of growth of new internet users is decelerating (the first billion was reached in 2005, the second in 2010 and the third in 2014), the impact of what this relatively recently large
“connected world” has, beyond well known commercial applications, is possibly an underestimated force of social and political dimensions in a low growth world. In fact, can this connectedness feed disconnection with an unexpected speed and degree in an increasingly polarized world, possibly forcing some global and local adjustments to misalignments and disequilibrium?

A theme we have discussed for many years, that of “Fragmentation in the Global Village” is increasingly visible in the income distribution area. Updated income polarization trends apparent in the latest data from the IMF, have the potential to create new demographic categories such as those raised in Dean Lebaron’s note “Forecasting the next long wave”, resulting in a shift of marginal power between “nation-states” and “market states”, all combining to create an environment of disconnection that the markets are not fully prepared for. It is not a world of de-globalization or a reversal of the globalization trends witnessed in the past 30 years. It is rather about “pockets” of wealth destruction or localized economic “vacuums” around the world touching people, regions and governments in a context of acute awareness of disparities given the global information sharing culture. Not expecting a backlash would be complacent.

IMF “Rising income Polarization” June 28 2016, by Ali Alichi

**Geopolitical disconnection**

The failure of the traditional global geopolitical framework to frame productive discussions in major areas of the world such as the South China Sea, the Middle East and Russia show unwelcomed and concerning signs of disconnection as well. Anybody who has spent the time to listen to local Russian media will be aware of how strong the war rhetoric there has been in the past couple of years. With oil prices to remain relatively low, the current Russian economic hardship
combined with the “cost of the on-going wars” all add up to create a fragile domestic environment which in turn will continue to feed potential for unexpected volatility in the global arena, at a time of decreased “human” or diplomatic connection with the country. Similarly, the South China sea activity and China’s rejection of recent recommendations by The Hague, combined with Japan’s recurring signals indicating the desire to change its constitution with regards to the scope of its defence policy, all indicate more latent volatility. Difficult issues and topics such as the ones mentioned above involving jurisdiction battles around spheres of influence are further aggravated by the lack of individuals or organizations with true mediation power. Potential vulnerabilities of other nations such as Turkey in light of the recent coup, and the implication of volatility there for Europe are also sources of future disconnections. Finally, Europe, as discussed before, is itself a difficult phase with rising Euro-skeptics, weak growth, the on going migration crisis - and lately, Brexit.

Risks and Opportunities

Unconventional monetary policies with growing diverging efficacy on economies and financial markets are all flags that long-term investors need to be mindful of over the next 12 to 18 months to position their portfolios.

1) Financial risk: tail risk event growing?

As we have seen with the “unexpected” Brexit outcome, the combination of a “numbness” in the markets induced by current unconventional monetary policies, combined with a difficulty in assessing real risk and reward in this new framework, can create extremely violent reactions. Low economic growth creates fragility and little room for policy mistakes, while the massive monetary ammunition used to reach the current equilibrium seems possibly disproportionate to its induced outcome. Scarce investment alternatives might bring some investors to the markets which would have otherwise stayed out of the markets, possibly creating more disconnection between market valuations and economic fundamentals. Disappointments or surprises may in turn get magnified by instantaneous reactions in the “connected world”. One way to look at it is to think that the probability of tail risk events has risen.

2) Positioning: 3 broad themes

A fragmented Consumer:

The Brexit “flag” is fueling increasing prospects for an even slower normalization of rates in the US than it was before. From that standpoint US consumers, and from around the world, will for the most part get an extra boost, and companies in the sector might continue to benefit. Paying close attention on how disruptive increasing Gini Coefficients can be, and mapping out the “nouvelle donne” for spenders will continue to be key. Understanding dynamics at the sub-sector level will also be increasingly important given the multitude of themes shaping the consumer space, as ongoing shifts in income distribution continue to fragment
consumers spending power. This in turn will impact the appropriate distribution channels, cost structure and competitive positions for companies. With real income of about two-thirds of households in 25 developed countries flat or below their 2005 levels in 2014, the combination of the aftermath of the 2008 crisis, demographic shifts (ageing), cultural changes (millenials) are truly impacting spending power differently for various products. Getting more for less will be an important theme. The impact on companies that cannot adjust their cost model will continue to be devastating. Companies who can find ways to service lower income segments with the internet at the right costs will benefit. In the grocery area for example, scope is quite large with the bottom 30% of earners represent 20% of grocery spend in the US, 19% in the UK and 22% in Russia.

On the other end of the spectrum, “new luxury”, ranging from well being to health, experience and safety, will in our view continue to gain wallet share at the high end.

Security

The inadequacies of the current global geopolitical framework and the sudden bout of volatility it will create will continue to support security related companies both at the industrials or technology level. Digital “warfare” at all levels will continue to increase and pricing power for companies positioned in the right segment of the market will continue to benefit tremendously. A hybrid strategy of listed and unlisted security in this area might be more judicious.

Infrastructure

With global growth being revised downward and monetary policies probably close to their maximum potential “per-unit” of new action, the role of appropriate fiscal policies should increase over the next 12 to 18 months. Budgetary restraints will continue to be a major potential road block but some areas of spending could provide growth and investment in much needed areas. Global infrastructure spending of 2.5 to 3 trillion, for example, is falling short of the US$6 trillion needed to meet average demand to 2030. With climate change issues continuing to grow at a time when political commitment globally appears to be waning, the need for infrastructure spending to pare climate change infrastructure damages will grow, making the minimum infrastructure spending per-annum even larger. Again in this area a combination of hybrid strategies including direct and listed investments is most appropriate in our view.

Conclusion

The impact of the “Disconnection in a Connected World” theme will continue to grow, create more volatility in the markets and could possibly represent a turning point. Long-term cycle turns are always very tricky to spot in the short-term, but the convergence of technological momentum with socio, economic and political factors could point to meaningful shifts for companies and their employees, not the least from a competitive standpoint. This suggests a relatively cautious
approach to portfolios both from an overall risk assessment and from a sector positioning standpoint, including the possibility of challenging the traditional asset class view of portfolio construction.

Virginie Maisonneuve & Giles Money

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