PERSPECTIVES

The Real Risk in Today's Global Markets

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While some observers might worry that the current global economic cycle is ending, Templeton Global Macro CIO Michael Hasenstab characterises the slowing growth we are experiencing as a cyclical slowdown, not the end of the cycle. He is more concerned with the political vulnerabilities he's seeing in the global economy today, and says the world's increasing fragmentation due to populist policies is a major concern.

A World of Extremes

I'm often asked what I see as the biggest risks within the global economy. Today I would say it's the extreme political landscape throughout many parts of the world. Rising frustrations due to factors such as immigration and income inequality have given rise to populism, both on the left and the right, which can lead to very dangerous and fiscally unsustainable economic policies. These populist policies promise a lot in the short term but can't be delivered upon in the long term, and can saddle governments with large amounts of debt.

We've seen these dynamics bubble up time and time again. In the United States, we have trade frictions with China and the inability of Congress to pass a budget. The discord going on in the United Kingdom around Brexit and how to handle it is another example. And then there is the rising popularity of anti-European Union, anti-establishment parties, whether it be in Germany or Italy or Belgium, and the rejection of President Emmanuel Macron's vision of an integrated Europe by the French.

My concern is that because the world is increasingly fragmented with many countries turning inward, it will be difficult to navigate a potential global shock. It's going to be increasingly hard to achieve the same kind of coordinated policy response between central banks around the world that enabled us to get through the Global Financial Crisis in 2008-2009.

Putting Slower Global Growth into Perspective

Global growth and the US economy appear to be in a cyclical slowdown, but we don't view it as the end of the cycle. China accelerated its production schedule in prior quarters to get ahead of potential tariff hikes that were originally targeted for January 1. Now it's curtailed that pace and reverted to a lower production volume—that effect feeds through to other countries. We don't think a recession is looming for the United States or the global economy. There is a slowdown in terms of some of the investment dynamics after a lot of stimulus, particularly in the United States. But the US economy is not massively overheated because we haven't seen the overinvestment or overcapacity develop that would need to be cleansed by a recession. Overall, we don't see the economic conditions for a massive recession, barring some major financial market event.

On the whole, we expect a transition from the synchronised global growth of recent years to US-led growth in 2019. The exceptionally tight labour market remains a defining part of the current US economy. The United States is beyond full employment, while at the same time both legal and illegal immigration have been restricted by the current administration. The natural effect would be that wages should trend higher, and that's exactly what we've been seeing. In turn, higher wages support consumption, which is the biggest driver of US economic activity. We expect strong labour markets, rising wages and robust consumption to continue to drive an expansion of the US economy in 2019.

China's Changing Role

China's role in the world is going through a sea change, in our view, with inward-looking US foreign policy helping to facilitate that change. Although China's growth is slowing, we believe it has the fiscal levers to prevent a deep economic slowdown, short of an exogenous financial shock. That being the case, a Chinese hard-landing scenario that everyone seems to fear probably isn't around the corner, in our assessment.

This changing environment is creating some new dynamics and economic vacuums for specific countries in Latin America, Africa, and Asia. China is now stepping in to fill the void and taking a bigger role in countries that have been shut off from the United States, particularly countries that the United States has been unwilling to extend financial support to. So, we think China's economic influence in the world is going to grow.

Opportunities in Emerging Markets

Given this complex global environment, we are focused on the fiscal, economic and social policies of individual countries, as that is what will ultimately drive economic activity, in our view. The big question is whether a country can reject short-sighted, populist politics in favour of a longer-term vision. For countries that can, we think there is great opportunity. Two examples are Argentina and Brazil, where the governments have been steadfast in pursuing responsible, orthodox policies despite ongoing political pressure and recent emerging market selloffs. We think that exposure to select emerging markets is an important diversifier in a portfolio because its performance is more dependent on the alpha of an individual country and less driven by broad market beta.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year.