MARKETS

Infrastructure Spending and Tax Reform Targeted

Confronting Regulatory Constraints

"The rumble was distant, but spoke with one voice that said Change, and those whose business was government could not help but hear." Barbara Tuchman — The Proud Tower, A Portrait of the World Before the War

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Not for the first time, the relatively small network of institutions and individuals empowered to set and manage economic and social policy in Western democracies are at risk of losing their permission to lead. Decades of relatively little progress for the middle class, exacerbated by a catastrophic financial system collapse, deep recession and weak recovery, has led to profound dissatisfaction with the elites who run the system that has been in place for 70 years.

Much has been written about the rise of Donald Trump and Bernie Sanders in the US and their strident attacks on the people and principles that have long underpinned the US and European approach to freer trade and more open borders. But the shocking decision by British (mainly English) voters to leave the European Union seemed an even more specific indictment of globalization and its credentialed advocates. Those same advocates -- the economists, politicians and corporate elites who scoffed at the idea of Brexit and sneered at those who might pull that lever -- only compounded the distrust and resentment.

“Those Whose Business is Government Cannot Help But Hear…”

Politicians and policymakers can ignore a cranky populace for quite a while before their hand is forced, but the rising rumble is now clearly being felt. David Cameron resigned as British Prime Minister after his grave miscalculation on Brexit. His senior partner in imposing discipline in the European Union, German Chancellor Angela Merkel, has been weakened by her decision to open Europe’s door to mass migration of refugees and faces a backlash from the right-wing Alternative for Germany Party (AfD). Francois Hollande in France is politquement mort and while the election of the National Front’s Marine Le Pen may seem unfathomable, her campaign to rip up EU treaties and cripple the single market may have a similar effect on the French election that Sanders and Trump have had in the US. That effect includes the about-face of Hilary Clinton, an architect of the Trans Pacific Partnership, as intense pressure from Sanders pushed her to declare her opposition to its passage in Congress.

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On the policy and regulatory side, the European Union president Jean Claude Juncker seeks to defuse popular anger by promising to spend billions on infrastructure improvement and tightening border security. In the US, as this piece is being written the Federal Reserve continues to resist the growing discontent of powerful bankers and investors crippled by abnormally low interest rates to stay on its uncharted course to stimulate inflation. And regardless of whether one can attribute to political sensitivity the growing belligerence of the Department of Justice toward mergers, if the policy continues under the new Administration, it will have a dramatic effect on corporate growth strategies.

Such mass disenfranchisement is typical in times of great economic stress; globalization and free migration of labor have always created winners and losers and the losers have always been vocal in protest, but those heretofore unyielding in their certainty of the benefits, the economists and policy experts who guide those in power, are now beginning to doubt themselves. New studies question the benefits of globalization and recognize that the unprecedented explosion of cheap labor in global markets, primarily from China in the past 30 years, upended theories of comparative advantage. In short, many economists now seem to acknowledge what middle class workers in the US have felt for years – other than cheaper imports, the benefits of free trade and movement of labor have accrued not to them.

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What does all this mean for CEOs of companies in the US and Europe as they survey a political and economic policy landscape that has been altered? What should they expect from the resurgence of populism and its determination to turn back the tide of globalization to protect domestic markets, jobs and companies?

And what risks do we actually face as we enter what might be very rough waters? Will the anti-establishment candidates in the US and Europe actually win or do so well that they create a crisis of confidence? How will the ruling class, the policymakers in the US and Europe, respond to such a clarion from voters?

A Slide into Global Recession?

In last year’s book, Teneo warned that we could find ourselves in a recession during the 2016-18 period. While we have so far managed to avoid an official recession in the US, there is no question that growth remains anemic; recent data on output and employment growth indicates the economy is slowing again despite optimism earlier in the year.

As the Federal Reserve deployed its entire arsenal to stimulate growth, financial asset prices since the Great Recession rose sharply, significantly outpacing both GDP and inflation. Essentially, the Fed has bet the ranch that the gap would close and GDP and inflation would catch up, allowing it to normalize interest rates and de-risk its balance sheet. The fact that that has not happened yet explains why the Fed has been stuck, unwilling to risk any further monetary stimulus and afraid to raise rates that would trigger a recession. The normally disciplined Fed communications process seems unhinged as Fed governors debate each other in public and any message discipline is lost.

The European Central Bank also seems to be staying pat in apparent recognition that its foray into negative rates was not worth the risk to the banking system. Only the Bank of Japan remains on the battlefield, with increasingly desperate maneuvers to maintain some degree of credibility and influence in the market. But there are clear signs that bond investors and bank lenders are starting to take matters into their own hands.

UBS and other market analysts believe that as systemic risk rises and political and economic policy uncertainty reaches an all-time high, credit spreads have begun to tighten and bank credit officers are pulling back. Long term interest rates in the US are now rising, which could mark an inflection point in the credit cycle that normally leads to declines in growth and employment.

That brings us back to the rising rumble of protest – the howls against austerity in Europe and the political shift in both US parties that might enable the first significant fiscal stimulus in eight years. In the US, Trump has opened the bidding with a (typically modest) plan to slash taxes and open the spending floodgates with a massive infrastructure plan aimed at growing GDP at 3.5 percent. Hillary Clinton is, for now, more cautious about fiscal stimulus, still using Sanders's talking points about free tuition and tax increases for the 1 percent. It seems obvious she will come around to the idea of spending, particularly as the mood toward stimulus in Congress appears to be shifting: US

House Speaker Paul Ryan has made it clear that infrastructure investment and tax reform will be in play after the election.

So it is possible that whether the US enters a recession or not, the long-awaited jolt of job-creating government spending could generate real GDP growth that should lead to strong relative performance for the US economy and revenue expansion for companies with a primarily domestic focus.

A Collapse of the EU and its Common Currency?

Britain's decision to leave the European Union has clearly exacerbated a crisis of confidence in the Eurozone and given the right-wings in individual countries a political opening to exploit. While Britain's planned exit is a dramatic event, the departure of one or more countries in the common currency would be another matter altogether. Anti-establishment fervor, directed against the European Union and all it represents, is rising across most of Europe. Driven from the right, by leaders in Hungary and Poland pushing for a "cultural revolution" against the hegemony of the European Union, as well as Austria, Sweden and Denmark; and from the center, in Italy, where the Five Star Movement wants to build on the momentum of electoral success in Rome and Turin with a referendum on leaving the Eurozone. As with most elections, it is not essential to win in order to rattle the established parties and force policy change.

Meanwhile, many Europhiles and the left are demanding an end to austerity and greater integration of the EU to restore the promise of the common market and currency. Their primary obstacle has been Germany, which regards itself as Europe's Chief Financial Officer after it staged its own recovery in the 90's from profligacy through self-imposed austerity and debt reduction. Merkel and her finance minister, Wolfgang Schauble, whose passion for the EU is directly correlated to his ability to control it, have stood strong against pressure to spend from less disciplined members France, Italy, Greece and other countries beset by staggering economies. But with Britain's departure, Germany's ability to enforce austerity in the EU might diminish its resolve to continue to shoulder so much of the burden of its governance and finances.

Clearly then, the Eurozone is headed for an even rougher patch as elections take place and their winners interpret the voters' message. If that message is unambiguous, a resulting threat to leave from Italy, France or one of the other members of the common currency will likely force an existential choice – integrate or separate. It is difficult to imagine a series of electoral outcomes where the heads of the main European states feel empowered to drive further integration of the governance and fiscal regime. At best, the "muddle along" strategy of the past several years will continue. But if the EU does start to come apart, it will oblige CEOs and equity investors in the US and Europe to factor in a chaotic period of adjustment as dissolution is negotiated and the weaker countries move to return to and devalue their currencies. It will also move the credit markets to sharply reprice the debt of those European countries that will abandon any pretense of fiscal discipline.

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A Pullback on Globalization?

While the politics of Europe and the US are complex with respect to government spending, antipathy toward the supposed twins of globalization, free trade and movement of labor is clear and growing. An almost certain casualty of the US and Europe turning inward would be the ongoing push in the US and Europe to liberalize trade. Even staunch advocates of globalization such as Stephen Roach and Larry Summers have begun to recognize its limitations and warn policymakers to revisit long-held beliefs.

Donald Trump has built a solid base of support among middle class white males, once a reliable part of the Democratic party base called "Joe Six-pack," who equate globalization with wage stagnation and a loss of job security. Such conviction is understandable, as Laura Tyson of the University of

California at Berkley asserts that the real income of 66% of the households in developed countries saw flat or negative income growth from 2005 to 2014.

Recognizing the threat, particularly the passage in the US of the Trans Pacific Partnership meant to position the US and other signatories to compete in a more balanced trade environment with China, President Obama appears to be pushing for a vote on the TPP after the election or before a new administration can take office. While a President Trump might try to prove his negotiating prowess by reopening the TPP, it is perhaps more likely he would pick other fights. And as president, Hillary Clinton would have to be extremely nimble in assuaging the left wing of her party if she backtracks on her campaign promise by working to pass the agreement in Congress.

CEOs of global companies need to consider the implications of a new world political order, where progress toward free trade and movement of labor is halted and access to growth markets is constrained. A reversal of globalization and an increase in protectionism would be nothing new of course. Since civilizations first started trading with each other, there have been cycles of progress and digression. Hostile governments and waves of nationalization of strategic assets have long been a fact of life for large, global energy and commodities players, but the recent long run of trade liberalization has benefitted companies of all sizes across a variety of industries. And it's not just foreign governments we need to fear, even in the US, we are quite capable of inflicting our own deep wounds; Roach reminds us that at the outset of the Great Depression, in part due to the passage in Congress of the Smoot Hawley Tariff Act, global trade collapsed by 60 percent in just three years.

Is Anti-Corporate Sentiment Entrenched?

The final, and possibly most enervating challenge to CEOs looking to expand revenues in a slow growth environment is what they perceive as an unremitting effort to restrain certain industries through complex regulation, a direct result of popular outrage after the financial collapse. In addition to the obvious effect on the financial services industry, where business models have been ruptured by Dodd Frank and the Volker Rule, companies in other industries are facing a Department of Justice increasingly determined to prevent large scale mergers.

Fortunately, capitalism is a self-adjusting system and entrepreneurs are beginning to find ways to create viable businesses in the market spaces where established players have been regulated out, offering merchant banking to companies along the energy and commodities value chain, for example. Along with business and credit, the size and shape of successful corporate entities seems to be cyclical as well, with aggregation often followed by divestiture, and if regulators remain antagonistic toward large scale combinations, CEOs will have to find other ways to create value while waiting for global demand to pick up. It will, of course. It always does.

What to Worry About in 2017

- Turn in the credit cycle triggers a global recession
- Hard correction in US equity markets opens door at more companies to short-term activists
- Rise of the right in Europe destabilizes policy and markets across Eurozone
- France threatens to exit the European Union, accelerating its collapse

What to Hope For in 2017

- An escalating EU crisis forces major reform of the fiscal regime and governance
- The US Congress and the new administration agree to major infrastructure stimulus package
- Successful US tax corporate reform leads to repatriation of overseas cash for domestic investment
- The US economy finally breaks out, with renewed corporate and consumer spending that lifts other economies