

“ We have
the power,
but do we
have the
wisdom? ”



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1 Technology: inflating political risk, impacting investment

SUMMARY: Michael Power argues that with technological advancements come unintended consequences and risks. The roll-out of automation, digitisation and artificial intelligence has the potential to impact supply/demand dynamics, transform society and politics, and shape the investment landscape. However, given this growing uncertainty, how do we remain focused on the long-term investment horizon?



There is a story — possibly apocryphal but with impeccable logic — that, when Henry Ford II commissioned a highly-automated car assembly line in Cleveland in the 1950s, he ran into his arch nemesis, Walter Reuther, union boss of the United Automobile Workers. Proudly pointing to his new plant, Ford gloated: “Walter, how are you going to collect union dues from these guys?”, Reuther swiftly retorted: “Henry, how are you going to get them to buy Fords?”.

This perfectly captures today's dilemma. Even as automation enhances the productivity of capital (measured by profits), it undermines the productivity of labour (measured by wages). Capital owners, techno-optimists, financial market participants and the ‘1%’ focus on profits and productivity, while most politicians, techno-pessimists, economists and the ‘99%’ focus on wages¹. A recent McKinsey study, ‘*Poorer than their parents*’², found that almost 70% of households in the 25 most advanced economies — some 560 million people — have seen their real incomes stagnate or fall since 2005. Unsurprisingly, populism is now on the rise.



In economics, Say's law of markets maintains that “supply creates its own demand”. Market fundamentalists strongly believe in this dictum. However, John Maynard Keynes, in his 1936 *The General Theory of Employment, Interest and Money*³, maintained that when markets fail, supply could overwhelm demand. He cited the oversupply of labour during the Great Depression when unemployment reached 25% in the US and 33% in some other countries. Keynes's solution, Keynesianism, was that the state must boost demand via ‘demand management’. ‘Macroeconomics’ was born, which essentially describes how the state uses fiscal and monetary instruments to achieve supply/demand equilibrium while keeping inflation in check.

Technology can disrupt market equilibrium

Technological breakthroughs tend to upset this supply/demand equilibrium

¹1% = super rich, 99% = everyone else.

²McKinsey, ‘*Poorer than their parents*’, July 2016, www.mckinsey.com/global-themes/employment-and-growth/poorer-than-their-parents-a-new-perspective-on-income-inequality.

³Keynes: John Maynard, *The General Theory of Employment, Interest and Money*, 1936, Macat Library; 1 edition (04.07.17).



by boosting aggregate supply, while cutting costs (often by reducing wages) and increasing unemployment, which suppress aggregate demand.

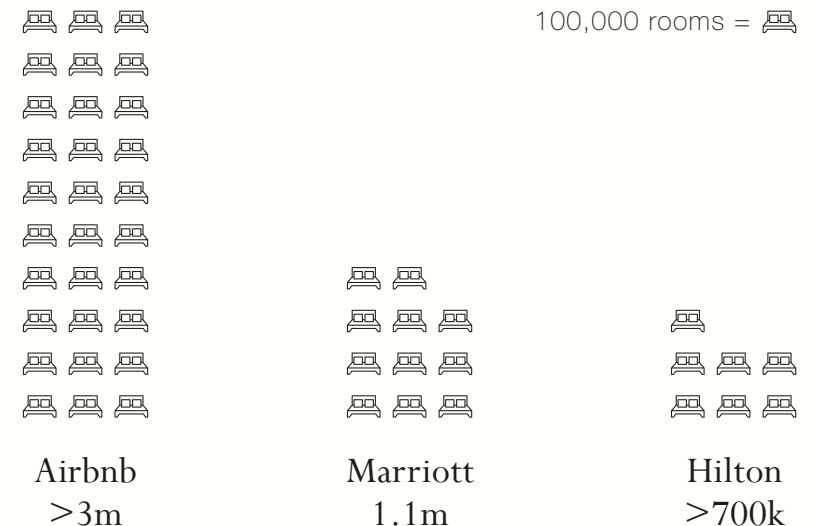
In terms of reducing demand, online retailer Amazon has destroyed far more high street jobs than its fulfilment centres recreated. Similarly, the rise of passive funds is transforming fund management, as witnessed by BlackRock's cost-cutting and job losses in its stockpicking unit.

On the supply side, direct rental website Airbnb lists more than 3 million rooms worldwide, compared to Marriott's 1.1 million rooms and Hilton Worldwide's 774,000 rooms. Taxi-firm Über, likewise, has massively increased the supply of cabs. In each case, prices for the consumer have fallen, often dramatically.

After motor taxis displaced horse-drawn carriages in the 1920s, there were more London taxi drivers than there had been Hansom cab drivers twenty years earlier. With Über and nuTonomy already having driverless cabs in Pittsburgh and Singapore respectively, the chances of having more cabbies in 2025 than there were in 2005 are now falling. The fact that

No vacancies?

Comparison of hotel accommodation vs. Airbnb





average wage growth in the West has been so lacklustre this century may help explain why persistently low inflation has generally surprised central bankers and economists. The effects of technological change may be more deflationary and far-reaching than many realise.

Thus the roll-out of automation, digitisation and artificial intelligence is leading many to believe that far more old jobs will be destroyed than new jobs created. Hardly neo-Luddites, Bill Gates, Stephen Hawking and Elon Musk have all warned against the social consequences of unrestricted employment of artificial intelligence.

Technology's tectonic transformation of politics

Unexpected electoral outcomes, such as Brexit and the election of Donald Trump, have occurred as populism has strengthened. The re-election of liberal Prime Minister Mark Rutte in the Netherlands, and Emmanuel Macron's victory in France, show that the social democratic middle has not (yet?) capitulated. However, politicians of all hues have not been shy about scapegoating foreigners (the right) or the rich (the left).

Donald Trump blamed Middle America's decline on offshoring manufacturing to low-cost China and Mexico. By doing so, he won the critical 'Rust Belt' states of Michigan, Wisconsin, Ohio and Pennsylvania, capturing the White House in the process. But a study by Ball State University's Michael Hicks found that 88% of manufacturing job losses are due to robots moving into US factories, not offshoring.

Populism is haunting investment markets

Post-Brexit, volatility as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), has remained muted, while currencies have arguably become the most important shock absorber of increased political risk, as witnessed by sterling's recent performance. Political classes are starting to water down 'austerity' programmes, already often practised more in name than fact. Even Germany has indicated that it will soften its line with regards to fiscal spending within the European Union. Perhaps this explains why, after months of European Commission stonewalling, Italy and Spain have been allowed to bail out troubled banks, including the world's oldest, Italy's Monte dei Paschi di Siena.



Accordingly, most Western nations are forecasting rising budget deficits as fiscal prudence becomes politically incorrect. Global investors fear that almost every democracy will capitulate to higher spending according to the logic that 'everyone is at it'. If the fallout from technological change intensifies further, Western governments may start to offer a Universal Income Grant so that its citizens can avoid the poverty trap. Finland is already pioneering just such a scheme.

In theory, responding to higher political risk should result in higher bond yields. Yet in practice, the ongoing search for yield and the whiff of a slowing US economy could yet drive investors back to the perceived safety of the bond markets.

Given that both aging demographics and lacklustre productivity growth are weighing upon Western economic growth, it seems extremely unlikely that the root causes of the current wave of populism will evaporate; rather they will probably intensify. If so, higher political risk will become a permanent and prominent feature of the business landscape.

Positioning portfolios for technological disruption

The risk anchors of today's investment universe centre on US Treasury bills and German Bunds. Given the background described earlier, long-term global investors need to consider two new risk anchors: assets representing Asian risk and renewable energy.

Geographically, as the sun rises on the East and sets in the West, new risk anchors — both fixed income and currency — must be introduced into a properly constructed global balanced portfolio. This suggests Chinese bonds and Chinese renminbi instruments. In June 2017, MSCI increased inclusion of China A-shares in its indices. In July 2017, the Bond Connect facility was opened, allowing foreign investors to access the onshore Chinese bond market via Hong Kong. A Pan-Asian bond fund, centred on Chinese bonds and cash, is increasingly a mainstay for forward-looking global portfolios. Asian property is also looking attractive. Those wanting equity exposure can start buying Chinese and Asian equities direct, or go via Western global franchise companies with expanding footprints in Asia.

Technologically, the potentially transformative renewable energy sector is an important factor to consider. Industrial revolutions usually harness a new

form of energy, enabling a quantum leap in productivity. Coal-fired steam drove the first Industrial Revolution, electricity the second and computers the third. Solar and wind energy are now driving the fourth. Not only is such energy infinitely renewable, once the capital costs of installation are absorbed, the marginal cost of operation will be near zero. This revolution will unleash more investable opportunities beyond the core energy-generating activities driving the revolution itself.

Conclusion

In 1926, in *'The End of Laissez-Faire'*⁴, Keynes highlighted the ever-shifting sands between politics and economics:

“We cannot therefore settle on abstract grounds, but must handle on its merits in detail what Burke termed one of the finest problems in legislation, namely, to determine what the State ought to take upon itself to direct by the public wisdom, and what it ought to leave, with as little interference as possible, to individual exertion”.

The spread of automation and artificial intelligence may be necessitating an increase in the involvement of “public wisdom” and a consequent reduction of the involvement of “individual exertion” in the Burkeian mix that makes up the modern political economy.

Many techno-optimists see the breakthroughs of our age as liberating. Ironically, if those technological advances also undermine the security of gainful employment, noting the imperatives of democracy, they may drive electorates further into the embrace of the state.



⁴Keynes, John Maynard: *'The End of Laissez-Faire'*, 1926, BN Publishing (25.03.09).