►On Target

Martin Spring's private newsletter on global strategy

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Europe Is Sliding Into Chaos

I have always believed in the ideal of a United States of Europe, but now its achievement looks increasingly unlikely.

Within months Britain will leave the European Union. Negotiators representing its remaining 27 member-nations, with their hardline demands, seem determined to weaken future relationships in a spirit of vengeance rather than to safeguard and foster remaining relationships.

If enforced, this intransigence will do as much damage to Europe as to the UK. Not only in the realms of trade – within the common market the 27 run a huge surplus on their trade with the UK – but also in defence.

Britain is the leading regional military power defending Europe against Russia. Its relative importance is likely to increase if the trend continues towards US disengagement from Europe as it shifts towards giving priority to the Asia-Pacific, and growing resentment against Europeans' taking a "free ride" on American military resources. Rich Germany, for example, shows no interest in paying its fair share of regional defence costs.

The latest foolishness is the EU's move to exclude the UK from the proposed Galileo programme that is designed to free Europe from dependence on America's GPS satellites. The EU intends to deny Britain's armed forces access to the new encrypted navigation system, and is denying the UK space industry access to contracts to manufacture its equipment.

The list of major problems now facing Europe is formidable:

► Concluding the Brexit negotiations – effectively, that has to be done in a matter of months -- and dealing with the consequences.

► Escalating tensions with the US, not only over trade, but also Europe's being forced to comply with sanctions against Iran, following Trump's cancellation of the nuclear deal.

► The emergence of a populist government in Italy, the Eurozone's third largest economy, hostile to European Union and Eurozone policies.

► Negotiating a new budget for the EU for the seven years 2020-27. The last round of negotiations took 20 months; this time things are going to be even more difficult. Ways have to be found to make up annual losses of €10-12 billion after

Britain's departure, but Brussels also wants to spend more on its current priorities while punishing countries whose domestic policies it dislikes.

► Resolving ways to handle the increasingly contentious issues relating to immigration. Germany failed to consult with other European nations before opening its doors to a million "unauthorized entrants" in 2015. It then forced through a policy of redistributing migrants around the union, which is fiercely resisted by many countries. Italy is stuck with more than half-a-million "illegals" and a continuing inflow. There's no agreement on how to seal, or even staunch inflow across, Europe's leaky borders.

► Germany faces mounting hostility from its fellow members of the EU and from the US for running a huge foreign trade surplus (8 per cent of GNP) because of very conservative fiscal policies and the advantage it gains from the cheapness of the euro.

Neither is likely to change. There is growing antagonism between the countries of the north (that tend to support Germany) and those of the south, which want less austerity in governments' spending policies to address poverty and unemployment.

► There are worsening divisions within the union rooted in cultural and political differences.

Most Germans fiercely oppose policies that would mean wealth transfers to citizens of southern European countries, who are allowed to retire earlier on state pensions. Most Poles fiercely resist being forced to accept Moslem refugees whose values are so different from theirs. There is growing antagonism between the democratic values of western Europe and the more authoritarian practices of the east (especially as the latter are gaining ground as they are strongly supported by those countries' voters).

► There are growing differences over continuing the anti-Russian sanctions stemming from Moscow's intervention in the Ukraine, and in particular its seizure of Crimea. Other differences relate to Europe's extraordinary dependence on Russia for energy resources. Germany favours the Nord Stream 2 gas pipeline connecting it directly to Russia. Other countries hate such dependence, would prefer to import liquefied natural gas from America.

Some favour centralized power, others oppose it

► France is now vigorously promoting reforms to bring about greater financial centralization in Europe such as a finance minister with overriding powers, a banking union, and an investment fund to help poorer countries catch up.

Germany has not been prepared to risk its loss of control through such centralization -- although it's now more supportive of such plans because of the strongly pro-Europe views of the Social Democrats within its new ruling coalition. Other EU members, including relatively important ones such as the Netherlands, are fiercely opposed to greater centralization.

► Finally, of course, there are those moves towards disintegration of Europe's military defences.

Europe's dependence on the US for its defence against Russia is symptomatic of wider failure to integrate regionally. There is no European army. There is no central finance ministry to manage and enforce what ought to be standard fiscal policies for all states, such as tax rates. There is a common currency, the euro, but it's used by only 19 of the 28 member-states. There are common policies to deal with major issues, but they are often ignored, particularly by the most powerful member-nations such as Germany and France.

The latest major crisis to erupt is the unexpected step into power of Italy's two most popular parties, which have managed to form a coalition government.

They are both upstarts -- relatively new alternatives to established parties that have seriously fallen out of favour with voters after 20 years of economic mismanagement. One thing they share is policies that would cost a lot and send the budget deficit soaring.

The Five Star Movement is Leftish, strongly supported in the south, very hostile to widespread corruption. It wants state handouts for the poor and to scrap a pension reform that raised retirement age. The League, far Right conservative, wants a single-rate, flat tax reform that would effectively limit the maximum income tax rate to 15 per cent. Its support is almost entirely in the north.

What brings them together is hostility to policies imposed by officials and their supporting political elites in Brussels and Berlin, particularly ones enforcing fiscal austerity and prohibiting state aid for troubled banks. Two of the latter recently failed, triggering big losses for ordinary investors.

Mass rebellion by Italian voters

Both parties are also very hostile to illegal immigrants; 640,000 of whom have flooded in from Africa and the Mideast over the past three years and are stuck in Italy. Neighbouring countries refuse to allow the migrants to move on into them or through them to elsewhere in Europe. Source countries refuse to accept back their citizens that Italy rejects as asylum-seekers and seeks to repatriate. Italians are furious that the rest of the EU largely reneged on promises to help pay for accommodating and processing the migrants, and to relocate them.

Behind the mass rebellion by voters is the brutal fact that since Italy became a founder-member of the Eurozone 15 years ago it has been stuck with virtually no growth in income-per-capita terms while almost all the other member-countries have prospered. Its unemployment problem, with its intensity focused on young people (35 per cent of whom are without jobs), and on the southern half of the country, is one of the worst in Europe.

Many blame this dire situation on inability to depreciate its currency, as Italy used to do, and the fiscal and monetary restraints imposed by the EU and the Eurozone. There is some truth in this. The Eurozone operates in such a way that it prevents member-states from adapting policies to accommodate individual needs.

The *FT* said this month: "Too little has been done to fix the underlying problems of the single currency – a fragmented banking system, inadequate crisis rescue capacity, and a lack of fiscal flexibility to offset asymmetric shocks. Germany, backed by an informal coalition of northern member-states, is opposed to anything that looks like risk-sharing, or a large counter-cyclical Eurozone budget."

Originally, Italy's populist parties threatened to scrap the country's membership of the Eurozone, or at least put the issue to a referendum. Both softened their positions on this, but wanted to appoint Paolo Savona, an eminent eurosceptic (he has described the euro as "a German cage") as finance minister. His appointment was sidetracked in favour of a less radical eurosceptic, Giovanni Tria – but Savona has been made minister in charge of relations with the EU!

I think it very doubtful that Italy will either choose to leave the Eurozone or be forced out. Britain's tortuous Brexit negotiations have made everyone in Europe aware of the horrendous complexities of such disengagements. And the Brussels elite will go to great lengths to avoid another country exiting European membership.

They may need to do so. The new government in Rome is determined to introduce cash handouts for less-wealthy citizens, big tax cuts, and state aid for troubled banks. If investors take fright at the prospect of a spending spree in Rome, which would be a serious breach of the European Union's fiscal rules and produce major conflict with it and the European Central Bank, that could trigger a flight out of Italian assets by both foreigners and Italians.

There would be significant risk of that ballooning into financial disaster. Italy has the biggest debt-crisis potential in Europe, with public debt of €2.3 trillion. The available lending capacity of the EU crisis rescue fund for the whole of Europe is less than €380 billion -- a panic would overwhelm the euro currency system.

Clashes over money won't be the only source of Rome's warfare with Brussels, Berlin and Frankfurt. Stir in a big row over forced repatriation of illegal immigrants. And possibly trouble over the union's anti-Russian policies (which the populists oppose). It all adds up to what seems certain to be an avalanche of conflict, with the European Union seriously distracted from addressing its other major issues.

Many of those stem from the lamentable failure of European leaders to convert people to the idea of sacrificing national sovereignty to bring about strong central institutions. That's why Europe, despite being in aggregate the world's largest economy, has no closely co-ordinated economic policies, depends on one superpower for its defence, and depends on the other for most of its energy imports.

Bent bananas and other bureaucratic idiocies

One important element of the political failure has been to allow the powerful bureaucracy in Brussels to interfere unnecessarily in the minutiae of people's lives. Although the Brits' decision to exit the union eventually turned on issues of sovereignty – over control of immigration from elsewhere in Europe, and dominance of European judges over the UK's -- it was fanned emotionally by Brussels' idiocies such as the ban on bent bananas. (European regulation No. 2257/94 required the fruit to be "free from malformation or abnormal curvature," as defined, to be sold within the EU.)

Bringing about complete unification of Europe was always going to be difficult because it encompasses so many different languages and cultures, unlike the US, China and Russia with their single national languages.

Europe failed to model itself on the world's most successful example of unification – Switzerland, with its four different languages and cultures. It has centralized authority for just a few key domains such as currency and defence. Control over most others is rooted in populist institutions – cantons (local states) and national referenda; several every year, I understand.

Is it too late to learn? Unfortunately I suspect other Europeans are too arrogant to think about doing so.

Your Future... Very Soon

What could lay ahead for us is mindblowing, says Jonathan Braithwaite of Barbados-based Mithril Advisors. Here's what he predicts…

► Software companies are going to disrupt most traditional industries over the next five to ten years. Uber is just a software tool – they don't own any cars, yet are now the biggest taxi company in the world. Airbnb is now the biggest hotel company although they don't own any properties.

► In the US, young lawyers already can't get jobs. Using the IBM Watson computer you can get legal advice within seconds, with 90 per cent accuracy – compared to just 70 per cent when the work's done by humans. In future there will be 90 per cent fewer lawyers, with only specialists remaining.

► Watson already helps nurses diagnose cancer, four times more accurately than humans. Facebook already has software that can recognize faces better than humans.

► Around 2020 autonomous cars will start to disrupt the motor industry. You won't want to own a car any more. You will call for one on your phone. It will show up at your location, then drive you to your destination. You will not need to park it, you'll only pay for the distance driven, and you'll be able to be productive while being transported. "Our kids will never get a driver's licence, and never own a car."

►Cities will be transformed because 90 to 95 per cent fewer cars will be needed, parking spaces turned into parks. Worldwide, 12 million people die every year in car accidents. Autonomous driving will save a million lives a year.

► Real estate will change. Because it will be possible to work while computing, people will move further away from city centres to more beautiful neighbourhoods.

► Electricity will become incredibly cheap and clean. Solar production has been on an exponential growth curve for 30 years, and now its burgeoning impact has become clear, with more solar energy capacity being installed worldwide than fossil-fuelled capacity.

► With cheap electricity comes cheap and abundant water. Desalination of salt water now only needs 2 kilowatt/hours per cubic metre.

► Medical devices will work with your smartphone taking your blood sample, scanning your retina, taking your breath. They will analyze biomarkers that will diagnose nearly any disease. And be so cheap that in a few years nearly everyone will have world-class medical analysis, almost for free.

► In just ten years the price of the cheapest 3D printer plunged from $18,000 to $400, and became 100 times faster. Manufacturers have started printing shoes; spare plane parts are being printed in remote airports. Soon you'll be able to scan your feet with your smartphone and print your perfect shoes at home. By 2027 10 per cent of everything that's being produced will be printed.

► 70 to 80 per cent of jobs will disappear in the next 20 years. There will be a lot of new jobs, although it's still unclear if there will be enough of them in such a short time.

► There will be an agricultural robot costing as little as $100. Farmers in Third World countries will no longer have to slave in their fields; they'll become managers.

► By 2020 there will be apps that can tell by your facial expressions if you are lying. Imagine a political debate where it's being displayed when participants are telling the truth and when they're not!

► The average life-span increases by three months every year, and the rate of increase itself is increasing. We may all live for a long time, probably way more than 100 years.

► The cheapest smartphones already cost only $10 in Africa and Asia. By 2020 70 per cent of all humans will own one. That will give everyone access to world-class education.

Are you ready for all this?

A Problem Young Investors Prefer to Ignore

Saving for retirement has always required a degree of self-discipline that young people often fail to apply. But now it's more important than ever, because of the stealthy build-up of problems that are starting to impact on retirees, and seem destined to worsen.

Central banks have imposed a regime of ultra-low interest rates that depress retirement incomes, mainly by locking in poor pension rates when people leave work, but also by ensuring that savagely-low rates are paid by income investments.

It's tempting to believe that this is a temporary situation, that central banks will soon restore "normal" rates of interest. But that's a dangerous assumption. Easy-money policies have inflated credit (and therefore debt) so prodigiously for so long that central banks have to be very careful – that is, very slow – about normalizing. And any signs of the impending arrival of another serious recession will force them to suspend normalizing, or even revert to easier money once again.

It's also very possible that, with high rates of saving in Asia's high-growth economies, but with tepid global demand for those savings because of corporate caution about investing in business expansion, the world could be in a semi-permanent state of capital surplus. That fundamental imbalance, just as much as central bank policies, could keep interest rates ultra-low.

Savers used to be able to count on reinvestment of income to drive accumulation of retirement capital over a working lifetime. They can no longer do so. They either have to save more aggressively… or face the near-certainty of poverty in retirement.

Savers have been shielded against the impact of this by the compensating factor of growth in capital values of shares, bonds, property, gold… almost all investment assets. But for how much longer can they count on that, given that valuations are generally very high, challenging potential for future expansion?

A different problem that menaces future retirees is that decades of bad government have allowed the liabilities of pension funds to grow far faster than their assets. Such imbalances can be ignored for a long time, but eventually they implode, as we have already seen in some American cities and states.

In Europe, where unfunded schemes are widespread, huge commitments are being built up to pay future retirees. They will have to be paid by working populations much smaller in relative terms. Taxes they pay will have to be forced up, and/or promised retirement benefits cut savagely.

The *FT* comments: “The upshot for young investors is that they will have to save harder, for longer – yet could still end up with a smaller pension pot than previous generations.” The millennial generation “is being asked to save money before it has had a chance to make any.”

Auto Industry Strategies

There’s a wide range of estimates about how long it’s going to take for electric cars to win the battle against internal combustion vehicles. That’s reflected in the different announced commitments that auto giants are making to investment in electrification between now and 2025.

Volkswagen easily leads the pack with $80 billion. That probably reflects its determination to bounce back from the emissions-cheating disaster and Europe’s war against diesel, as much as its big role in China, the world’s most promising major market for electric vehicles.

The second largest investor will be another German giant, BMW, which plans to put $47 billion into cars and batteries. The next biggest are three Chinese automakers: Geely, Changan and SAIC.

Ford plans to invest $28 billion, or significantly more than General Motors at $20 billion. Does the latter reflect caution from its chastening experience as a pioneer in America, where it markets its Chevrolet Bolt at the same price as comparable conventional vehicles, but loses $9,000 on every one it sells?

Also interesting is that Toyota, which competes against Volkwagen at the top of the world market for sales of conventional cars, only plans to gamble $10 billion on the electric revolution, as does Daimler Benz.

The Politics of Energy

The changing role of the US in global energy supplies thanks to the shale revolution, which has turned the country from importer to exporter, is starting to have an impact on Europe.

"The continent's dependence on Russian natural gas supplies may be challenged by the emergence of the US LNG business," suggests energy investment banker Allen Brooks. "Cheap and dependable gas supplies from the US may make European leaders more willing to agree to US demands for increased military expenditures, as those leaders consider their experiences having been held hostage to Russian geopolitical desires via... manipulation of natural gas supplies in the past."

Diminishing needs for Mideast oil are making the US less willing to become involved in that region's conflicts. "The world of international politics is rapidly being upended by the growing volumes of US oil and natural gas."

Australian Property and Banks: Locked Together

The inherent risk that explains the relatively high yields available on shares of Australian banks is their high exposure to the property market -- 63 per cent of their loans are in mortgages. House prices have risen by 65 per cent in Sydney over the past six years and by 55 per cent in Melbourne.

Chinese buyers, who have been a major influence driving up housing prices in recent years, are disappearing as the federal government applies tougher rules and higher taxes to discourage overseas investors. The share of foreign buyers receiving approval has halved since 2014.

However another major influence, immigration, continues to underpin demand. Annual net inflows have risen from 100,000 in 2004 to 250,000 last year.

The key real estate risk for the banks, CLSA's Christopher Wood argues, is if regulators act to curb interest-only mortgages for prudential reasons. Such mortgages still account for about a third of all mortgage loans.

Such loans are cheaper for borrowers to service on a cash flow basis, and investors can deduct their interest payments against tax on buy-to-let properties.

Any action to end this "rich man's tax break," as the opposition Labour party has proposed, or any tightening of officially-imposed lending standards, or a combination of both, "could have significant negative impact at the margin in a property market which has for years been driven by credit growth at least as much as it has been driven by immigration."

The Threat of Quantitative Tightening

Most market participants are "massively under-estimating" the likely consequences of major central banks' reversing their easy-money policies they've practised since the global financial crisis, say Incrementum's Ronald-Peter Stöferle & Mark Valek.

The "everything bubble" – values of all investment assets have been bloated by extreme credit creation – "is at grave risk of bursting as more and more liquidity is withdrawn." The contraction in assets of the US Federal Reserve is gradually ratcheting up, and will reach $50 billion a month from October. In total, the Fed's balance sheet it to be reduced by $420 billion this year and by $600 billion in 2019. The European Central Bank will end its bond-buying programme in December.

However, Stöferle and Valek argue: “This monetary normalization plan is unlikely to survive a significant decline in even one, let alone several, asset classes” such as equities, bonds, real estate. In other words, the Fed will reverse course and revert to easy-money policies of low interest rates and bond-buying.

What Machines Can’t Do

Artificial intelligence is a misnomer, Henry Kissinger argues in *The Atlantic* magazine. The machines can outperform humans, and are likely to win any games assigned to them, because of their unprecedented capacity for memorization and computation. But they cannot think in a way that is not subject to mathematical process.

“The driverless car illustrates the difference between the actions of traditional human-controlled software-powered computers and the universe [they] seek to navigate. Driving a car requires judgments in multiple situation impossible to anticipate and hence to program in advance. What would happen, to use a well-known hypothetical example, if such a car were obliged by circumstance to choose between killing a grandparent and killing a child? Why? Which factors among its options would it attempt to optimize?”

His basic point is that machines are not conceptual thinkers, and never will be.

The Brutal Truth about Investment Returns

The key to long-term investment success is to focus on avoiding losses as far as possible, rather than on making capital gains, Russell Taylor advises in *Money Management*.

“The brutal truth of investment mathematics never changes – a sudden fall in a share price can result in a 50 per cent loss of capital, which then requires a doubling of what remains merely to get back to the original starting point.” Moreover, such “temporary market shocks seem to affect prices in a perverse way: the share that has fallen by 50 per cent never seems to be the one that recovers.”

Taylor recommends a strategy that focuses on compounding reinvested dividends as history has shown that to be by far the most important driver of capital gains.

Tailpieces

Risk to German automakers: President Trump is preparing to impose a total ban on imports into the US of German luxury cars, reports *Wirtsschaftswoche*, a reputable business magazine. That would cost them about €5 billion a year, according to one expert estimate.

In an interview last year the president complained about all the Mercedes-Benzs parked outside houses on New York’s Fifth Avenue. In contrast, “how many Chevrolets do you see in Germany?” Now the US Department of Commerce has launched an investigation into car imports to determine whether they “threaten to impair the national security” of the US.

Why does the EU apply a tariff on US car imports four times greater than America does on those from Europe? Such facts underpin Trump policies.

Germany's military: The latest example of their unpreparedness because of obsession with political correctness is that the army is running out of underwear because of directives that such clothing must be made of cotton coming from "sustainable" farming. It can't find suppliers who qualify.

Then there's the problem about giving recruits rifle firing practice. All 180 army ranges for training over distances of less than 50 metres have been closed. Reason is that soldiers are only allowed to shoot when wearing ceramic body armour. Only a few hundred of the ceramic vests are available. The rest are either in use in foreign deployments, or have gone beyond their replace-by dates. So now army recruits are completing their basic training without any rifle shooting practice!

Italy and the dodgy banks: The reason political developments in Italy have been causing so much angst on European bond markets is because of "the ill-health of Europe's banks, which remain bloated and over-levered," says the *FT*'s Chief Markets Commentator, John Authers.

"This makes them vulnerable to risks such as an Italian default." [Italy owes more relative to the size of its economy than any other European country apart from Greece]. "As the banks remain huge, they are effectively too big for their governments to save. It is European banking health that makes any risk to the structure of the Eurozone so toxic."

WhatsApp: The Facebook program is widely used in emerging economies such as India, Brazil and Indonesia, with users sending 60 billion messages a day. But it's said to be "a potential tinderbox for misinformation and misuse" as users can remain anonymous, there is no hint of where messages originate, and everything is encrypted. Govindraj Ethiraj, the founder of two websites that back-check Indian political and governmental claims, says WhatsApp has an "insidious" role as spreader of false information.

China: Billionaire Michael Bloomberg contrasts very short-term US policymaking with the long-term thinking behind Chinese projects such as the Belt & Road Initiative. "They go around the world with time-frames in decades. Unfortunately at the moment America's time-frame is the next temporary budget resolution."

Matchmaking: Getting married is becoming more difficult in Japan as women get choosier about partners… and is becoming more of an organized business. The proportion of couples who meet and marry through specialist agencies has risen to more than 11 per cent. You can invest in this business. One of the most active in "marriage partner" services is a Tokyo-listed small cap,kj IBJ.

US Wise words: *Provide for the worst; the best can take care of itself.* Yiddish proverb.

Martin

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