MONTHLY BAROMETER
PRESCIENT & SUCCINCT ANALYSIS OF WHAT'S OUT THERE

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- On all fronts, **global economic growth remains soft**: facing headwinds in the US, tepid in the Eurozone, underwhelming in Japan and decelerating across emerging markets (with exceptions, such as India). For reasons expanded below, and barring a productivity miracle triggered by technological innovation, **GDP growth will disappoint in the coming years**.
- Despite all the hype about technology and innovation, **productivity is slowing down - or even falling - around the world** (with the exception of India and sub-Saharan Africa)**.** This is one of today's great economic paradoxes that predates the onset of the "Great Recession" and for which there is no satisfactory explanation; that said, weak investment does seem to be an important factor. Let's take the example of the US. Productivity fell by 2% in Q1 of this year (Y-o-Y), having risen by an anemic 0.4% per year since 2010, compared with a yearly 2.9% between 1995 and 2005. This is occurring against the backdrop of the 50 largest US companies hoarding more than $1tr of cash, despite real interest rates having hovered around zero for almost 5 years. Can this be attributed to a lack of opportunities? Or fears about the future? Whatever the reason, **this has set into motion a vicious circle that is holding back GDP growth and progressively turning into a self-fulfilling prophecy.**
- Productivity is the most important determinant of long-term growth and rising living standards, so the absence of it means that we'll have less of each. But how can we be sure? Some argue that we are much better off, even with stagnating or declining real incomes, because gains in consumers' welfare are substantial. However, their contribution to GDP growth is uncertain - Skype, Facebook or Twitter did not even exist a few years ago, and it's hard to tell the extent to which they render our lives "better". One thing is certain: **gains in consumer's welfare (if real…) do not raise incomes or increase tax revenues.**
- On the demand side, **there is another important factor holding back long-term GDP growth: rising inequalities**. A recent OECD report states that in developed countries, the economic growth of the past two decades has been of little or no benefit to 40% of the population. It also estimates that the rise in income inequality between 1985 and 2005 suppressed 4.7 percentage points of cumulative GDP growth between 1990 and 2010. The only "easy" measure that can significantly alleviate the problem is higher taxation on the rich. This is on the way.
- Our structural "bullishness" about Europe, often derided, is vindicated by the following recent data: **global FDI flows fell by 8% last year (Y-o-Y) but increased by a third in Europe** (to $305bn, half of which went to Britain, Germany and France). A global poll conducted by E&Y among CEOs concluded that Europe is the world's most attractive investment destination, followed by China and the US.
- The bond market just swapped euphoria for anxiety, with a "Bund mini-tantrum" and the yields of many sovereign bonds rising substantially in the course of the month. However, **the growing confidence that "lowflation" (or deflation) risks are receding may be misplaced**. Why? Two reasons stand out. (1) The financial markets disregard powerful, long-term deflationary trends that are, by nature, non quantifiable: globalization, technological innovation, rising inequalities, ageing, and so forth; (2) **the deflationary trend in Asia will endure because it is structural in nature, not temporary or cyclical**.
- Asia (excluding Japan) is the continent where the build up in debt has erupted the most – **the aggregate debt/GDP ratio having quadrupled over the past 10 years**. In a situation where domestic credit rises twice as fast as GDP, the combination of increasing leverage and decelerating growth will soon prove unsustainable, bringing credit expansion to a brutal end.
- Financial development is essential for a modern, buoyant economy, but there is a threshold beyond which its positive effect on economic growth begins to decline while its cost in terms of economic and financial volatility starts rising. This is the case today. A new "Financial development index" elaborated by the IMF shows that **the financial sector is too big for its own good and for the good of the economy at large**.
- This month, on a daily basis, there have been tragic reports of uncontrolled migration. In the Mediterranean Sea, hundreds of Arabs and Africans died while trying to reach Europe; in the Andaman Sea, Rohingyas were stranded having left Myanmar and Bangladesh and attempting to reach Malaysia or Thailand; while in Central America, impoverished families desperately try to send their children alone to the US. **There are now more than 50 million displaced people worldwide, more than at anytime since the end of WWII**. Long-term economic benefits of immigration are manifold for recipient countries, but as the world becomes more chaotic and disorderly, **there is no end or ready solution in sight for this trend that will exacerbate social and political tensions.**
- **In many countries and many industries, water is increasingly becoming an acute global and business risk**. According to the UN, demand for water will more than double by 2050, when 40% of the world's population will live in areas under severe water stress. Competition for water is starting to affect companies' balance sheets. Earlier this month, for example, Coca-Cola abandoned a $81m project to build a bottling facility in southern India after farmers protested that it would exhaust groundwater supplies. **The challenge of water scarcity is fast becoming very significant both** for researchers and investors.
- Ford Motor just invited 2,000 Londoners to subscribe to its GoDrive car sharing service - the first time an automotive company emulates the Zipcar model. The sharing economy is now forcing car and other forms of ownership to go the same way as software or music. **As far as expensive assets are concerned, the trend of renting rather than owning is unstoppable.**
- Apart from the many credit risks susceptible to cascade into market events, major "must-watch" issues for investors and decision-makers include: (1) Greece's negotiations about its upcoming default; (2) growth deceleration in China and its inevitable knock-on effect; (3) global deflationary pressures; (4) the "distress loop" in EM hard currency corporate bonds (in excess of $2tr) that will coincide with the Fed's first rate hike, probably in September; (5) global geo-political turmoil, with a focus on Yemen and Ukraine, and the terrorist risk posed by the 20,000 foreigners (from 100 countries) training in Iraq and Syria. **For real-time or in-depth analysis on any of these, and if you are interested in prediction markets to better forecast some of the risks, please contact us.**