# Global infrastructure needs

## OVERVIEW

- Global infrastructure needs

## UK

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## SPECIAL FOCUS

- Hedge funds: where now?
Global financial markets were concerned about several issues in late 2018: from US interest rate increases to Brexit; from European political developments to trade tensions. We think that these concerns will ease in 2019.

**Late 2018 uncertainties**
The US Federal Reserve’s fourth interest rate increase of 2018, on December 19th, unsettled financial markets even though the move had been widely anticipated. Markets had already been concerned about a number of issues in the final few months of 2018: uncertainty about the direction of President Trump’s policies on a range of issues; Brexit; European social and political issues; uncertainty about trade and tariffs; and slowing global economic growth. Although we do not see all these issues being quickly resolved, we think they will ease during 2019. By the second half of the year, we think global economic growth will rebound from a temporary softer patch and, with inflation remaining subdued, broad global economic conditions will remain benign.

**Growth and oil**
Developments in the oil market are always a key uncertainty for global markets. Late in 2018, as the oil price had fallen by more than one third from its recent peak (see Figure 1), new production cuts were agreed by OPEC and other key producers in order to try to stabilise the price. There are grounds for thinking this may be successful, but there is clearly a wide range of potential outcomes. In the first half of 2019, this oil price will feed through to lower headline and underlying inflation rates in all the major economies. This will ease any upward pressure on policy interest rates. In the US, that will mean, we think, there will be only one or two increases in the Federal Funds rate in 2019, and those will probably only be later in the year. It is very unlikely that the Bank of Japan or the European Central Bank will raise policy rates at all during 2019.

In the US, we think President Trump will continue to focus on achieving a high rate of economic growth. Help will come from a lower oil price: President Trump has tweeted that this acts “Like a big Tax Cut for America and the World”, a point with which we agree. Trade tensions with China will, we think, ease. Pressure on interest rates will be reduced. And we expect to see some progress on infrastructure building. Plans for a US$1 trillion boost to the infrastructure were part of President Trump’s election campaign in 2016, but so far little progress has been made. US spending on infrastructure is relatively low by world standards and, more important, is expected to be below future needs (see Figure 2).

One concrete example of the shortfall comes from US bridges. Of the more than 600,000 bridges in the US, almost a tenth is considered “structurally deficient” and it will take 37 years to remedy the problems based on current spending (see Figure 3).

Such infrastructure spending can have a powerful effect on economic growth. The multiplier effect from infrastructure spending is estimated, for example, at around 1.6, meaning that for every one US dollar increase in government spending, overall gross domestic product (GDP) increases by US$1.60. Given that the US plans to utilise private sources of finance for much of this infrastructure spending, the impact can be further magnified. Infrastructure spending has a potentially
3. European and US bridges

**EUROPE**

Genoa road bridge collapse raises general concerns about bridge construction across Europe. 30% of road bridges in Europe had some sort of defect, according to a 1999 study.

**UNITED STATES**

Of 612,877 bridges in the US, some 54,259 are “structurally deficient.” They have an average age of 67 years and are crossed by vehicles 174m times every day. It is estimated it will take 37 years to remedy all the problems at the current rate of progress.


Even so, there are a number of concerns about how effective a boost to infrastructure can be over a short time horizon. First, many such infrastructure projects take a long time to plan and implement: not many will be “shovel ready.” Second, McKinsey, a consultancy, has estimated that more than 98% of construction projects worth over US$1bn are late or over budget. The average delay is nearly two years. The average cost overrun is 80%. Third, the financing of such projects can lead to an unwelcome boom in credit growth, as they did in China in 2009-10 (see Figure 5), with subsequent issues in relation to the creditworthiness of the entities financing such projects.

In the US, there are already concerns about some issuers in the corporate bond market having too high a level of debt. While we think that these issues are exaggerated, certainly for investment grade bond issuers (see Figure 6), the market’s appetite for financing such projects cannot readily be relied upon.

4. US fiscal multipliers

*The multiplier indicates how much total output (GDP) changes in response to a US$1 increase in the deficit resulting from the fiscal policy change. Source: EPI (Economic Policy Institute). Data as at 18 July 2017.

While much global infrastructure spending may be needed just to facilitate continued growth, an entirely new infrastructure is needed as the world moves from fossil fuel-based technologies to those based on renewable energy, a trend which is only just starting (see Figure 7).

Great progress is being made on this front, with rapid growth of wind and solar power generation, at costs which are now the same or lower than those for fossil fuels. Coupled with better and cheaper electricity storage as battery power improves and electric vehicles become more popular, the energy, transport and communication infrastructure of the future will look very different.

7. World energy consumption

Source: BP. Data as at 1 January 2019.
After a weak fourth quarter of the year, total returns from world equities in US dollar terms were negative for 2018. That relatively poor performance came after strong returns in 2017.

**Asset market performance**

World equity markets produced negative returns of -8.2% in US$ terms in 2018 (see Figure 8). The weakness came after a strong year in 2017, when returns were as high as 23%. Global bond market returns were modestly negative in the year, as coupon income was not enough to offset capital losses. The US dollar strengthened against most currencies, with the notable exception of the Japanese yen. Emerging markets were under pressure from the rise in US interest rates, the strength of the US dollar and country-specific issues (notably in Argentina and Turkey).

**Bond markets**

The strengthening of the yen against the US dollar turned a modest local currency return from the Japanese bond market into a gain of 3.8% in US dollar terms in the year (see Figure 9). In the eurozone bond market there was a notable divergence of performance: capital gains were seen in the German bond market as yields fell during the year; but Italy stood in sharp contrast, with a rise in yields reflecting concerns about the fiscal plans of the new government. The benchmark US 10-year bond yield peaked at over 3% in early November, but after that fell back sharply to 2.7% at the end of the year, 0.3% higher than at the start of the year. The resultant modest capital loss was offset by coupon income and produced modestly positive total returns for the overall US government bond market.

Australia and New Zealand bond markets produced returns of over 5% in local currency terms, although in both cases currency weakness meant these translated into negative returns in US dollar terms.

**Equity markets**

None of the major developed equity markets produced positive returns in 2018 (see Figure 10). In the US, total returns were minus 5%, although they should be seen in the context of the 22% total returns which were registered in 2017. In local currency terms, several large emerging markets – India, Brazil and Russia – produced negative total returns (-3.5% and -3.3%, respectively), reflecting capital losses as yields rose.

Overall global government bonds produced negative returns (-0.8%) in US dollar terms. Global corporate and high yield bonds also produced negative total returns (-3.5% and -3.3%, respectively), reflecting capital losses as yields rose.

1 All based on Merrill Lynch indices in US$ terms
The US Federal Reserve steered a course to higher interest rates in 2018. With the economy remaining strong, we see the Fed raising rates one or two more times in 2019, most likely later in the year.

Forging ahead
The US Fed pushed ahead with four interest rate increases in 2018 (see Figure 11). That path had been well signalled by the Fed: but the increases were widely criticised by President Trump; and the fourth increase in December contributed to a surge in financial market volatility. In that context, a key issue for 2019 is whether interest rates will rise further. Market expectations are that this is unlikely. Indeed, such expectations imply that we have seen the peak of interest rates during the current tightening cycle.

Further short-term interest rate increases may, if the longer-end of the yield curve remains anchored by continued low inflation expectations, lead to a further flattening, or even an inversion, of the yield curve (see Figure 13) in 2019. A commonly-cited concern is that this has, in the past, proved to be a leading indicator of recession. We still think such fears of recession are exaggerated.

The fact that actual real interest rates are now in line with the US Fed’s estimate of their long-term equilibrium rate (commonly referred to as r*, see Figure 12) also lends support to such a conclusion. However, there are two very important cautionary notes. First, the equilibrium real interest rate may rise in the future if, as we expect, the US continues to maintain strong real economic growth. Second, there is an argument that rates should be above their equilibrium level as the economy is still growing strongly.

Private investment
One reason for that is the potential general boost to US infrastructure discussed in the Overview section. Furthermore, private residential investment is still depressed (see Figure 14). However, the US housing stock is ageing, house prices are rising and credit conditions are generally quite easy. Demographic shifts are also relevant: many in the Millennial Generation (born between 1981 and 2001) are now buying their first homes and the existing housing stock is often not well matched to their specific needs.

1. United States

The first quarter of 2019 will be critical for resolution of the issues facing the UK’s withdrawal from the EU. We think that, maybe at the last minute, a deal will be agreed.

**Path to Brexit**

There is still, even as the 29 March 2019 date for the UK’s withdrawal from the EU nears, much uncertainty about how events will unfold. It could be that the UK obtains some further concessions from the EU on the current withdrawal agreement, enabling parliament to vote in favour of it. It seems that a majority in the UK parliament think that ‘crashing out’ of the EU without a deal should be avoided. However, if the UK parliament does not vote in favour of a deal, there could either be a general election (if the government were to lose a vote of confidence); or, more likely, a second referendum on Brexit. It is difficult to see how either of those could be consistent with leaving the EU by the end of March, so in those cases the timetable may be extended. Amid this uncertainty, it is somewhat surprising that the UK economy has continued to grow, employment levels remain very strong and there has been a pick-up in real wages (see Figure 15).

**15. UK wages and prices**

The government’s estimates of the impact on the economy of the UK leaving the EU range from a modest reduction in GDP (of 2.5% over 15 years, on the basis of the current plan agreed

**16. How Brexit could affect UK growth**

If a second referendum were held, we think it is likely that there would be a vote to remain in the EU for two reasons. First, there have been several second referendums in Europe in the past where, after concessions have been won, the country has changed its mind (see Figure 17).

Second, in the UK, demographic changes since the time of the first referendum (a fall in the number of older people more likely to vote for Brexit and a rise in the number of younger people more likely to be in favour of remaining in the EU) would tilt the vote in favour of remain. Whether that were to happen, or whether a deal along current lines were agreed, we think that reduced uncertainty will help sterling recover from an undervalued position (see Figure 18) as 2019 evolves.

**17. Second referendums in Europe**

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The eurozone economy looks set to recover from a soft patch as 2019 progresses. In France, a fiscal boost should not be undermined by higher bond yields.

**Recovery from a softer patch**

The second half of 2018 saw a softer patch for eurozone economic growth. The implementation of the new Worldwide Harmonised Light Vehicle Test Procedure (WLTP) for fuel efficiency and emissions adversely affected (particularly German) car production. That itself cut German GDP growth by 0.5% in the third quarter. However, the rest of the industrial sector, as well as services, remains reasonably firm. Although economic growth forecasts for 2019 have generally been trimmed a little (see Figure 19) the general picture is for both real growth and inflation to remain relatively stable at around 1.5-2.0% in the next two years.

**Second**, the new German CDU leader, Annegret Kramp-Karrenbauer (AKK), is seen as a “mini-Merkel” providing broad continuity with the policies of her predecessor. Third, in France, labour market reforms have already been implemented and significant tax concessions, in response to the protests by Les Gilets Jaunes, should boost disposable income. Unlike in Italy, where planned tax reductions led to higher bond yields, thereby reducing their effectiveness in stimulating the economy, this is most unlikely to be the case in France. German and French bond yields remain very close, and we expect that to remain the case. Furthermore, there is little indication, as yet, of foreign investors seeking to reduce their holdings of French sovereign bonds, which remain quite high (see Figure 21). That is in sharp contrast to the situation in Italy, where sales by foreign investors undermined the bond market in 2018.

**Calmer politics**

The political situation across the eurozone also looks set to calm somewhat in 2019. The Italian government is now behaving in a less confrontational manner with the European Commission with regard to its fiscal stance. This should see a further narrowing of the bond yield spread between Italy and Germany (see Figure 20).

**ECB bond buying**

There is, however, some concern about the impact of the ECB ceasing its purchases of government and corporate bonds. ECB bond purchases were launched in March 2015 and initially focused on the biggest and most liquid government bond markets. They were extended to include corporate bonds in June 2016. The ECB now owns a fifth of the stock of eligible corporate bonds and about a quarter of eligible government debt. Coupon and redemption proceeds from these bond holdings will be reinvested for the time being. Consequently, we expect the impact on bond markets to be contained. Any increase in the ECB’s policy interest rate (the overnight deposit rate has been minus 0.4% since March 2016) still appears to be some way off: perhaps not until 2020.
Economic conditions in Switzerland are stronger than those in the eurozone, yet interest rates are lower. However, the Swiss National Bank (SNB) is unlikely to raise interest rates before the ECB.

Following the sharp appreciation of the Swiss franc in January 2015, the Swiss economy slowed markedly, but subsequently recovery set in quickly. Economic activity rose gradually, with GDP growth peaking above 3% year-over-year in the first half of 2018. The labour market is strong and property prices are growing modestly (although they have perhaps become a little high in absolute level). The economy has since slowed (see Figure 22, which shows two key barometers of Swiss activity) but it is still expected to have grown by about 2.5% on average in 2018. Overall, the Swiss economy has been doing well in recent years.

Reassuringly, the low level of inflation allows the SNB to maintain an accommodative monetary policy (see Figure 23). At 1% year-over-year, CPI inflation is in the middle of the 0-2% range that the SNB uses as its definition of price stability. However, CPI inflation has been rising together with global oil prices. Services price inflation, which constitutes a large part of the CPI basket, can be thought of as a simple measure of underlying inflation, and has been fluctuating around 0.5% year-over-year since 2012. This suggests that inflation may still be a little too low for the SNB, although it is well within the 0-2% range.

Given Switzerland’s high openness to trade, it is unsurprising that the main risks to the Swiss economy relate to developments abroad. Recently, economic activity slowed sharply in many of Switzerland’s export partners. Although, it is too early to tell whether the global economy is hitting a temporary soft patch, it is decelerating to its steady-state rate of growth or if it is the start of something more sinister, this is an obvious cause of concern for the Swiss National Bank (SNB).

Finally, we note that the exchange rates of the Swiss franc against the euro and the dollar have been broadly unchanged in recent years. This suggests that, while strong, the currency is not blatantly misvalued.

With Swiss short-term interest rates at an exceptional -0.75% (see Figure 24), it is hard to believe that making monetary policy marginally less accommodative will lead to a deterioration of economic conditions.

While the SNB is unlikely to move in advance of the ECB, there are several reasons why it might want to do so. Economic conditions in Switzerland are stronger than in the eurozone, as evidenced by its positive output gap. Swiss inflation is closer to the SNB’s objective than eurozone inflation is to the ECB’s objective; the Swiss economy has proved resilient to a strong franc and any overvaluation appears modest. Given that the ECB is unlikely to start to raise interest rates before the autumn of 2019 at the very earliest, rates will remain low in Switzerland for some time.
Forty years on from China’s first moves to reform its economy, the country has clearly made great progress. We see the next phase of its development as being at the centre of a dynamic Asian region.

Forty years on
In the forty years since China’s first moves to open up its economy were taken in December 1978, the economy has grown enormously. It is now 88 times larger than it was then, measured by GDP in current US dollar terms (see Figure 25). That translates into an annual average growth rate of almost 12%. It is now an economy with a GDP (at current exchange rates) of US$13 trillion, two-thirds the size of the US. India, starting its reform programme later and more hesitantly, lags far behind.

Given that China and India are similarly populous (1.4 billion and 1.3 billion people, respectively, in 2018), GDP per head in China is two and a half times larger than in India (see Figure 26). But, on that measure, China is still far behind those Asian economies that grew rapidly from the 1950s onwards: Hong Kong, Taiwan, Singapore and South Korea.

Looking ahead, demographics may now start to curtail China’s potential growth. Lessons from Japan are interesting: its working age population peaked at 73% of the total population in 1997, just as many decades of strong growth came to an end. Growth has now been stuck at a low rate for several decades (see Figure 27). China has just passed a similar peak in the population of working age (70% in 2017) but India’s working age population will continue rising for many years to come. That argues in favour of India potentially delivering stronger growth than China.

One solution for China suggested by Japan’s experience is for people to work for longer: the share of over-65s working in Japan is much higher than in other economies around the world, for example (see Figure 28).

That may well happen but China’s future, as we see it, lies to a much greater extent in embracing trade with the rest of Asia and along the new Silk Road to Europe and Africa. China’s domestic growth may slow, but the country will continue to have a pivotal role in the broader Asian region and, indeed, throughout the world.
Brazil and Mexico both have new presidents. Both presidents are intent on bringing important changes to their economies. Which one will prove to be the more successful?

**Inflation and interest rate trends**

One recurrent issue for Latin American economies has been high inflation and interest rates. In 2019, however, inflation looks set to remain subdued in the main economies in the region (see Figure 29), typically in a 2-4% range. That is a rate which is more characteristic of western developed economies than those of Latin America.

Yet interest rates are still elevated in both Brazil and Mexico, meaning that real interest rates (see Figure 30) are high in those two economies. This provides an interesting return opportunity. Yet, the attractions and challenges in those two economies go far beyond any considerations of inflation and interest rates. No less than the future structure and functioning of the two economies is at stake under their new presidents.

**Brazil**

The fractured nature of Brazil’s Congress, where the party of President Bolsonaro holds less than 10% of the seats, suggests that passing needed reforms may be difficult there as well. The University of Chicago-trained economist Paulo Gueddes has been placed in charge of the economic reform programme, with changes to unusually generous state pensions high on his agenda. He is likely to maintain the freeze on public spending initiated by the previous government.

Reforms of the nature being planned in Brazil and Mexico can normally be expected to have some short-term adverse effect on economic growth. In that context it is hard to judge which economy will prove most resilient, but we would expect Brazil to grow marginally faster than Mexico in 2019 (see Figure 31).

**Mexico**

Historically, Mexico has been regarded as a better-run economy than Brazil, embracing a western style of technocratic economic management as long ago as the 1980s. More recently, however, the difficulties of combatting corruption and the excessive power of state organisations led to a desire for change. The figurehead for that change is President Andrés Manuel López Obrador, or AMLO, as he is known. So far, however, his populist agenda has proved disconcerting for financial markets. Most notably, in October he said he would cancel, on the back of a referendum, a US$13bn new airport in Mexico City which was already one-third built. Nevertheless, a new version of NAFTA (the North American Free Trade Agreement) has been successfully negotiated with the US and Canada (and given a far less memorable name – the USMCA, US-Mexico-Canada Agreement). AMLO has a reputation for being frugal, able to bring discipline to public finances, although these are, certainly by the standards of the region, not badly run. Policies of clamping down on corruption are, of course, highly commendable but quite how much can be achieved remains to be seen.
Hedge funds came to prominence in the early 2000s, notably because they produced positive returns in an equity bear market. 2018, however, was another poor year for hedge fund returns. How should we see this development?

**Hedge funds: a 25-year perspective**

In the equity bear market of 2000-2002, when the MSCI World Index almost halved in total return terms (see Figure 32), hedge funds came to prominence. The generic claim made by many such funds – that their returns were not correlated with overall movements in the financial markets – received support from the fact that during that equity bear market they produced (albeit modest) positive returns.

Over the twenty-five years of hedge fund returns shown in Figure 32, the annual average compound return has been very close to that from the MSCI World Index (7.3% p.a. compared with 7.4% p.a., respectively). Hedge fund returns have, however, been far less volatile (with a standard deviation of 6.7% p.a. compared to 14.5% for the MSCI World Index). On this very broad analysis, therefore, the case for exposure to hedge funds remains intact: similar, but uncorrelated returns to equities, but with lower volatility.

**2018: a difficult year**

2018 was, however, a difficult year for many hedge funds with an overall modest negative return (in the eleven months to end-November 2018 from the Dow Jones Credit Suisse Hedge Fund Index). Furthermore, the last year that returns exceeded 10% was 2010: since then average returns have been just 3% p.a.

How can we explain the recent poorer performance? There are four main factors.

First, the hedge fund industry has growth in size. As more capital has been deployed, market inefficiencies have, arguably, been eliminated more quickly.

Second, the industry tends to be prone to herding behaviour, with favoured trades quickly becoming crowded. We saw evidence of that in early 2018, for example, when there were substantial net long positions in oil, in anticipation of a continued rise in the oil price (see Figure 33). As the oil price fell, these positions often proved unprofitable.

Third, weakness has been concentrated in several specific types of hedge funds: those using quantitative strategies; those taking offsetting long and short positions; and several macro hedge funds seeking to take advantage of broad economic developments. Several quantitative strategy hedge funds faced difficulties in 2018 as a result of quite rapid changes in the direction of financial markets. Generally, such strategies work better in trending markets. Long-short hedge funds experienced difficulties for three reasons: they generally have a long bias and so were adversely affected by the negative returns in equity markets; sectors and stocks (such as technology) which did well for much of 2018 and which were favoured by many hedge funds performed poorly later in the year; and the rapid decline in equity markets at the end of the year did not provide much time for hedge funds to adjust their positions. Some macro-driven strategies have been unsettled by the quite sharp softening of the global economy, especially late in 2018.

One final factor is suggested by Sebastian Malaby, author of an extensive study of the hedge fund industry: there has been a general trend for the industry to become more conservative as assets under management have grown. The “2 plus 20” fee structure – a 2% management fee and 20% of the upside above a certain hurdle rate – used to be considered a strong incentive to generate returns above the hurdle rate. Now, as assets have grown, the 2% fee itself may provide an adequate reward for some managers, who are consequently inclined to adopt more conservative strategies.

We still see hedge funds as potentially useful and valuable financial instruments. Careful selection of hedge fund managers remains, however, of the utmost importance.

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