Episode 5 - GROWTH: Trade, Inflation and Balance Sheets

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MANDY

Hi, I'm Amanda Hale, and once again I am joined by my colleague Andrew Newson,

and we welcome you back to the next episode of our Industry Perspectives podcast series.

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To recap, last time we discussed various influences on growth in financial markets through the lens of the AI revolution, innovation and increasing power demands.

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In this episode, we are again joined by our industry experts, Nathan and Rob, where we will expand on our growth discussion,

This time looking at trade, inflation and balance sheets.

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ANDY

Switching to trade, in the time of increasing economic sanctions, tariffs and other restrictions, are we starting to see evidence of a broader deglobalization? And if so, what is the future of global trade?

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NATHAN

I'm going to argue vigorously that deglobalization is not the right description of where we are. That when we look at indicators of global trade and capital flows and other measures of global integration, I think what we've seen is more a flattening out in those indicators. So we're not coming together and being more globally integrated on a year-to-year kind of basis like we were in the 90s and the early 2000s. We were opening up and integrating and capital flows were rising and there was liberalization in various ways externally. We're not seeing that. But by the same token, the macro data just are not showing an unwinding of that in any kind of meaningful, significant way. Now, having said that, when you start looking at some of the disaggregated features of these data, what you see is a reprofiling and rebalancing of global trading relationships and global economic relationships. And I kind of touched on that. For example, with U.S. imports,

we're importing less from China. But in aggregate, we're actually importing more than before because we're importing more from Vietnam, Mexico, other emerging markets in particular. And then, of course, as a result of AI, we're importing significantly from Taiwan, from Korea and other jurisdictions that produce those kinds of goods.

So you see that that reprofiling. Similarly, as I mentioned, with China, China exports less to the United States, but its total exports continue to grow at a very solid pace where they're exporting more to the ASEAN countries and Southeast Asia, other emerging markets. And their exports to Europe have increased as well. So I would characterize it as kind of a stay system globalization, a stabilization, kind of that global process of integration. And then within that, a rebalancing or reprofiling of globalization.

It may be a little grandiose to call where we are globalization 2.0. And it may be better to say, in my view, that we're kind of in a transition to a new equilibrium that over time will be globalization 2.0, which is going to be less aggressive than what we saw in the 90s and 2000s. But the reality that we live on the same planet and that there are gains from trade and gains from financial integration is a reality that's hard to escape.

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MANDY

So Rob, do you agree with that?

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ROB

I think it's funny because once you establish globalization, it's very hard to get rid of it in a funny way. It's very hard to destroy globalization or to really minimize it because commerce flows like a river. And a river can find ways around any obstacle. And you'll find that part of that resilience in the global economy is the sort of adopting and being flexible or adjusting to different challenges or different hurdles. And because commerce will continue, commerce and business will continue no matter what. The thing I worry about, Nathan, and maybe you can comment on this, is if there's anything I think that could potentially be an impediment to globalization, it's inflation.

Higher prices can stymie commerce. And in that, I would think that's the bigger enemy of globalization than, say, geopolitical events, which I think, you know, the global economy has learned to adapt to.

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NATHAN

Yeah, that's a very interesting thought. And I have to say it's one I haven't really reflected extensively on. But I'm inclined to agree with you. And as you are in a world with higher

inflation, one, inflation is correlated with uncertainties and instabilities. And two, it also often means a reduction in purchasing power. And then you're how do people respond? They respond by pulling back. And that means they're going to be buying, you know, more or less of everything. And that certainly includes imports and the like. But then further, what kind of political kinds of policies are they going to be endorsing? And I think they're ones are likely to be more insular. So in a deep way, inflation could very well drive de-globalization.

Now, having said that, maybe one flip side to this is that in many emerging markets, when they have severe inflationary episodes, it has in the past prompted a desire to reform their economies. And historically, these reformers have often been ones who have sought to open up the economy to subject it to increased competition, to make it more efficient, to make it less inflationary. So you could argue that either way. But for a start today, I would not think that inflation is a friend of globalization.

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MANDY

OK, so let's tackle another issue. And I think it's probably one that markets seem to be increasingly worried about. How big a threat are surging government debt levels? The situation in the US is getting a lot of recent attention. But isn't this a risk for many other countries as well?

06:41

NATHAN

I have to say that on many of these issues we've discussed, I really do look at them as being two-sided, where there's upsides and downsides and opportunities for firms and investors.

This issue of elevated public debt levels, I just look at it as almost unmitigatedly bad news. I don't know where the upside is, and it is one that I find broadly depressing. I think the leader in this discussion, and first off, given the size of the economy and the size of the debt in terms of just absolute magnitude, is the United States, where our federal debt is running around 100 percent of GDP, our budget deficits are likely to be at 6 percent of GDP or higher. As far as the eye can see, at least through this coming decade, there's not a lot of will to do anything about it. The implication of those deficits is that Treasury issuance in the coming decade is likely to total close to $25 trillion dollars of securities, stated differently on average over the next decade. The U.S. Treasury is likely to be in the market selling $2-2.5 trillion dollars of treasuries a year. And that is going to be a significant drain on available capital for firms and other countries and so forth.

And markets have taken note, and I think that the U.S. Treasury market is less stable than it would be in terms of day-to-day and week-to-week trading, than it would be if the U.S. had a more disciplined fiscal position. And I think U.S. Treasury yields at least a solid and maybe even more, but at least a solid 50 bps higher. Now, finally, let me emphasize that I focused on the United States, but this is certainly not a problem that is unique to the United States. As many of our listeners will know well, certainly on this list you should also include France, Italy, Belgium, Spain, the U.K. of course, Japan, Canada.

Many of the major developed market economies have very high debt levels right now from a historical standpoint. And some of the emerging markets, too, when we look, were surprised at the high level of public indebtedness in Brazil, India, and China, for example. So this is a worry. It's a risk out there, and it's something that we're watching closely, and I think the markets are watching closely.

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ROB

Please note that Nathan did not mention Greece among the countries that have a fiscal issue.

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NATHAN

I just missed it.

09:37

ROB

I have to be proud about Greece because they've come a long way since the financial crisis.

You know It's funny because, to me, fiscal deficits are a little like global warming. Despite all the warnings that people have given on global warming, it kind of creeps up on you, and all of a sudden you go, "Hey, we're having a lot of droughts and a lot of heat waves and a lot of other things." And all of a sudden it sort of appears, but it's been growing and just very silently growing for a long time. And people don't quite know how these things impact the overall economy or the global economy. I do have a question for Nathan before that.

When I think about it, we've over the years have seen small effects in markets that are really the effect of fiscal deficits. One is, and this may be a little complex, but one is negative swap spreads. So right now, when you look at Treasury yields, you can fund them at a spread, which means that the bank rate that you're borrowing at has an

implied better fundamental condition than the U.S. Treasury. And those swap spreads have been negative for some time. And while that doesn't have any immediate effect, it's the first warning that you know you could have liquidity challenges in a market like the Treasury market, which has inordinate liquidity right now. Then a few years back, we had the UK gilt crisis, which, you know, was a direct and very profound way of worry around the fiscal deficit. And the most recent one, and the headlines that are causing it, is the sort of currency intervention in Japan, one country that has a high deficit versus the U.S. that has a high deficit.

And, you know, the reluctance of the part of Bessent to see Japan sell Treasuries. So these are all the signs that we're starting to see, and we've seen more. So far, though, it really hasn't affected the dollar. The dollar has shown extraordinary strength during the year. Now, one reason why that may be the case is there is an argument and a debate, and Nathan, you can tell me whether you agree with it or not, that we have to stop just looking at the deficits. That if you were to say the United States was a big balance sheet, we would probably be balance sheet positive, because look how many assets we have on the asset side of the balance sheet versus the deficits and the liabilities that we have on the liability side.

The other thing is that most of the deficits reside with public debt. We don't have that much leverage in the system with private corporations, private companies. It's funded growth. It's funded the steady health of these corporations. And so what do you think, Nathan? If I'm looking at the United States as a balance sheet, it seems a lot healthier than to just look at deficits.

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NATHAN

Oh, categorically, yes. And that's a very, very important point, that when you think about the overall national balance sheet for the United States, the level of indebtedness of our corporates and of our household sector is moderate.

And then when you think about the asset side of the balance sheet, I mean, candidly, the U.S. economy over the last 15 years has been a wealth producing machine. And when we look at overall levels of wealth in the economy, it's just extraordinary where we are. So the U.S. as an entity, when you look at assets and liabilities, it has huge, huge, huge net worth, hundreds of trillions of dollars of positive net worth.

The problem that we have is not a national solvency problem. It's a governance problem where we have instructed the government to our elected representatives to spend a 24 percentage of GDP and tax an 18 percent of GDP and to borrow the difference. And it's a governance problem that needs to be resolved. But it does mean that it's not that the country is bankrupt. And I think that also gives you the insight into why the dollar has

been as resilient through this as it has, is what has maintained the value of the dollar is the desire to hold dollars to invest in dollar denominated assets. That at the moment, by a variety of metrics, well over half of the global market cap in the world is in the United States. And beyond equities, there's a whole array of financial assets that are broad ecosystem for people to invest in. And I think the demand for those private assets is what's driving first and foremost the value of the dollar, even in a world where markets are increasingly anxious about treasuries in the outlook there.

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MANDY

Well, that time went by very quickly again as we wrap up our penultimate discussion on growth in financial markets.

But there is still plenty to discuss on this growth topic.

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So stay tuned for our concluding episode, with Nathan and Rob, where they will discuss mega trends, challenges and opportunities.

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