OUT OF THE ORDINARY

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Leadership and self-deception

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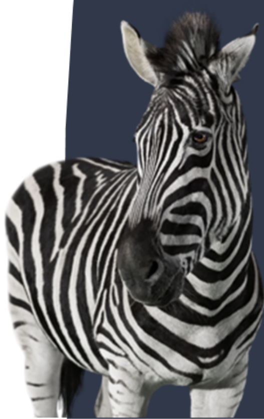
One consequence of listening to lots of podcasts is that I hear many book recommendations.

In the light of recent events here in the UK (and elsewhere), one suspects that many politicians might benefit from reading Leadership and Self-Deception. There is no need to rehash the goings-on of the past weeks, although I'm sure books will be written, and TV



mini-series made. I am writing this not long after it was confirmed that Rishi Sunak will become the new Prime Minister, which happily releases us from the prospect of waiting any longer for certainty.

I will leave it to markets to have their say about what they think, especially as they have been vocal in making their displeasure about unsuitable policies felt. Much of the reaction occurred overnight on Sunday and when markets in Europe opened on Monday morning, following Boris Johnson's withdrawal from the race on Sunday evening. Currency markets were the first to show their hand, and we saw the pound gain a cent against the dollar and about the same versus the euro. However, those gains were gradually given back over the course of the day as positions were squared off and, possibly, as investors reevaluated the fact that the incoming PM has a huge task ahead of him. It's not as though any new rabbits can be pulled out of a hat magically to close the yawning fiscal and current account deficits.

Indeed, spending cuts and tax increases would seem to be the order of the day. Bond investors seem to like that prudent approach, and both the ten-year and thirty-year gilt yields fell 0.3% during the day. The ten-year yield is now 3.74%, lower, remarkably, than the yield of the 10-year US Treasury (4.22%), and a far cry from the 4.6% it twice reached over the last month.

However, we will have to wait (at least) a week until the Chancellor (presumably Jeremy Hunt still, if Westminster chatter is to be believed) presents the new budget alongside the fiscal plan. I must admit that a return to austerity was not top of my list in terms of how governments would choose (or be forced) to deal with mounting levels of debt.

How to cut national debt

To recap, I believe that there are four potential ways to cut debt relative to the size of an economy. The first, and most pleasant for all, is to grow the economy productively faster than the pile of liabilities. One could make the case that this is what Liz Truss and Kwasi Kwarteng had in mind, but their plan was fatally flawed. The second is austerity, tried and tested (and seemingly failed) after the financial crisis. Given the drift of politics in the last few years to deliver more support to (for want of a better word) populist politicians who campaigned with some success on a manifesto of free lunches for all, I felt that austerity was a dirty word, but I didn't reckon with the power of the Bond Vigilantes who declared that enough was enough in the case of the UK. Now that the die has been cast, I suspect we will not be the last country to be brought to heel.

Next on my list is default. That's not really a realistic option for a sovereign country with a free-floating currency and the ability to issue debt and print money and is usually the last resort of countries with huge external liabilities in currencies other than its own. But access to the printing press can cause rampant inflation and so the default comes disguised as a currency devaluation.

Forced to vote on the most probable outcome, I would have gone for Financial Repression, described by economic commentator Russell Napier as "stealing money from old people slowly". The practice involves allowing inflation to rise at a faster pace while at the same time suppressing interest rates and bond yields. This can be done by control of the central bank's interest rate policy (theoretically not possible in the UK today, but...) or by forcing financial institutions and savers to buy overvalued fixed income products. It's a silent killer of the real wealth of risk averse savers.

And so, where is the self-deception in all of this? To my mind in the fact that growing economies at the pace we have become used to is a pipe dream, especially as many studies show that after a certain amount of debt has been accumulated, every new pound or dollar of debt produces less growth than the last. Yes, debt can be productive in the right circumstances, especially if used for productivity enhancing investment, but possibly not to support rampant consumption.

That's not to say that growth cannot be achieved, but there is less likely to be a rising tide that lifts all boats. I would like to think that this is where skilled investing makes its strongest case in the longer term.

International leadership issues

A leader who doesn't have to bother with the inconvenience of party in-fighting or ballot boxes is President Xi of China. Good for him, perhaps, but markets delivered a massive thumbs-down to the confirmation of his third (and quite probably not final) term. Like many a successful autocratic leader (with success being defined in this case by the level of autocracy achieved!), he appears to have removed all challengers from his party's apparatus and changed the rules to his desire. No President has served a third term since Chairman Mao, and the limit on time in power was deliberately introduced by Deng Xiaoping to prevent autocracy and the development of personal cults.

Further evidence of Xi's positioning can be seen in the new appointments to the Politburo Standing Committee, who are viewed as being strong Xi supporters rather than skillful economic managers and unlikely to challenge his opinions, certainly not in the way that now-retired Premier Li Keqiang was wont to do on occasion. Neither was any putative successor identified.

As for the policy content of the National Party Congress, there was minimal focus on economic issues, with the emphasis on resource security, military sovereignty and medical advancement, as well as a continued focus on "common prosperity". Covid seemed barely to get a mention, and there was certainly no relaxation of the zero-Covid policy. It would appear that any prospect of the sort of stimulus that China has provided in the past remains on the back burner. As for the Taiwan situation, there was no escalation of rhetoric, but the long-term plan remains very much one of "inevitable reunification".

In market terms, this was reflected in a 3% fall for the CSI 300 Index in China, and a much sharper fall of more than 6% in the Hang Seng Index. The Hang Seng Internet & Information Technology Index fell more than 10% on Monday morning. This reflected a view that private enterprise and innovation will not be rewarded as handsomely as in the past and global investors are voting with their feet.

Does President Xi need the book too? His delusion (possibly shared by President Putin) is that his country can be returned to more autocratic rule without mishap. Also, that economic growth can barrel along at 5% without having to engage with foreign capital. But

China's population has already savoured the fruits of economic aspiration and will not give them up easily. We have long held that the price of social stability in China under Communist rule is the carrot of greater wealth accumulation. What happens if that carrot is removed? The country is also dealing with the fallout from a real estate crisis which seems set to constrain the economy from achieving the sort of growth it has historically. Certainly, we cannot now blithely assume that investing in China can be done on the same basis as it was even just a couple of years ago.

Economic Commentary

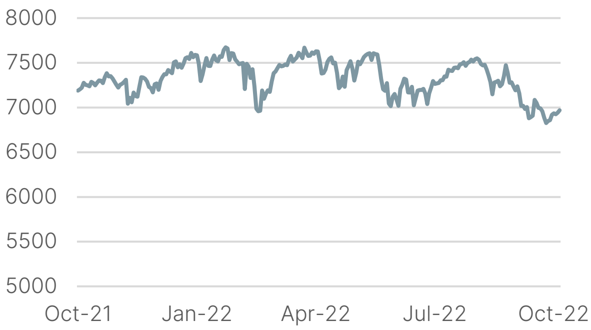
FTSE 100 weekly winners

Just Eat Takeaway.com N.V.	20.6%
Smurfit Kappa Group Plc	9.1%
Abrdn plc	7.1%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	7.1%
Antofagasta plc	6.5%
Ocado Group PLC	6.1%
DS Smith Plc	5.6%

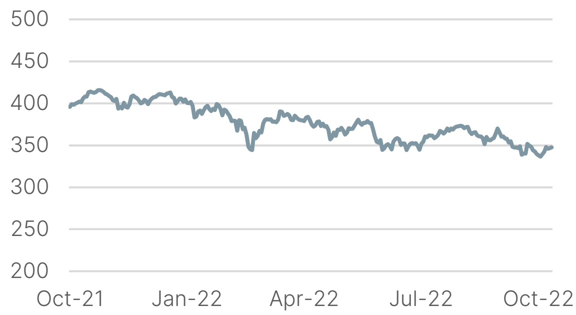
FTSE 100 weekly losers

Hargreaves Lansdown plc	-8.7%
Auto Trader Group PLC	-7.1%
Hikma Pharmaceuticals Plc	-5.2%
Kingfisher Plc	-4.2%
B&M European Value Retail SA	-4.1%
Polymetal International Plc	-3.8%
Ferguson Plc	-3.5%

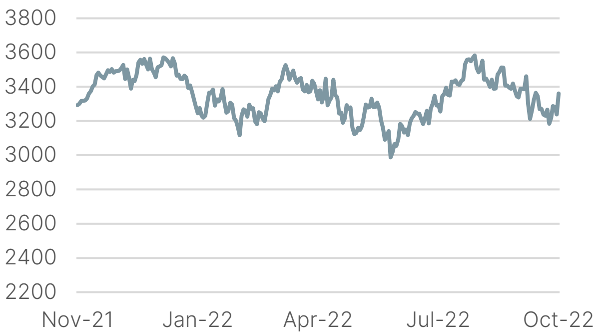
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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