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Winter Is Coming: The Geopolitical Recession Begins Now

July 22, 2019 | by Drummond Brodeur

Executive summary

I expect to see a significant global economic slowdown in the next 12 months, with a high chance of a recession around this time next year. I'm not concerned whether we see back-to-back negative quarters; a recession is defined as a significant slowdown in aggregate demand, which is highly likely in the next year in my view. While I believe the direction is set, the pace and severity will remain very policy-dependent. The primary driver of the slowdown is what I am calling a "geopolitical recession" (term borrowed from Eurasia Group) that is creating a permanent state of endemic uncertainty and instability in the global political economy. It is a shift from four decades of increasing globalization to one of deglobalization and collapsing global governance. The escalation in the global tech and trade wars will drive a decoupling of global supply chains and significantly lower economic growth. I expect the negative impact on earnings to be significant, as decades of increasingly complex interconnectivity cannot be unwound without unintended consequences.

Monetary policy cannot undo the trend. It may cushion the impact but cannot reverse it. For a decade, monetary policy has been the solution to financial tightening-driven slumps, and hence all backward-looking correlation algorithms will buy the U.S. Federal Reserve (the "Fed"). They forget 2007 when the reason the Fed was cutting interest rates was because the economy was tipping over. The market bought that one, too. It did not end well.

This is not just about U.S.-China trade. China's economy was already slowing from deleveraging efforts aside from trade, and while we expect further policy easing will offset a drastic slowdown, the Chinese are not looking for a big reacceleration. Europe and Japan cannot drive global growth as they are merely warrants on global trends with limited ability to set an independent direction. Add in Brexit and Italian/populist movements and Europe is also a contributor to the geopolitical recession concept. It is not just the U.S., its president and China. It is the new global normal.

As rates everywhere go to zero, investors who require a positive real return will ultimately have to own more risk assets, and with rates in the 0–2% range, a price-to-earnings (P/E) range of 15–20+ makes sense. The reason for our cautious positioning today is that I expect to see a significant market correction as earnings estimates for 2020 get slashed. That would be a time to buy.

The takeaway from a geopolitical recession is that elevated political uncertainty will drive slower economic growth, lower earnings and elevated market volatility. Active allocation through the cycle with a strong understanding of potential policy outcomes will be required. The past decade has been all about monetary policy. Today you need to add fiscal, trade, technology and geopolitical policies into your repertoire.

The geopolitical events in May 2019 have caused me to become more structurally bearish on the global and U.S. economic outlooks than I have been in a decade. With markets drifting complacently at all-time highs, Signature Global Asset Management has shifted its fund positioning to a defensive stance, with lower equity exposures and higher bonds, cash and gold weights across the portfolios.

Winter is coming. My 2019 target for the S&P 500 Index was 3000. We are there. Fade the rally, watch the policy space, watch the hard data, watch earnings announcements. Buy risk assets when investors fear winter will never end, not when they see sunshine in Fed invincibility.

Read the full version of Mr. Brodeur's outlook for the third quarter of 2019.

Sources: Bloomberg L.P., World Bank and Signature Global Asset Management, as at July 8, 2019.

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