

## The Absolute Return Letter



June 2019

# The Cost of Rising Populism

*“Patriotism is loving your country and fellow countrymen. Nationalism is hating your enemy more than you love your countrymen.”*

**Baroness Ros Altmann, Member of the House of Lords**

## Populism vis-à-vis misallocated capital

Ros Altmann is a long-standing friend of mine and an ardent supporter of a united Europe (like I am). I often think of Ros and the brave battle she is fighting in Westminster these days to keep Europe together.

Having said that, this month's Absolute Return Letter is not about Brexit but about populism, although there is a powerful link between the two – more on that below. I will look at the costs associated with rising populism and I will argue that one of the biggest costs is plenty of misallocated capital.

Don't get me wrong, though. Populism often leads to *a lot* more than rising amounts of misallocated capital, one of the worst being an increased risk of war but, after all, this is a financial newsletter. I am not going to speculate on whether the presence of Donald Trump, Nigel Farage or Boris Johnson (probably the next Prime Minister of the UK) could result in war. I will stick to the financial costs associated with rising populism.

*Misallocated capital* is a term I will bring up repeatedly in this month's letter, so let's define what it actually is. Economists use the term to describe capital that is deployed unproductively. One example: As society ages, more and more capital will be set aside to service the elderly, and that is, at least in economic terms, an unproductive use of capital, i.e. it is misallocated.

That is only the short answer, though. Here is the slightly longer, and more correct, one. Assume you make a portfolio investment or purchase a business or other asset, and that the return on that portfolio investment or business is below your cost of capital. If that is the case, the capital you deployed in the first place is said to have been misallocated. In order to adjust for the cyclical ups and downs, the capital was only misallocated if the return is below the cost of capital when assessed over a full economic cycle.

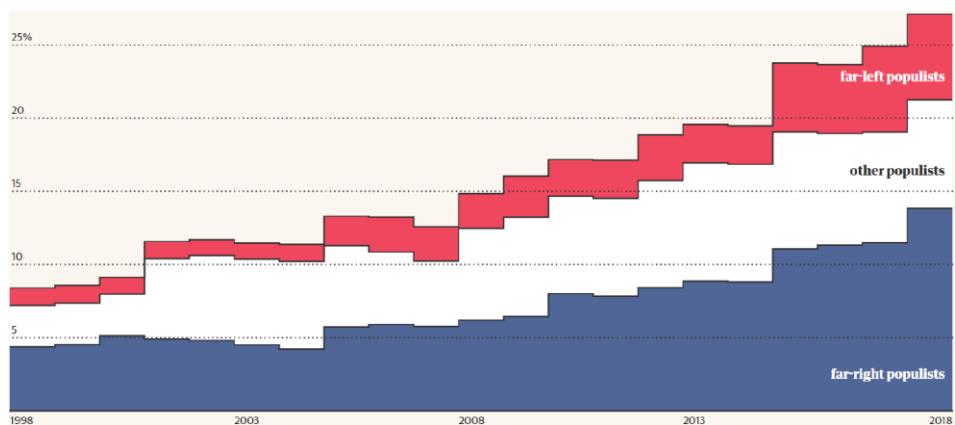
## A quick word on Brexit

A quick word or two on Brexit before I begin. Here in the UK, it is virtually impossible to do *anything* these days without Brexit somehow entering the frame. Even at dinner parties with family and friends, if you start the meal by agreeing not to talk about Brexit, sooner or later, it enters the conversation anyway, and I have heard of entire families that have fallen out as a result of the mess in Westminster. Things are not easy in the UK at the moment!

Only a few weeks ago I came across an article in the New York Times, written by Thomas L. Friedman, which sums up better than anything else I have read more recently why the British are getting it so horribly wrong. Friedman argues that the British have totally lost perspective of the big picture. Let me quote what I think was one of the finest passages in a great article:

*"Trump is fine with a world of competitive European nationalisms, not a strong European Union. So is Vladimir Putin. So, it seems, are the Brexiteers. How quickly they've all forgotten that the EU and NATO were built to prevent the very competitive nationalism that ran riot in Europe in the 20th century and brought us two world wars."*

Nationalism is a key driver of populism, and populism is a key driver of the political agenda in more and more countries around the world. In Europe alone, populist parties have more than tripled their share of the total vote over the past 20 years with populist leaders being in government now in 11 European countries<sup>1</sup>. More than 25% of all Europeans now vote for a populist (Exhibit 1).



**Exhibit 1: Populist vote share in Europe, 1998–2018**

Source: [The Guardian](#)

In what is to follow, I will argue that populism leads to plenty of capital being misallocated. Obviously, both private and public capital can be misallocated but, in the context of this month's Absolute Return Letter, which zooms in on populism, it goes without saying that I am referring predominantly to public capital.

## What exactly is populism?

The rise of populism in Europe is most definitely a consequence of the middle classes being financially squeezed (more on this later), but it is also a function of the series of crises Europe has been subjected to in recent years

<sup>1</sup> Source: [The Guardian](#).

– serious economic problems in Greece, the war against ISIS and the subsequent stream of refugees from Syria and Iraq, plenty of illegal immigrants, numerous terror attacks, etc.

The Cambridge Dictionary defines populism as:

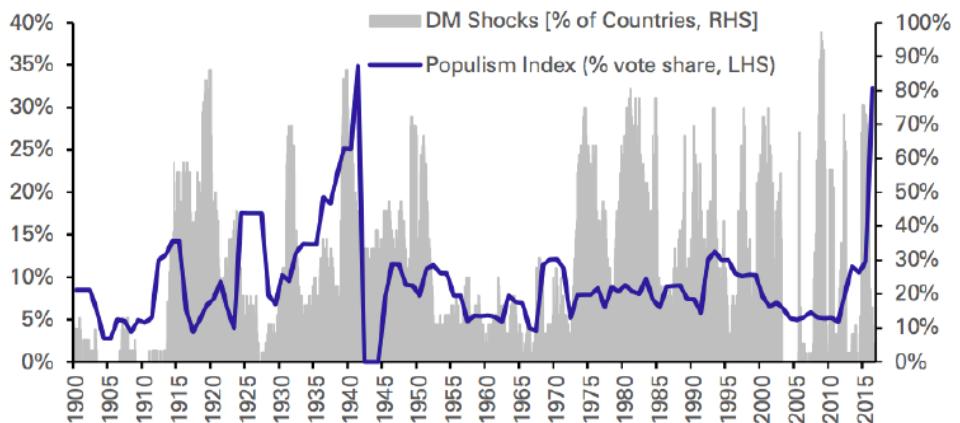
*“political ideas and activities that are intended to get the support of ordinary people by giving them what they want.”*

If ordinary people feel their living standards are under pressure (as they arguably are), a scapegoat needs to be identified so that something or somebody can take the blame for their misery.

Here in the UK, not one but two scapegoats have already been identified – immigrants who supposedly take jobs away from ordinary people, and the EU which supposedly runs the country these days. That neither of those two claims are even remotely true is entirely irrelevant to these people.

Populism is far from a new trend. Every now and then, it rears its ugly head, more often than not with devastating implications to follow.

Adolf Hitler was the most notorious populist of the 20<sup>th</sup> century. He took advantage of a desperately poor German populace who needed *something* to change after years of despair. Deutsche Bank Research runs a populism index (Exhibit 2). As you can see, we are going through a phase now not dissimilar to 1935–39, where a sharply rising gap between rich and poor also led to a monumental rise in populism.



**Exhibit 2: Populism index**

Source: Deutsche Bank Research

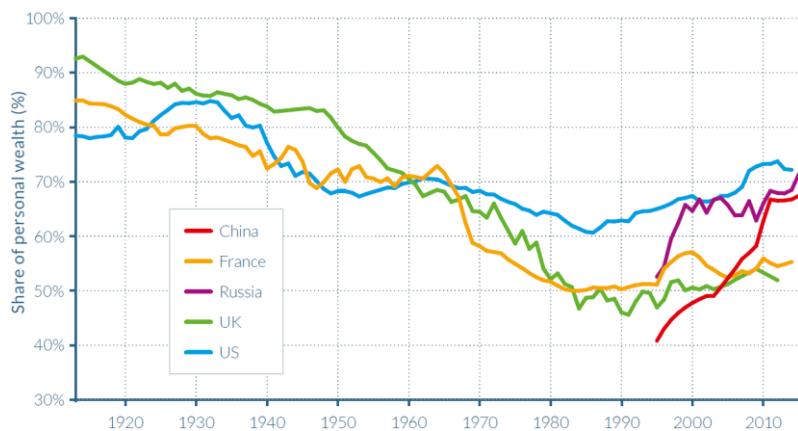
## The rising gap between rich and poor

Is the gap between rich and poor really getting bigger or is it just hearsay? Let's turn to the World Inequality Report 2018 which you can find [here](#). I strongly recommend you download – and read – this report. It is deeply fascinating.

Spending power is very much a function of income, but it is also a function of wealth – assuming you have any. Through most of the 20<sup>th</sup> century, the wealthiest 10% lost out to the bottom 90%, i.e. the gap between rich and poor got smaller, but that all changed in the 1980s as we entered the Great Equity Bull Market (Exhibit 3).

The extraordinarily benign financial market conditions of the last 30–40 years have been a major source of wealth creation since the early 1980s. The rich began to grab a bigger slice of the pie and have done so ever since. In

other words, even if the poorest 90% are wealthier than ever before when measured in absolute terms, they feel poorer as they can see the wealthiest building their wealth much faster.



**Exhibit 3: The wealthiest 10%'s share of total wealth (by country)**

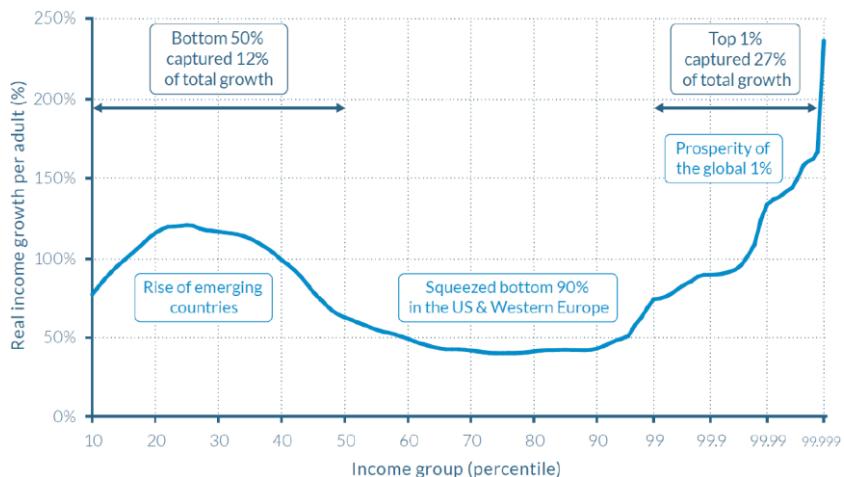
Source: *World Inequality Report 2018*

### A similar story on income growth

Switching from wealth to income growth, a similar picture is unfolding. If we rewind to the Absolute Return Letter of November 2017 (which you can find [here](#)), you may recall that I introduced the now (in)famous elephant chart – based on work conducted by a research team at World Bank in 2013.

The chart revealed that, between 1988 and 2008, the middle classes of the developed world were the big losers, doing even worse than the poorest people of this world. The middle classes of emerging markets fared much better, only surpassed by the global elite who did the best of all in terms of income growth.

Another group of economists<sup>2</sup> have since updated World Bank's work from 2013 and have found that the gap between rich and poor is even bigger now than it was only a decade ago (Exhibit 4).



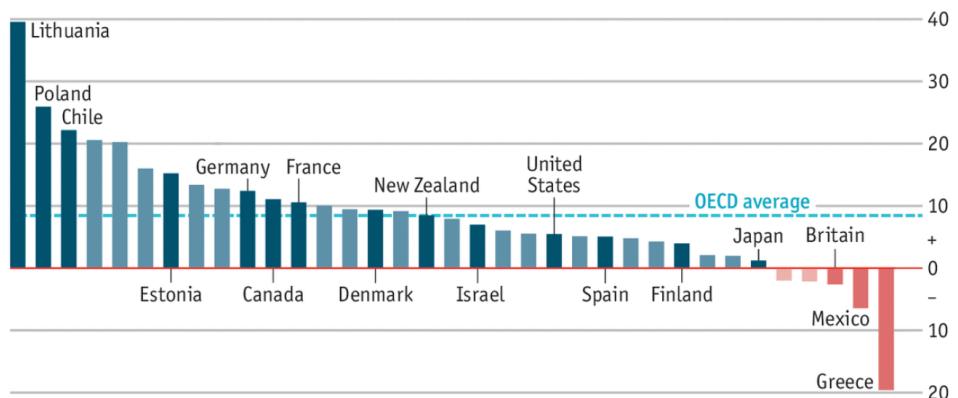
**Exhibit 4: Global real income growth by percentile, 1980–2016**

Source: *World Inequality Database*

<sup>2</sup> A team led by Facundo Alvaredo, Lucas Chancel, and famous inequality research trio Thomas Piketty, Emmanuel Saez, and Gabriel Zucman updated the elephant chart in the 2018 *World Inequality Report*.

As you can see, the top 1% of income earners captured no less than 27% of the total growth in income between 1980 and 2016. Meanwhile, the bottom 90% got squeezed – at least in the US and Europe – and that is consistent with World Bank's 2013 findings.

Exhibit 4 is global in nature, but the OECD regularly collects data on real income growth on a country-by-country basis. As is evident when looking at Exhibit 5 below, the UK comes out as one of the outliers with negative real wage growth (when measured in absolute terms) between 2008 and 2017. Only Mexico and Greece have fared worse than the UK in the last 10 years or so.



**Exhibit 5: Real wage growth by country, 2008-17 (%)**

Source: *The Economist, OECD*

## What happens when the gap between rich and poor grows?

All over the world, the middle classes underwrite economic and political stability. Hence, when the middle classes are unsettled, so is society at large.

In the US, they chose a political outsider as their next President. In the UK, they chose an uncertain future outside the EU. In Italy, they chose a comedian to run the biggest political party. The middle classes of those three countries sent exactly the same message to the establishment:

*"We are not happy with the state of affairs. Something needs to change. We want a better life!"*

I am not even sure all those people know precisely what it is that must change, but *something* needs to. Every now and then, a populist shows up on the stage, seeking to take advantage of the general discontent and, from that point, things tend to get hairy.

As I mentioned earlier, when people are unhappy, they start looking for scapegoats, and sometimes the choice of scapegoat defies logic. If the middle classes of the UK feel increasingly squeezed (as they do), perhaps they should have a go at the super-rich instead of blaming the EU – an institution that has nothing whatsoever to do with the rising gap between rich and poor.

As EU governance rules are based on consensus, in effect, the EU epitomises what populists despise. And because of the EU governance model, everything takes time, which often makes the EU a scapegoat for problems that have nothing whatsoever to do with it. Many populists argue that the EU is undemocratic. In reality, it is anything but – perhaps even a little too democratic sometimes.

## Why rising populism will lead to slowing GDP growth

Up to this point, my logic has been fairly straightforward – a rising gap between rich and poor has led to broad discontent amongst ordinary people which has paved the way for populists. So far so good, but now it gets a tad more complicated. I will now argue that rising populism is at least partly to blame for the slowdown in economic growth that we have been subjected to in recent years.

Why is that? We know that capital being misallocated leads to falling productivity growth, and we know that productivity growth is one of the two basic drivers of GDP growth. Hence, if populism leads to capital being misallocated, populism will, by definition, lead to slowing GDP growth.

What is it that populists do that cause capital to be misallocated? Populists do what ordinary people want politicians to do *irrespective of the economic rationale*.

Example 1: Only a few days ago, Boris Johnson declared that “[with me as Prime Minister] the UK will leave the EU in October, deal or no deal”. Does that make any economic sense whatsoever? Absolutely not! Could it lead to much more capital being misallocated? Most definitely yes! Is it what (many) people want? Oh yes! In other words, Boris Johnson is a prime example of populism running riot.

Example 2: As society ages, the elderly will have a bigger and bigger say on the fiscal agenda. Most politicians are prepared to do irrational things, just to buy votes. If enough elderly want a spa in their local nursing home (yes – nursing home spas already exist), I am sure we will see a few more of those pop up in the years to come.

Rising populism will almost certainly lead to rising public debt levels, as populists are masters at spending public money. That has always been the case and particularly so when money has been cheap. As public debt-to-GDP rises, more and more capital will have to be deployed to servicing all that debt, and capital used to service existing debt is by definition misallocated capital. It is effectively a vicious circle that can only end in tears.

## Cheap money – the root cause of misallocated capital

Capital being misallocated in large quantities is one of the most important reasons why GDP growth is as pedestrian as it currently is, and the low cost of capital we are currently ‘blessed’ with is the number one reason so much capital is misallocated at present.

When interest rates are low, households buy property they can only afford because interest rates are extraordinarily low. Corporates buy back their own equity rather than making productivity-enhancing investments as that makes earnings look much better than they actually are, and governments (increasingly under the control of populists) spend public money on transfer payments rather than on things that would improve productivity – for example by improving the failing infrastructure. All of the above is classified as misallocated capital, and the root cause is cheap money.

It is actually possible to calculate how much misallocated capital each country is saddled with but, to do that, I must introduce the Wicksellian Spread (or Wicksell Spread), named after the 19<sup>th</sup> century Swedish economist, Knut Wicksell.

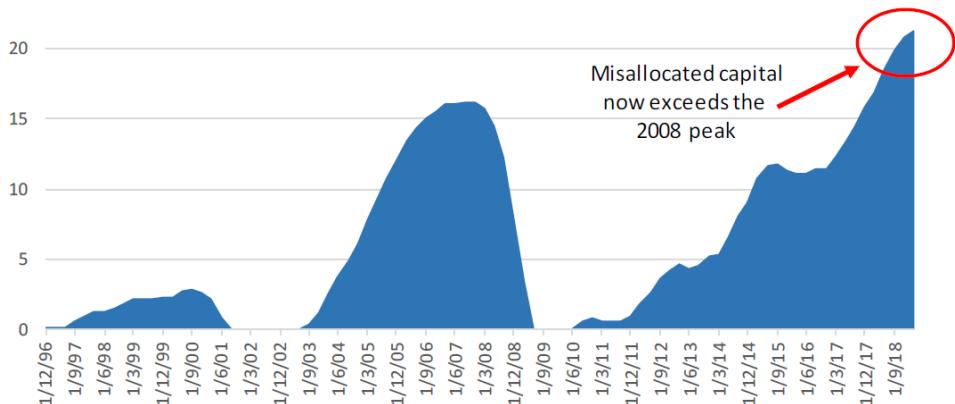
Wicksell argued that capitalism works best when the cost of capital to the average business is about 2% higher than nominal GDP growth, and time has proven him right. Economists have since agreed to use the 10-year BAA corporate bond yield as a proxy for the cost of capital to the average business, and the Wicksellian spread is the 10-year BAA corporate bond yield less nominal GDP growth.

Over the years, it has proven to be one of the best – probably *the* best – indicator of banks' willingness to lend; hence it is a superb indicator of where we are in the credit cycle, and of what can be expected of economic growth going forward.

I note that the Wicksellian spread always climbs as we approach a recession. In the 2001-02 recession, it peaked at almost 6%, in 2008 it exceeded 10%, and it is currently nowhere those levels.

Once you have established how big the Wicksellian spread is, you can calculate the cumulative amount of misallocated capital. You do that by subtracting the Wicksellian spread from 2% and then multiply that result by GDP for the quarter in question. That result is again multiplied by-debt-to-GDP.

Using that methodology, MacroStrategy Partnership (my favourite research shop) has found that the amount of misallocated capital in the US now exceeds the already elevated levels of 2007-08 (Exhibit 6).



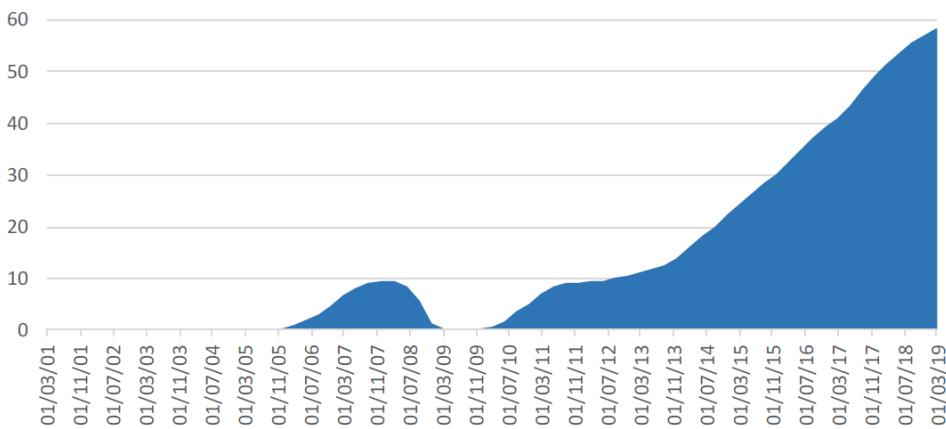
**Exhibit 6: Cumulative misallocated capital in the US (% of GDP)**

Source: *The MacroStrategy Partnership LLP, Bloomberg*.

Perhaps more surprising to you (it certainly was to me), even if it is bad enough as it is, the US is nowhere near the top of the international league table in terms of misallocated capital. Out in front with so much misallocated capital that it adds up to no less than 77% of GDP is China (all those bridges to nowhere!).

In joint second place with 58% is Australia and ... (the big surprise) Germany. The membership of a very unproductive monetary union has resulted in the very productive German economy having interest rates (borrowing costs) that are way too low for its own good which has led to a huge amount of capital being misallocated (Exhibit 7).

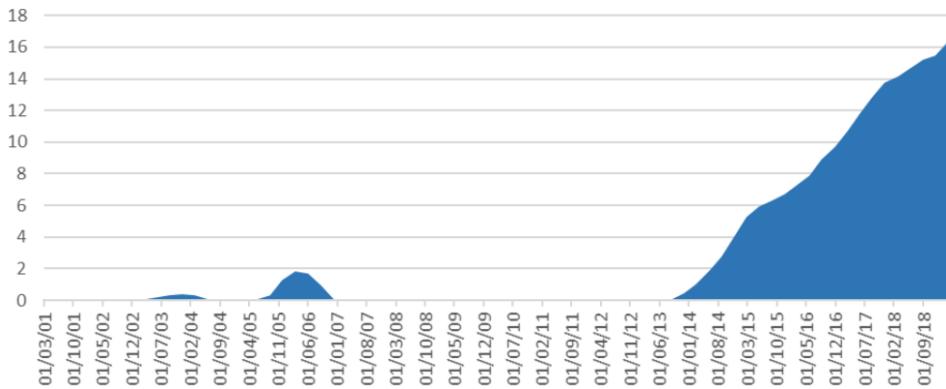
How more precisely that will manifest itself down the road is difficult to say, but there are certainly dark clouds gathering on the horizon in Germany if Knut Wicksell's approach still works and MacroStrategy Partnership's calculation methodology can be validated – a topic I will return to in a future Absolute Return Letter.



**Exhibit 7: Cumulative misallocated capital in Germany (% of GDP)**

Source: *The MacroStrategy Partnership LLP, Bloomberg.*

Finally, let me share the UK picture with you. At about 16% of GDP, it is bad enough as it is – particularly as it came from nothing only a handful of years ago – but it is still better than elsewhere (Exhibit 8).



**Exhibit 8: Cumulative misallocated capital in the UK (% of GDP)**

Source: *The MacroStrategy Partnership LLP, Bloomberg.*

## Summing it all up

Let's wrap it all up. A grotesque amount of misallocated capital – capital that could (and should) be deployed to enhance productivity – is an important reason why GDP growth is as pedestrian as it currently is. And, as you have just learned, the emergence of populism doesn't make the problem any smaller.

If misallocations in the private sector are mostly funded by banks, as they were in the years leading up to the Great Financial Crisis, they pose a systemic risk, as we all learned some ten years ago. These days, most private sector misallocations are funded by either private credit or equity (whether private or public). That is bad enough, but it doesn't pose the same level of systemic risk; hence a repeat of 2008 is not as likely as many doomsayers claim.

As far as misallocations in the public sector are concerned, a rather depressing picture unfolds. The rising gap between rich and poor will almost certainly lead to more tailwind for populist parties and, as we have learned from various incidents over the past few centuries, populism often leads to authoritarianism. If we want to protect our democracy, it is therefore critical that we find ways to reverse the trendline expressed in Exhibit 3.

It is in that context you should think of Brexit and the newly held elections for the European Parliament, where populist parties all over Europe gained further momentum.

Here in the UK, more people than ever hold a job today, and the unemployment rate is near all-time lows. Average living standard are undoubtedly better than they were when I first moved here nearly 33 years ago. It is almost impossible to find anything that's worse - public transport, maybe, but it is hard to blame Brussels for that, even if Nigel Farage tries every now and then.

Yet, over 30% of the UK electorate voted for Nigel Farage and the Brexit Party in the Euro election, and there is an aura of self-destruction hanging over the UK at the moment. That leads me to finish this month's Absolute Return Letter with a second quote from Thomas L. Friedman's recent Brexit article in the New York Times:

*"What we're seeing is a country that's determined to commit economic suicide but can't even agree on how to kill itself. It is an epic failure of political leadership."*

**Niels C. Jensen**

3 June 2019

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