Nationalism is power hunger tempered by self-deception. George Orwell

Nationalism has been brewing in many hotspots around the world for centuries – but now we are facing it in the three largest economies: the United States, parts of the European Union, and China. The US president is calling himself a nationalist, the leader of Italy's League is aiming to unite Europe's nationalist parties, and the Chinese president is preaching a nationalist revival. And there are other nationalists in Russia, in Britain, in the Philippines, in Egypt, in Venezuela, and many more. George Orwell wrote "Notes on Nationalism" back in 1945 in surprisingly realistic words, saying that nationalism creates a sense of superiority and ignorance of truth and often leads to self-deception and hunger for power at the expense of others. **What are the implications of rising nationalism for markets in 2019 and beyond?**

We are facing turning business cycles after an extended synchronized global expansion against a backdrop of excessive stimulus, high leverage, unsustainable levels of debt, and binding policy constraints. **Nationalism could trigger the next US recession; nationalism could undermine confidence in Italian debt dynamics; and nationalism could unravel titanic credit risks across China**. These are three storm clouds for 2019 that could lead to a synchronized global downturn with nowhere to hide, although it could become an opportunity to re-align asset allocations with three compelling long-term themes: carbon pricing will shape the next expansion with huge changes in mobility and transportation industries; automation will transform employment and concentrate wealth among innovators; and health expenditures will rise even faster with new technologies and aging populations facing scarce resources. Growth through innovation will favor capital markets at the expense of large banks.

STIMULUS DISRUPTION REACHING US ECONOMY

Modest growth, low inflation, and easy monetary policies have characterized the US economy since its rebound in 2009. Over the past two years, the US economy reached full potential as output gaps closed, unemployment touched historical low levels and pricing pressures picked up, while monetary policy has been slowly tightening. Fiscal policies have become highly expansionary with an ill-timed tax reform, while looser energy and regulatory policies have further boosted short-term output. Meanwhile, earnings revisions have turned mostly downwards, business confidence has become more fragile, while geopolitical and trade tensions have increased uncertainty and boosted commodity prices. The US dollar has strengthened, although twin fiscal and trade deficits remain substantial. Equity markets have reached new highs although earnings may have peaked and technicals have deteriorated. Credit markets have reached frothy levels while default rates have remained below historical averages.

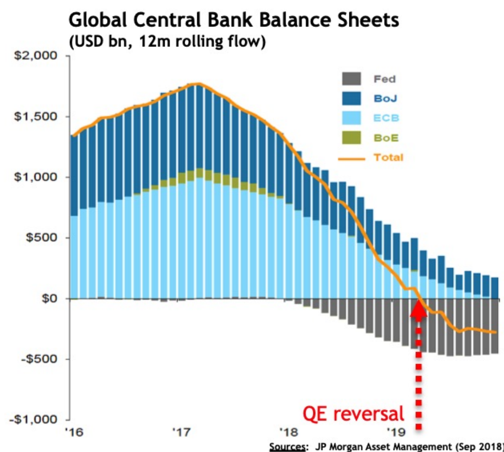
Synchronized late-cycle global growth is increasingly becoming disrupted, even in the best-case scenario where Europe and China are slowing down without major surprises from Italian convulsions or from trade conflicts. Recent US quarterly growth rates of 4% are expected to moderate to below 3% during 2019. The Federal Reserve is expected to add four interest rate increases just to reach the 'normal' 3% level. Fiscal stimulus is expected to be receding in 2019, unless a large infrastructure program is introduced, which is unclear in a polarized US congress. Trade frictions could easily reduce growth further and push inflation and interest rates higher. There is hardly any upside scenario to this basic slowdown projection for the US.

Recession Indicators Flashing Chart 1

Leading Indicators for US Recessions (latest level versus long-term average) — 6 out of 10 orange or red

Indicator	Level
Yield Curve Inverting	+0.25%
Leading Indicators	+0.5%
Unemployment Bottom	3.7%
HY Default Bottom	2.0%
Core PCE Growth	2.0%
Global QE Tightening	<0
Copper/Gold Price	-5%
Global Trade Friction BDI	-22%
Earnings Revisions	-1%
CAPE Valuations Top	31

Sources: Bloomberg and IMF (November 2018)



The US economic expansion is already in its 10th year and would become the longest ever US expansion in June 2019. By comparison, less than 5% of baseball games ever make it into an 11th inning. 2019 looks like a turning point with slowing growth, rising rates, and declining profit margins, with serious risks of disruption. Odds are above even that a US recession will start in 2019 or at the latest in 2020. **Six out of ten recession indicators are already flashing orange or red** (chart 1), valuations are very extended, and **global liquidity will be tightening** during 2019 (chart 2). However, predicting a recession is a no-no among economists and bankers, who are keen to share optimism and to protect their institutional interests. For example, in June 2008, the FED and the IMF predicted 1% to 2% ranges for US growth in 2008 and 2009, which turned out quite differently at -0.3% for 2008 and at -3% for 2009. Also in June 2008, when Goldman Sachs had already taken short positions on US mortgages, its chief strategist gave an optimistic end-2008 S&P500 target of 1380, only 35% off from reality that turned out to be 890. **Do not expect any candid forecast for recessions**.

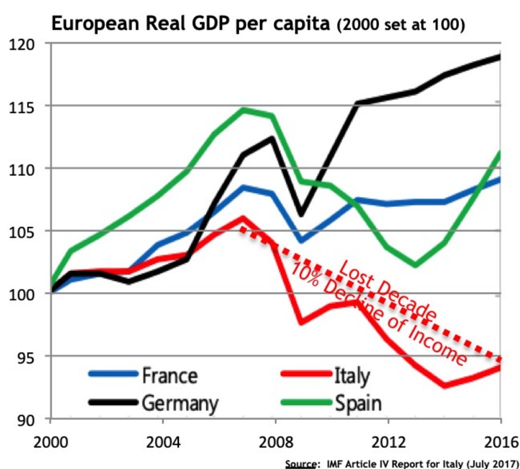
ITALIAN BANKS ARE WEAKEST CHAIN

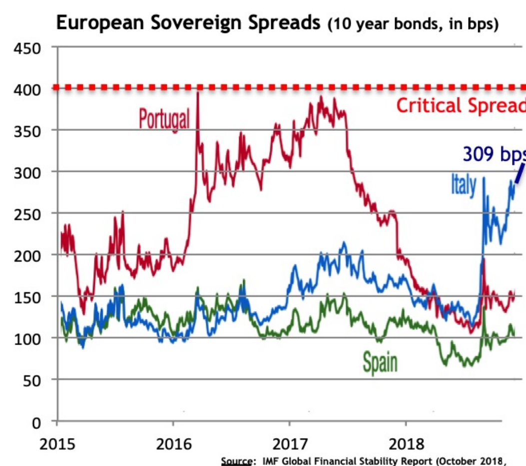
2019 could become a climax where French and German leaders are facing the ire of nationalists with European elections scheduled for May 2019. French President Macron stated that he stands as a patriot against the threat of nationalism, invoking former President De Gaulle who understood patriotism as love of your own people in contrast to nationalism where hate for other people comes first. Italian Deputy PM Salvini is leading the nationalist movement, including PMs from Hungary and Poland, and far-right parties in France (Front National), Germany (AFD), and Austria (Freedom Party). He has launched an anti-immigration manifesto and has blamed the EU for the "massacre" of Italian industries and vowed to disrespect EU budgetary rules. Italian growth has stalled in 2018, while EU growth has slowed to below 2%. Despite running a current account surplus and moderate fiscal deficits, Italian debt has grown to 130% of GDP while productivity, investment, and employment remain below EU averages.

Italy has become the problem economy of Europe – incomes are stagnant, divisions are rising, and governance is problematic. Italy has lost a decade with declining incomes (chart 3) and declining productivity. Italy is deeply divided, one third of its population is living in eight Southern provinces which account for only 22% of Italy's GDP and 10% of its investment and its exports. Southern Italian unemployment remains among the highest in Europe while some Northern Italian regions are among

the wealthiest. Italian banks are still among the weakest in the European chain, trying to resolve massive non-performing loans, while struggling to maintain their capital ratios and holding a large share of government bonds.

Italian Deputy PM Salvini has been elected as a hard Eurosceptic and nationalist who described the Euro as "crime against humanity". He has vowed to disrespect EU rules, to increase budget deficits, to reverse pension reforms, and to lower retirement ages to 62. He wants to introduce new Italian treasury bills (mini BoTs) to finance deficit spending, which could also become a parallel domestic currency, especially in the unofficial economy. European institutions are heavily objecting to such a parallel currency, as it might create additional liabilities for Euro partners (Target2 system). Italian spreads have risen to 309 basis points above German 10-year bonds (chart 4). If spreads widen further to about 400 basis points, banks are concerned that their capital could be wiped out by losses from their massive bond holdings, which may lead to some form of capital controls. **2019 could become a flashpoint for the Eurozone** with no good choices and plenty of downside risks from an Italian fuse.



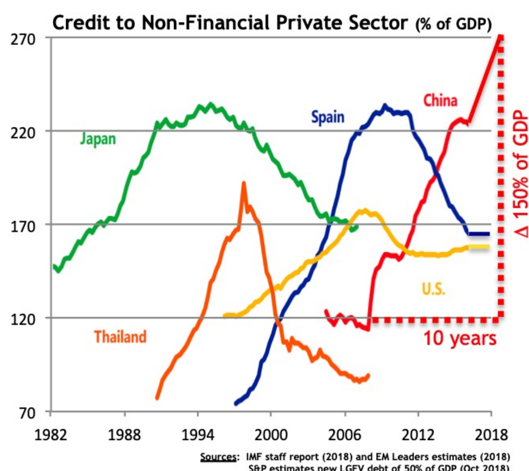


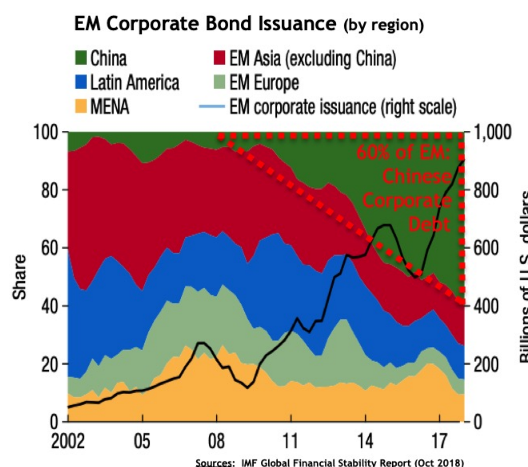
CREDIT MELTDOWN SLOWING CHINESE ECONOMY

Chinese growth was 9% during the Lehman crisis but its stock market lost 70% of its value by October 2008. Then a large stimulus program of RMB 4 trillion (12% of GDP) was initiated to support infrastructure growth and real estate development. Initially, state bank loans were directed into projects, which often became unprofitable. Then bad bank loans were transferred into local government financial vehicles (LGFV), which are quasi-corporate debts, guaranteed through local land collateral. These stimulus measures have massively grown over the past decade, with annual fiscal deficits that the government puts at 3% of GDP but the IMF puts at 11% of GDP, incl. LGFV expenditures. Eventually, most of the LGFV debt was converted into RMB 14 trillion government debt in 2014, and the government estimated that its level had stabilized. In October 2018, S&P and local analysts examined the actual growth of post-2014 LGFV debt and found "rampant growth" of RMB 40 trn, an annual buildup of debt exceeding 15% of GDP (chart 5). Total non-financial sector debt has grown from 210% to 370% of GDP over four years, representing mostly corporate and LGFV debt. **S&P states that China is now facing a "debt iceberg with titanic credit risks".**

Economists estimate that China’s sustainable growth rates have been around 5% and any stimulus measures pushing growth above 5% have accumulated into bad debts, meaning that over $3 trillion of bad debts could have been added over the past decade, mostly in LGFV and SOE corporate debt. Corporate debt issuance has grown from 10% to 60% of total EM issuance over the past decade (chart 6) and rollover problems are around the corner. So far, strong growth, new land sales, rising real estate prices, and creative accounting helped to roll over that bad debt. However, policymakers tightened new credit in 2018 while real estate developers scaled back land purchases, real estate prices started to slide, default rates picked up, and the stock market already had a 25% correction. Still, local governments are trying hard to achieve the 6.5% growth target for 2018 by further inflating the LGFV debt bubble but they critically depend on strong land sales for new collateral, which in turn forces real estate developers to further increase their leverage. This cycle may come to an end, even in a benign global environment, with or without any trade friction.

Investment banks have become unusually cautious in their assessments of China but don’t dare to predict a recession or an unwinding of the LGFV debt bubble. Rating agencies have become more frank, and they note the massive mispricing of high-yield debt in China. Evergrande Group is China’s second largest real estate group with debt exceeding ten times its earnings and six times its equity. Its chairman had to put up $1bn of his own money recently to refinance its debt with 13% coupons, but another $40bn of its debt is coming due next year. It has accumulated massive land and unoccupied investment properties, which are valued at 50 times its annual sales. Analysts are calling that a massive Ponzi scheme and that stock is most heavily shorted in Hong Kong markets. Many real estate professionals say “winter is coming” to a conglomerate that used to be rated AAA by local agencies, but barely single B by global agencies, which are warning that **the debt iceberg has started to melt as rates are rising, business cycles are turning, and real estate prices have turned south**. The Chinese debt iceberg today represents a major global financial risk, although it is hard to predict the exact timing of the next Lehman moment.





Triggers for a Chinese credit meltdown, or an Italian currency crisis, or a US recession could come from three sources: a traditional monetary tightening (most likely), a systemic default in a highly leveraged system (possibly from real estate), or a policy mistake such as trade conflicts or currency conflicts (nationalism in US and Europe), besides black-swan geopolitical risks (nationalism in China could create new tensions around Taiwan and the South China Sea). Markets are not expecting even one of these three storm clouds for 2019 and have long benefited from below-normal volatility.

CHINESE POLICY RESPONSE MAY BE UNORTHODOX

Investment decisions depend not only on market expectations and potential risks but also on the likely policy response to these three storm clouds. The **US policy** appears most predictable: political pressure on the FED is unlikely to succeed, with further tightening expected to continue until rates are being normalized. Trade conflicts are more likely to recede as soon as markets start sputtering. Fiscal policy will most likely be used aggressively to respond to a materializing recession, possibly through a major bipartisan infrastructure program. The **EU policy** response appears to be more protracted but equally predictable: compromising with nationalists is not promising, ECB help for Italian agitators is unlikely, dimensions for potential bailouts would be prohibitively large and hazardous, so that any conflict with Italy might soon lead to ItalExit and to a subsequent strengthening of the remaining Eurozone framework.

No developing country has ever advanced to a developed country without going through at least one major financial crisis. China might now also face that historical dilemma, and Chinese storm clouds today appear larger than combined storm clouds from the US and EU. There is no way to stop the Chinese debt iceberg from melting. A massive default is somewhere on the horizon. But policy makers could decide to inflate away that debt, and they may well do so for political reasons. Why would China prefer a decade of declining prices and incomes after defaults at most SOEs and real-estate companies despite bailouts of state banks and local governments? Would it be politically easier to inflate away their domestic debt through QE-infinity after using dollar reserves to cover foreign debts? Would it be morally desirable to change relative prices through carbon taxes that would help to address China's terrible environmental problems and that could be blamed for rising inflation? Would Chinese citizens be better off with protecting their real assets rather than their paper assets and corporate balance sheets? That policy decision will mark a critical juncture.

NEVER LET A GOOD CRISIS GO TO WASTE

Winston Churchill used this maxim after the Second World War to rebuild a globalist world with the United Nations and to strategically redesign political and economic structures. A crisis could cause the nationalist pendulum to swing back decisively in the US, in Europe, and in Asia where openness and interdependence are invaluable. Investors also want to be positioned to buy into the most promising long-term assets just as they did in 2008, when US banks and real estate continued to struggle, while US and EM equity markets came back strongly. The main future structural change could see "safe" assets migrate from fixed income paper assets into real assets but with environmentally sustainable pricing. Three sectors look most promising today: **low-carbon mobility, industrial automation, and health technology**.

Emerging markets could experience a re-rating and re-pricing in such an environment where its massive resources are more valuable but carbon liabilities are fully priced. Canada recently introduced a national carbon tax that is rising to $50 per ton of CO_2, reputable research institutes recommend a price of $100 per ton and 1,400 companies are already using internal carbon-pricing up to $200 per ton (IBRD, CPLC, Ecofys). Contingent carbon liabilities are highest in utilities, materials and energy, consumer sectors and industrials, especially in the transportation sector, which may see a big transformation. Low-carbon mobility is a growth industry where emerging mid-cap companies in the US, Europe and Asia could become industry leaders in self-driving cars, electric or hydrogen aircraft, and in energy storage. Many institutional investors already use low-carbon indices as benchmarks for their reduced-carbon portfolios.

Investors will have many opportunities to express their views in public equities: buying Russian gas exporters rather than Australian coal exporters; buying Chinese goods made with solar energy rather than Indian goods made with old energies, reducing food wastage especially in China and the US, and by buying small modern e-cars rather than gas-guzzling SUVs. Productivity improvements from R&D might become much more pronounced, especially in innovative industries where industrial robots are being utilized, and longer-term in artificial intelligence. China is on track to reap the largest benefits from technological innovation with fastest R&D growth. Many emerging markets also have rapid growth in healthcare expenditure, which only accounts for an average 3% of EM equity markets, as compared to 12% in the ACWI, and which typically rises quickly as per-capita incomes increase.

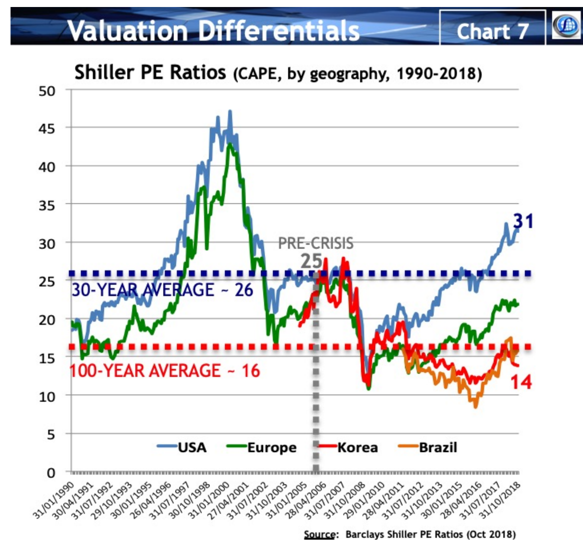
Investors differentiate not only between countries and themes, but also across and within sectors. The financial sector is the largest sector that has grown to 25% of EM equity markets, as compared to 18% in the ACWI, mostly due to the growth of large public banks across Asia (four Chinese state banks represent 4% of the index) that performed rather poorly as compared to private banks in Latin America and other emerging markets. Consumer and mortgage finance services showed the best performance over the past three years, whereas capital markets have lagged behind. Insurance and asset management are growing rapidly in emerging markets and remain significantly smaller than rising EM per-capita incomes would suggest, and these two areas are also among the most defensive in times of higher volatility.

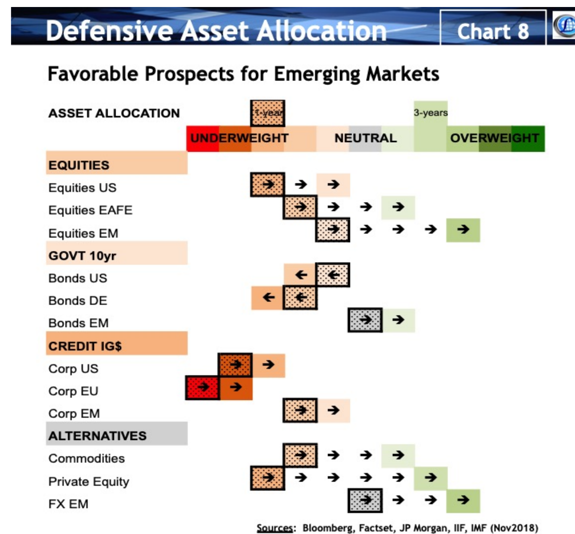
INVESTMENT PHILOSOPHY: LOCAL & GROWTH & QUALITY

Emerging markets are a dynamic growth story, rather than a story of stale state banks, or cheap gas stations, or clumsy old-style industrials. Local analysts across emerging markets are highly skilled to identify the best growth companies with strong quality. Information asymmetries can be substantial where these mid-cap growth stocks have no foreign research and where valuations are not measured with international norms. Quality can be substantially enhanced where local analysts measure and evaluate ESG progress and carbon exposure among their favorite stocks. EM Leaders has developed its proprietary sandbox based on these local insights before comparing locally favored stocks across countries and valuation metrics. Companies in our sandbox are typically one notch smaller, more domestic and growth oriented than those analyzed by global analysts in London or New York. This is our main source for extracting bottom-up alpha from active stock selection in less efficient markets.

Emerging markets are also more volatile than developed markets. Historically, weak macro conditions created the occasional crises across emerging markets, but their size and frequency have declined as macro policies have improved substantially. However, China may represent a contagion risk for global markets, given its size and its highly leveraged financial system. Moreover, volatility has been increased by the high correlation between emerging markets and their exchange rates, which often jointly and indiscriminately decline during financial crises. Hence, country selections and risk management become paramount for any emerging markets portfolio to limit the downside. Companies in our portfolio typically have lower beta and less downside, less leverage and lower valuations than found in the underlying indices.

How to position for 2019? The market consensus does not predict any major crisis nor recession for next year and has a late-cycle limited-growth baseline forecast for 2019 with 3% US growth, 2% EU growth, 5% EM growth, and 6% Chinese growth, and tightening monetary policy across the board bringing real interest rates above zero for developed markets and to about 4% for emerging markets. Interest rate dynamics point to a peak in USD while peak earnings may signal a top in most equity markets. The market consensus also views substantial downside risks with most analysts predicting that any potential crisis would have major market downside given the extended stimulus policies and the high current leverage. In a nutshell, **defensive positioning with higher quality would be wise** (chart 8), building short-term cash to invest afterwards into longer-term growth themes. EM currencies appear cheap whereas credit appears expensive. EM Asia and India appear overextended, Russia and Brazil appear more attractive. Technology is still a great long-term story for evolving mid-cap firms whereas FANG and BAT valuations may have peaked already.





Investors realize that Shiller PE ratios are diverging, above 30 in the US compared to below 15 across EM (chart 7). Historically, when CAPE ratios exceeded 25, then the probability of losses during the subsequent three-year period has been 65% (Robeco). Moreover, substantial risks from Europe and/or China could materialize next year, and nationalists could well pull the triggers through trade conflicts, parallel currencies, or highly inflationary policies. Nationalism is not only a threat to patriotism, it can also destabilize markets, but eventually the tide shall turn back to global collaboration.