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WHAT I LEARNED THIS WEEK

Excerpt from July 12, 2018

1 A deeper meaning of a failed Brexit.

In section 4, we discuss why we believe Brexit is dead. If that is indeed true, the implications could extend way beyond the U.K. and the E.U., and **the bullish case for the euro and the pound.** It may be recalled that shortly after Brexit, Donald Trump won the presidency and the world was convinced we were headed for economic nationalism, fragmentation and the breakdown of the existing order.

In recent months, the success of populist parties in Italy have raised the suggestion that populism, defined as economic nationalism, is alive and well and that the election of Emmanuel Macron was the outlier. Perhaps it's the other way around. (Our definition of the current populist wave is closer to that of Obrador—cutting salaries at the top and increasing wages at the bottom.)

Perhaps the economic nationalism favored by Donald Trump is really the outlier. And the failure of Brexit for all the reasons we discussed shows that supply chains are too intricate and have been built up for too long to break. The same will likely hold true for Trump's trade war with China. As we show in section 2, the supply chains with China may simply be too deep and complex to rip up.

Also, as we have written many times, in an age of bullying by the superpower, **small nations understand it is wise to be part of a powerful trade group.** Otherwise, they have no leverage. To their dismay, the *leave* supporters of the Conservative party in the U.K. have discovered they hold few cards. Such painful examples are the most powerful lesson of all.

And what about the nations in Eastern Europe like Hungary and Poland that are pushing the boundaries of what is permitted under E.U. law? **How will they feel about their own security next to an energized and aggressive Russia if NATO's credibility is weakened?** Will they decide that closer cooperation with a strong E.U. is in their best interest—apart from the economic advantages—and mollify their excesses?

We can't help but notice how the rest of the world is powering forward supporting free trade and making free-trade agreements with each other, subjects we write about almost every week.

The E.U. and China are now preparing to build their economic ties without the U.S. Last week, at a joint news conference held for Chinese Premier Li Keqiang during his visit to Europe, German Chancellor Angela Merkel said that *Germany and China are both committed to multilateralism and a rules-based global trade order*.

She reportedly said: "We both want to sustain the system of World Trade Organization rules…but we also discussed market access--you could call it reciprocity". **BASF, the world's largest chemical company, which is Germany-based, signed a Memorandum of Understanding (MOU) to build a $10 billion highly-integrated (Verbund) facility in China's Guangdong Province.** *This project will be 100% owned by BASF and is set to become the company's largest investment ever.* Before, the Chinese government usually would ask for a 50:50 joint venture for huge projects at such scale. But it didn't do so this time, which is a message to the Trump Administration that non-U.S. multinationals may begin to receive competitive advantages in China.

The E.U. and Mexico agreed to update an existing trade agreement, signed almost 20 years ago, which will allow almost all goods to move between the two sides duty free.

The E.U.'s new trade agreement with Canada (CETA) went into force (provisionally) last autumn. A new trade agreement between the E.U. and Japan has been agreed to "in principle". Last month, the E.U. launched free-trade negotiations with Australia.

According to the *21st Century Business Herald*, **as of June 2018, China had signed 16 free trade agreements (FTAs) with 24 countries and regions,** including bilateral FTAs between China and Australia, South Korea, Switzerland, Iceland, Costa Rica, Peru, Singapore, New Zealand, Chile, Pakistan, Georgia, and Maldives.

China and its free trade partners represented 14.9% and 10.3% of the world economy, respectively, in 2016, with a combined share of 25.2% of the world's total GDP. **If other free trade areas that are being negotiated with China are also included, they would together account for 43.3% of the world's total GDP.**

But then there is the darker, riskier possibility. **In the next recession or global financial crisis or debt crisis, the world enters a *sauve qui peut* or "everyone-for-themselves" mentality.** One of our most thoughtful clients wrote to us on this subject, as follows:

> *The failure of Brexit is a painful reminder of how difficult it is to manage a complex economy that lacks the oxygen of growth.* ***One thing is to embrace populism, a different issue is to be able to deliver on its promise.***
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> *Little growth and too much debt have turned the global economy into a zero-sum game, and* ***any changes to its current order have significant unintended consequences.*** *Trump's bullying will probably buy the U.S. some time as weaker nations concede, but as we have witnessed, the real confrontation will be played among superpowers, and* ***at the end of the day a democratic system will find it hard to come up on top.*** *No wonder so many nations are veering off towards despotism.*
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> *There is simply too much debt around and a precarious balance: not only in the world of supply chains, but also in the flow of capital. The nation that attracts more capital will have more time to play their cards and potentially play the winning end.* ***It all boils down to the dollar, and a lot of Trump's projections of power are intended to keep the "exorbitant privilege" of the world currency.***
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> *Countries that promote free trade and cooperation are well aware that the current situation allows for very little shocks to the system, and that there is little room to experiment with big change, or "shaking the tree".*
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> ***We are playing with fire, and the risk of domino effects is extremely real.***
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> *What you present is the rational view, and it entails a defence of the status quo until the economy picks up again and debt can be reined in; but the status quo would be the end of Trump and as such,* ***we will continue to witness the collision of tectonic plates between the U.S. and the rest of the world.***

This is perhaps the most dangerous time in the markets since September 2008, because of the unpredictability and illogical behavior of politicians. Recall that Lehman was essentially "forced" into bankruptcy to prove a point about moral hazard, namely that the Bush administration would not bail everybody out. Of course, the unintended consequences were devastating, especially with regard to the uncertainty surrounding which firms the government would ultimately save and which would be allowed to fail, leading to a global trade-credit freeze as confidence in the financial system evaporated.

This very unpredictability was highlighted in a July 6th article in *The New York Times*. We quote as follows:

> *"**There is no apparent plan,"** said Daniel Price, a managing director of Rock Creek Global Advisors, an advisory firm, and a former trade official in the George W. Bush administration. **"The administration has given no indication what the off-ramp is or what their objectives are."***
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> *"Trump is treating trade policy as though it were a real estate deal, where the goal is to beat your opponent, step on his throat and humiliate him," said Daniel Ikenson, the director of trade policy studies at the Cato Institute.*
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> *Even if it works and nations like China blink, Mr. Ikenson said, **"the cost to that will be trust in the U.S.,** and it will encourage other governments to behave this way when their backs are against the wall."*

Last spring, we noted that China is now viewed in the U.S. as a strategic opponent and not a strategic partner. With Trump's attacks on Merkel this week, we can add Germany to the list. Who will be next?

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