Populism Clouds Europe's Future

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These are confusing times in both the United States and Europe. The forthcoming U.S. presidential election has two unpopular (according to the polls) candidates running against each other. One is viewed as untrustworthy and the other as dangerously extreme. In the U.K. the "Leave" vote was a shocker. Britain is the second largest economy in the Union, and its departure creates concern about whether others will follow. Because of that there may be an effort by EU leadership to achieve the separation quickly. Some worry that the EU will punish Britain for its decision, as a warning to other countries considering defection. I hope not. Article 50 of the Lisbon Treaty provides for a two-year period of negotiation of a withdrawal agreement. A work-out result involving continuing trade relationships with the continent, or even being part of a single market, would be ideal. At this point, Angela Merkel seems to be in favor of a gradual withdrawal. In any case, the "Leave" outcome is a setback for growth in Britain, in Europe and around the world at a time when economies are generally struggling. Not a good sign for markets for the rest of the year. While the vote was decisive, key "Remain" constituents did not turn out as expected. Younger voters were 75% in favor of "Remain" and they had a 36% turnout. Scotland, which favored "Remain," had a low turnout. The weather in and around London was bad favoring "Leave"; older, less educated rural voters held sway. The overall turnout was a heavy 72%. There is some buyer's remorse, but it is done.

The economic historian Walter Russell Mead, a professor at Bard, believes that Brexit and nationalism generally derive from a systemic crisis related to (a) the economic vulnerability of the Eurozone; (b) the Middle East refugee crisis and fear of terrorism; and finally © Russian aggression. In the United States, he sees skepticism toward trade agreements and a growing isolationism. Donald Trump's ascendency to the Republican nomination is also a reflection of those populist ideas. So is Bernie Sanders' younger-voter following, which emerged in response to growing inequality and a lack of opportunity. A major common thread in both Europe and the United States is the fear about immigration. On both sides of the Atlantic the average person is concerned about the loss of jobs to immigrants who will be satisfied with lower wages. In Europe there is the additional worry that if Turkey were to become a member of the Union and its people have easy entry into any member country, the flow of immigrants into prosperous nations like Britain would be considerable.

The ethnicity issue is central on both sides of the Atlantic. The Orlando shootings by an American-born Muslim did not temper the views held by the President and the likely political candidates. The Democrats argue that the few should not contaminate the many. As expected, Donald Trump believes the incident proves all Muslims should be excluded from entry into the United States. Trump recognizes that terrorism has made Americans generally afraid, and therefore is useful politically. Voters who are scared, on either side of the ocean, are likely to act emotionally, which is what made the outcome of the referendum uncertain. While economic issues argued strongly for Britain remaining in the European Union, fear of disruptive immigrants ultimately dominated the thinking of many people. When fear is the controlling factor, fundamentals on the other side of the issue play a smaller role. This will be a consideration in elections across the continent in the coming year.

During June I traveled to London, Amsterdam, Paris, Geneva and Zurich, meeting with investors and discussing the factors that were contributing to asset allocation uncertainty everywhere. I think it is fair to say that Europeans are baffled by the prospect of Donald Trump becoming President of the United States. They view him as threatening to the world order. While they know that American political leadership can veer off in troublesome directions, they believe that Trump represents a new precedent that they hope can be restrained by Congress if he is elected. The confusion that populism has created on both sides of the Atlantic has made asset allocation decisions difficult for European portfolio managers. I didn't find anyone who was enthusiastic about any asset class. Most were looking for a place to hide until the outlook clarified, but the feeling was that the investment landscape would not improve soon.

The greatest concern was about what would happen if the developed world slipped back into a recession for any reason. Everyone was aware that the current expansion began in the middle of 2009, making it one of the longest on record. If we got into an economic recession on either side of the ocean, what policy steps could be taken to hasten the recovery? Interest rates are already at record lows and further monetary accommodation might be less productive than previous efforts. Conservative governments in Europe and a Republican Congress in the United States are not likely to pass legislation providing major fiscal stimulus measures. Central banks dealt with the financial crisis of 2008-09 very effectively, but there is no guarantee that the next crisis will be handled with similar skill.

At present, Europeans seem resigned to a prolonged period of slow growth. They are puzzled by the negative interest rates in Germany and Japan but believe there is significant risk aversion among investors who are looking for a place to store their money until they develop more conviction about where they can find capital appreciation opportunities, and some are willing to pay the banks a storage fee to do it. They are also unsettled by the uncertain political outlook on the continent as they look ahead to the numerous elections scheduled over the next year. Angela Merkel has lost political capital at home and with other members of the European Union over the immigration issue, and she was the putative leader of the continent. Europeans have no idea of what to expect after the new leadership takes over in Washington. They would expect Clinton to follow Obama's policies but are unwilling to count on that.

Europeans are aware of the importance of monetary expansion in causing the equity markets to rise and keeping interest rates low. They wonder what will happen to the U.S. economy when the Fed starts shrinking its balance sheet back to more normal levels. It has $4.5 trillion in bonds on its books now; back in 2008 it had $1 trillion. In my discussions, I pointed out that a serious reduction of the Fed balance sheet was unlikely to happen soon, because the economy is vulnerable to any form of monetary tightening.

Everywhere I went, investors pleaded with me to suggest an asset class where they could get double-digit returns. When I told them that future nominal returns from public equities were more likely to be closer to 5% than 10%, they were disappointed but understood my reasoning. If world real growth were 2% and inflation were 2% and productivity were 1%, 5% is all you were going to get in earnings. We had a number of discussions about productivity. I suggested that we needed to see productivity of about 1% for profits to improve and the standard of living to rise. Currently we are running at about half that rate. Many believe that the measurement process does not pick up the contributions to productivity that have come from technology. One pointed out that in Europe the underground or "black" economy plays an important role, and its output data is not picked up in the productivity figures.

The general thinking in Europe is that growth is slow but okay. Youth unemployment is still high, but real GDP growth for the continent should still be 1% for 2016. The refugee crisis is under control for the moment and some jobs are being created. The problem may be in part a result of the European Union becoming too big, with too many countries and no strong central leadership. The bureaucracy is cumbersome and costly and the regulatory framework has become a burden. Consequently, companies are always looking for ways to cut costs and reducing the work force is a prime option. It used to be that if you went to work for a big company, you had a job for life. There was a social contract between a company and its employees. Now all that is gone. In this climate of uncertainty, many people are attracted to candidates with extreme positions, but so far the outsiders are not yet in control.

Europeans are very worried about political instability in the Middle East leading to a rise in the price of oil. Some believe that the recent rise carries a supply disruption premium. They say oil cannot be looked at as a simple supply/demand problem. Terrorism and regime change in key countries has to be taken into account. Some thought the enthusiasm about energy was unfounded. The price may stay lower than expected because of fracking and increased production from Iran. Many Swiss investors are buying gold again. They believe that the lack of attractive opportunities in other asset classes will drive more investors to become more defensive. They also feel that political problems in Europe and the United States will make gold attractive.

There wasn't much of an appetite for investing in China or the emerging markets. European investors recognize the appeal of countries with a growing middle class, but the short-term political problems and weak commodity prices have kept them on the sidelines. Several believed there were opportunities in Africa but were reluctant to make investments there. One pointed out that the German work force is shrinking faster than the Japanese. Since Germany is the prime mover in European growth, this is a serious concern for the future.

One investor said market volatility and a lack of discernible trends discouraged him. Another noted that the mobility advantage would always favor America. Europeans have a language problem that limits moving, and they have difficulty selling their houses. On the favorable side several said that Europe is ready for change and it will be driven by young people who are dissatisfied with the status quo. Throughout the continent's history, as Europeans grew older they accepted life as it came to them, but younger people today want more opportunity and they are pressing their leaders to provide it for them. It is uncertain whether they will be successful, but Europe is likely to be a more vibrant place economically as a result.

Greece continues to be a problem. Its loan obligations may be extended, but the prospect of the government ever paying the money back remains dim. There is too much corruption, people don't pay their taxes and the industrial base is small. The country will continue to be a drain on Europe and weaken the Union. Greece is no longer in the headlines, but the problems are still there. The question is whether the stronger countries like Germany will support the weak ones forever.

Governments play a much larger role in European economies, with state expenditures representing 50% or more of total GDP in many countries. What's more, Europe is very resistant to change and reforms are hard to implement. One investor said he thought there might be a movement in France to outlaw robotics in manufacturing plants. In any case, the French will use almost any excuse to strike. While I was there, there were widespread disruptions over work rule changes. As for China, European investors were concerned about accounting practices (among even the best-known companies), low-level corruption and market volatility. High-level corruption seems to be under control. While most expect growth to continue at a somewhat slower pace, some were concerned that a banking crisis caused by non-performing loans could create a hard landing.

Although the investors I talked with were worried about the immediate-term problems of asset allocation, some reflected on longer-term problems that were worrying them. Health care has improved and people are living longer and some are working longer, but fewer workers are going to have to support more retirees. This is likely to put a burden on government entitlement programs, causing taxes to be raised. Climate change may have an impact on food production and create shortages as the population grows. What will cause productivity to rise? With terrorism increasing, aren't we going to have to spend more money protecting ourselves? Will pollution in Asian cities limit the growth of that region? In an investment environment already afflicted by low returns, these longer-term problems may make asset allocation even more difficult. Almost all the investors I talked with felt their total return targets were too high, but they were having difficulty convincing their superiors to lower them to more realistic levels.

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