THE WATCHLIST 2024

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Watchlist 2024: Boiling over?

On many fronts, 2023 lived up to expectations and surprised along many more – few would have predicted David Cameron making a box office return to frontline politics this year. Conflict in the Middle East, so perennial a theme that it is almost a proverb, exploded in a new, terrifying direction. The Russia-Ukraine conflict ground on. A banking crisis in the US and Europe betrayed the dangers of central banks (CBs) turning off the liquidity taps and pursuing one of the most aggressive periods of monetary tightening in memory. A false prophet of the crypto world was brought crashing down. Inflation cooled but remained too high as the global economy spluttered along, defying expectations, whilst bond yields surged to the highest levels since the global financial crisis. Stocks also defied gravity, riding on a wave of inflation and AI in equal measures; the Magnificent 7 trotting into town to tame bears.

So, what could be in store for 2024? We may sum it up with one word: conflict; chiefly the conflict between the unipolar and the multipolar world views playing out in favour of the latter. Ongoing conflict in the Middle East and Ukraine and continued trade conflict between the US and China seem unavoidable; whilst we may also look towards the battle for the soul of America; the fight for the post-Brexit Britain ideal; the conflict between the net zero agenda and the pressing reality of life; even a renewed bout of currency wars and an existential fight for cash.

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1. The Global Economy: Fighting to Avoid a Hard Landing

Boiling the frog? The global economy continues to limp along with remarkable resilience despite unprecedented monetary tightening by central banks. Recovery from the pandemic has been solid enough – the US continues to lead the way. The Euro area has limped along gamely but Germany has really started to suffer, China has been hobbled by its property market woes and the US consumer runs hot on a mix of fiscal and monetary easing during the pandemic that is still swashing around. War and inflation remain giant headwinds to animal spirits. Structural shifts are taking place under our feet as globalisation gives way to mercantilism; deflation to inflation; peace to war. So, what of 2024? The headwinds may become stronger as the shift gather pace. First, we could look to the US, where the Fed predicts a feather-lite landing with ultra-hard policy rates. Surely this is overly-optimistic? The IMF thinks the global economy is still heading for a soft landing, despite a multitude of headwinds.

Faced with these headwinds, markets could be less assured and priced for central banks to reverse rate hikes next year. There is a risk, however that the softness of the landing sees inflation reaccelerate, leading to further tightening. And even if central banks are done, we must respect the long and variable lagged effects of monetary policy tightening.

We are not sure whether the mood of 2023 tells us much about the unknowns of 2024. Or rather, does it matter what the Fed and other central banks, forecasters etc believe will be the policy next year? The wild swings in bond markets throughout 2023 show the market changes its mind a lot. And in the words of Mike Tyson everyone has a plan until they get punched in the face. Next year if we have a major recession could it punch the Fed in the face – but would they revert to cutting to stimulate?

The reason why I think risks for growth are heavily skewed to the downside is that I don't think they do – the inflation paradigm has shifted and CBs are avowedly "Higher For Longer". In our 2023 Watchlist, I talked about a kind of rolling recession – no major collapse, headline growth rates nominally positive but a kind of 'recession but not as we know it'. It's the inflation effect. Despite monetary tightening by the Fed, ECB and other major central banks, there was still a lot of stimulus working through the system – from the IRA in the US, to easing by the PBOC and the Fed's liquidity backstop in the wake of the banking crisis. As we move into 2024, the forces weighing on growth in 2023 should only become more pronounced: conflict risks, deglobalisation, trade wars, etc. The frog is being boiled but he won't notice until the water is too hot. It seems likely that central bank tightening will lead to a synchronized global downturn in 2024. Moreover, the uncertainty of US elections and the wider geopolitical outlook are important factors to consider.

So far, the world's economies have handled higher rates better than we might have been expected. With so much tightening already in the pipeline, perhaps the greatest risk for the global economy may be that central banks not only maintain the degree of restriction baked in by rate hikes, but deepen it. There is a risk that inflation picks up again, encouraging central banks to continue hiking into 2024, which could be the catalyst required to begin a synchronised global recession in 2024. In my view, a notable uptick in inflation expectations in the US in Q4 would should be a notable concern And remember, war is inflationary.

Faced with these kinds of headwinds, wouldn't central banks just slash rates? Whilst this is a possibility, it may be likely that they stay restrictive longer than they might otherwise because inflation remains so persistent. It could be characterised by being way too loose on the way in and way too tight on the way out, although this may be too simplistic a take and ignores the problem of persistent inflation.

In short: slowing to negative growth, sticky inflation and rates staying higher for longer: we appear to be entering the stagflation arena. This may be too pessimistic a view – a soft landing, rate cuts, real household income growth and an AI-driven surge in productivity is the alternative take. A recession might be different this time. Governments are unlikely to provide relief. CBs will not cut – at least not beyond slicing rates in attempt to maintain the degree of restriction broadly with what they are doing now. This is nuanced and different in each case – the BoE cannot stand rates as high as the US even if inflation is worse.

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2. Global conflict:
From Ukraine to Gaza, and where next?

"This may be the most dangerous time the world has seen in decades."
- Jamie Dimon

Multipolarity – a new world order: the US-China trade war, the global pandemic and Russia's invasion of Ukraine; three horsemen of regime change in the world's geopolitical and economic shape. The fourth – escalation in the Middle East, a Chinese invasion of Taiwan, or perhaps the end of the dollar's hegemony? Last year we talked about a Chinese invasion of Taiwan being a tail risk – this remains the case but the sense of a world entering a new phase of geopolitical uncertainty and conflict is getting stronger. On Ukraine the IMF warned that the invasion will *"fundamentally alter the global economic and geopolitical order should energy trade shift, supply chains reconfigure, payment networks fragment, and countries rethink reserve currency holdings. Increased geopolitical tension further raises risks of economic fragmentation, especially for trade and technology".*

Almost two years on and this remains the case. We are entering a new long-term phase of global instability as the post WW2 consensus buckles under the strains of massive fiscal deficits, mass migration, ageing populations in the West and deglobalisation – a new paradigm. Governments are likely to raise more taxes, incur higher deficits and need to spend more on defence than they have done since the end of the Cold War. In a speech I cited many times over the last year, European Central Bank president Christine Lagarde warned of a world of "more multipolarity as geopolitical tensions continue to mount". She was no outlier: talk about fragmentation and deglobalisation littered the speeches of central bank policymakers in 2023

First Ukraine. Now Israel. This is the multipolar world; and it doesn't stop here. The fear is that this is the beginning of a multi-front, multi-phase, conflict – in essence a global conflict (world war?) in the making. It won't be a straight nuclear shoot out with the Russians or Chinese, but an escalating conflict fought horizontally on multiple fronts requiring ever increasing deficits and spending to finance our aims. Where else might we look for conflict? Violence between ethnic Serbs and Albanians has been simmering in Kosovo. Azerbaijan and Armenia have fought sporadically, Yemen has gone through horrors of late. For a potential earth-shattering conflagration we need to look to the East; and a potential move by Beijing to invade Taiwan. So, is now the time for China to annex Taiwan? Probably not – the base case would assume some years in the future, but that time is, surely, getting closer. US Treasury Secretary Janet Yellen said the US can 'certainly' afford to support wars on two fronts, referring to Ukraine and Israel. But a third? It would have to, but then we enter the realm of even higher deficits, more risk, more conflict. The only bigger danger, perhaps, is if America takes a step back.

3. US Election:
Gloves off for Trump win

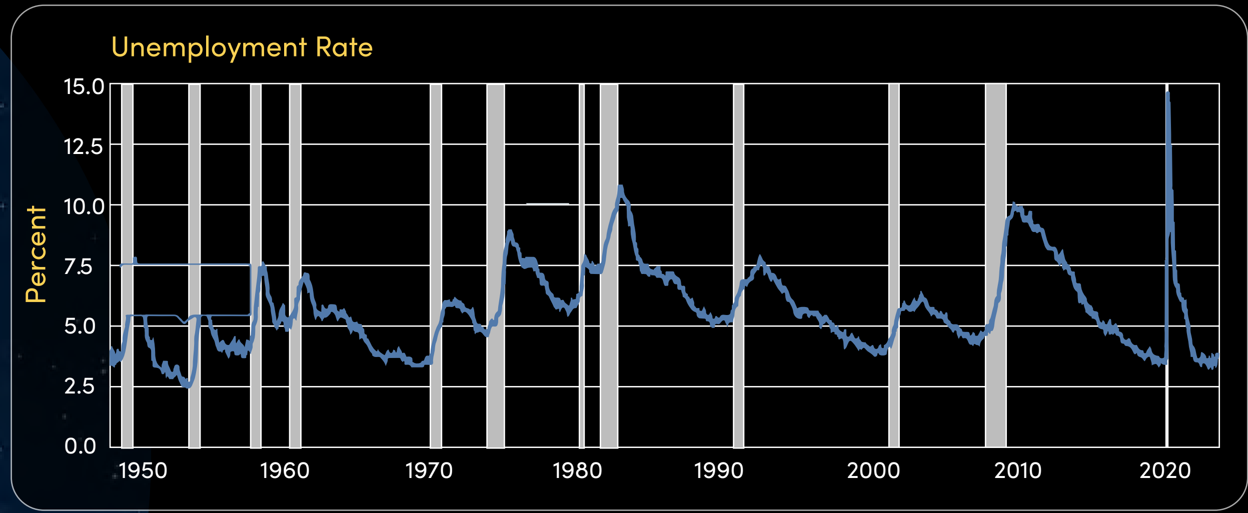
"Praise the Lord and Pass the Ammunition"

This will be a proper street fight, and Trump might be the tougher brawler. Foreign policy fiascos aside, it will come down two key things: the economy and the extent of polarisation: how much do you not want the other guy. Exactly a year before the election, polls showed Trump leading Biden in five of six key battleground states. The Republican frontrunner lead in Arizona, Georgia, Michigan, Nevada and Pennsylvania, with Biden ahead in Wisconsin – the incumbent president took all six in 2016. The election campaign kicks off properly with the Iowa Republican primary on January 15th and by March next year we should have a clear idea of who's going to be contesting the November poll.

Although the labour market and economy in the US held up pretty well in 2023, . The reason might be obvious enough – living standards. Inflation is still too high, and people generally feel worse off. There are obvious concerns about the hard landing that the Fed is so keen to avoid – whether the US actually enters a technical recession or not, people don't feel too great about things. Americans appear to have become a lot more pessimistic since the pandemic. Over 40% of people expect the economy to be worse in the next five years than better. This is worse than in the aftermath of the GFC in 2010 when unemployment was at 9%.

So, what's up? There may be various factors – social media amplifying fears; a series of miserable events from Covid to the war in Ukraine. We might also put it down to the kind of wistful longing among the American middle class for something their parents took for granted: that things will get better over time. The shifting sands of globalisation and its retreat make for a more uncertain world. And we should note inflation plays a crucial role in shaping kitchen table discussions about who to vote for.

What happens if Trump wins? If the Republicans gain control of the White House and Congress, it puts Biden's signature Inflation Reduction Act (IRA) in doubt. This could have consequences for sectors like energy, and more broadly for markets in general.



Unemployment is really low – why the gloom?

What about foreign policy? Trump may well choose to 'put America first' by jilting Ukraine. This may result in less guns and money heading to Ukraine (realtors on the Cote d'Azur look away!), but we cannot know for sure what material impact this would have on the war. The fear in the West is that a Trump unshackled by thoughts of a further term would run roughshod over alliances and treaties, especially Nato. The uncomfortable truth for Democrats is that he didn't do this when he was in power and it seems unlikely he would do so now. In fact the world was a much peaceful place under Trump because he was seen as a strong man. On Ukraine, well, we already see signs of fracturing among the allies amid war fatigue that has nothing to do with Trump.

For Taiwan, the stakes could not be higher. Which leads us to China and the extension and furtherance of trade wars. Some argue that we could be 'stunned' by a Trump-led détente with China. I think nothing could be further from the truth -it was Trump who pushed the Chinese relationship to breaking point, not his Democrat predecessor whose own VP is now President. Biden may have taken as tough if not a tougher line on China; but that does not mean that Trump views Beijing as a point of differentiation. A Gallup survey in March showed just 15% of voters holding a positive view of China, the lowest since polling on the issue began in 1979. Sounding tough on China is not going to be unpopular.

Everyone always wants to know how the stock market does in election years and what a Republican/Democrat victory will mean for returns. Election years tend to underperform and realised volatility tends to be higher. But equities often rally in the weeks after the election as the uncertainty goes away – remember the Trump bounce!? We might be in for another.

4. The Fed and the bond bear market

Respect the lags: Where now, bonds? A worried man with a worried mind; it could be the words to describe Fed chair Jay Powell. It's also the first line of Dylan's Things Have Changed, an apt song for this chapter. Finance professionals who entered the industry as far back as 1985 have known only one thing – bonds go up, yields go down. But the bond bull market is over – the inflationary regime change has wrought major changes for fixed income, and we seem to see a long-term secular bear market. The Fed put is gone, deficits are rising. The great bond bear market has already wreaked havoc – but as we enter 2024 is the bear dead or just hibernating? Back in September the Fed's projections revealed their hand. The big change was for the dot plot in 2024. It signalled real rates could be much higher – the core CPI forecast was unchanged at 2.5% but the median expected Fed funds rate was revised up to 5.1% from 4.6%. Simply, this implied the Fed will keep rates more restrictive for longer.

It's able to do this because the economy remains solid, and the labour market has held up remarkably well. For example, the expected unemployment rate was revised down significantly (to 4.1% in 2024 from the June forecast of 4.5%) and is projected to stay there through the forecast period. Further ahead, rates are expected to be seen 50bps higher through 2025 as well with the median at 3.9% from 3.4% in June, falling to 2.9% in 2026.
Fed officials are predicting higher growth and inflation and rates, for longer. Does this add up? The Fed seems to be saying they've ascended the (rate hiking) stairway to (economic) heaven. And who can argue? Unemployment remains near decades-lows, growth is good albeit spluttering a bit into the year-end and the Fed revised up its GDP forecast for this year and next; all whilst carrying out the most aggressive hiking cycle in decades and intending to maintain more restrictive policy for longer. Call that American exceptionalism or something. Few seem to be fretting about a hard landing.

But could this change? As we discussed above, the effects of monetary tightening are still to be fully felt – the economy cannot run counter to reality forever.

If headwinds strengthen, the question for bonds is really what is the reaction function of CBs? Post GFC the reaction function was clear; post-pandemic comedown it's far less clear. The question in 2024 is this: does the Fed lean back on old habits and cut when things get tough next year? Or, rather, faced with sticky inflation, does it stick to the higher for longer mantra?

If the Fed sticks to the dots roughly and does a first cut in June next year, the current trends indicate headline & core CPI will be between about 3-4% - could this be taken as an implicit admission that it is tolerating higher inflation?
Frankly, I think it will need to – things have changed. So, the Fed cuts – disinflation means that leaving rates where they are would make policy more restrictive just as inflation and growth cool...which would not make sense. So higher for longer, but a cut is coming.

But long term it seems likely that fixed income remains firmly under pressure because budget deficits are soaring in the US and elsewhere.

In Europe, Italy and France are signalling that budget deficits are rising – investors are starting to awaken to the fact that they are going to be bigger for longer. Italy said the fiscal deficit this year would be 5.3% of GDP, up from a forecast of 4.5% earlier this year. Next year's forecast deficit was raised to 4.3% of GDP from 3.7% earlier this year.

The deficit picture is key. It's not just perennial offender Italy; the US cannot get close to getting its deficit down and everywhere in the West spending is rising. Inflation, surging migration and spiralling healthcare costs put even more pressure on the budgets of European and US governments.Bond vigilantes are back – higher structural deficits are a problem when the CBs are not there to mop it up. CBs had kept the vigilantes quiet for years but higher for longer has let them out.

Huge issuance and Fed QT: can the market absorb all that issuance just when the Fed steps out? It seems to have – retail and institutions are buying the bonds that the Fed is not...but demanding a much higher yield – they are far more discretionary than the automatic buying of the Fed. It was never really about 'who' would buy the Treasuries but 'what' price they would pay. We are finding out they appear to want more bang for their buck. Indeed the Federal Reserve Bank of New York's gauge of the 10-year term premium turned positive in 2023 – a sign that investors want more return for holding duration and points to the long end staying higher for longer.

Japan is also a factor as it exits its policy of yield curve control (YCC) – albeit slowly – and seems to be mechanically pushing up global bond yields. Investors appear to be scrambling to be on the right side of it when it does pull the trigger on exiting negative rates.

The key risk for the market though is this: does weaker economic data bring down long-term rates, or do they stay higher for longer and therefore a lot more restrictive for longer? As the IMF puts it, the risk lies more in premature celebration.

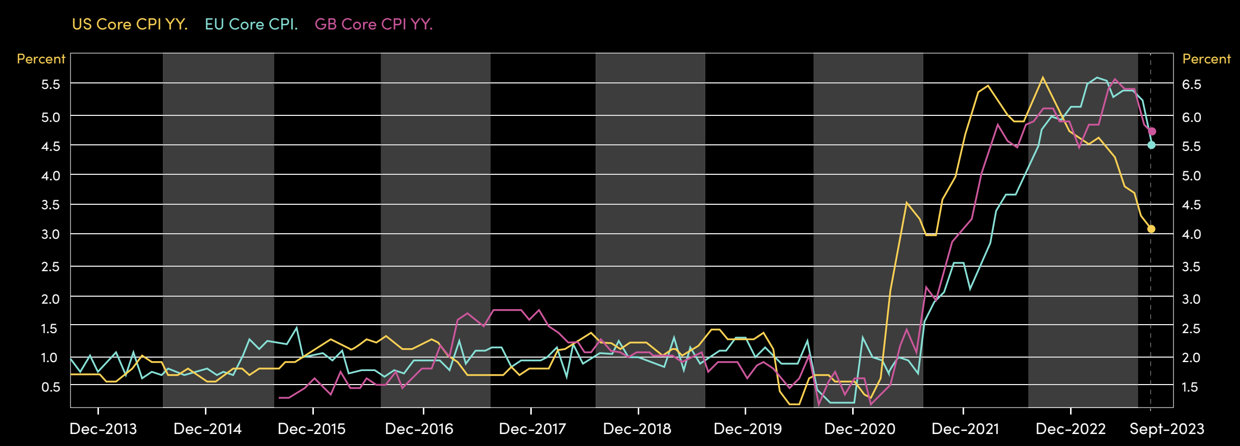
"Most unresolved episodes [in sustainably reducing inflation] involved 'premature celebrations' where inflation declined initially only to plateau at an elevated level or re-accelerate."

5. Inflation resistance:
the last mile is the hardest

"The key policy challenge today remains fully taming inflation, and the last mile is typically the hardest. The burden is falling on many shoulders, but the risks from not acting promptly will be greater in the long term. Central banks are committed to staying the course to restore price stability and protect people's purchasing power". – Agustín Carstens, General Manager of the BIS

Inflation is proving resilient, sticky. This looks as though it may continue through 2024 even if the big inflationary shock has passed. Getting inflation back down to 2% - the target set by most central banks – will elude them. The last mile is going to be the hardest. Inflation is expected to stay above 2% beyond 2024 in most of the G7. It's come down a lot but been noticeably resistant to dipping below 3%. Wage growth has not normalised – bumper pay agreements with unions proves the point. Even in Europe, where growth is weaker and inflation has fallen below 3%, wage growth is still high. To absorb higher wage growth you need one of two things: lower profit margins or better productivity, neither of which have been common in recent years. The Bank of England expects inflation to keep on falling in 2024 and reach its 2% target in the first half of 2025. The Fed thinks core PCE inflation will fall to 2.6% next year from 3.7% in 2023. But neither is anywhere close to this yet and their record on forecasting has been less than stellar. Meanwhile China is dealing with outright deflation, which threatens stability in financial markets.

The problem is partly structural and partly the un-anchoring of expectations. Even as we saw decent disinflationary trends as 2023 progressed, there is a degree of stickiness in core inflation that monetary policy alone won't shift, which is why to a large extent expectations have not fallen. For example, US Conference Board one-year-ahead inflation expectations jumped to 5.9% in October – way ahead of where CPI trended, and indicative of the psychological impact of inflation and the entrenching of expectations. UoM year-ahead inflation expectations inched up in November to 4.5% indicating that the large increase between September's 3.2% reading and October's 4.2% reading was not a mistake or a one-off. The current reading is the highest since April 2023 and remains well above the 2.3%-3% range seen in the two years prior to the pandemic. Long-run inflation expectations also rose to 3.2%, the highest reading since 2011.



Core inflation is coming down, but remains too high for central banks

Market-based assumptions have also been stubborn, as evidenced by the 5-year, 5-year forward inflation expectation rate. As Jay Powell put it: "If you expect inflation to go up 5% then it will".

Meanwhile the structural bits have changed too - the ECB is warning that so-called friend-shoring – i.e. retrenching from China – will be inflationary – the inflationary paradigm has changed – the forces of multi-polarity, deglobalisation etc are going to lift prices. *"...from a purely economic perspective, trade fragmentation would entail sizeable costs in terms of substantially distorted trade, decreased welfare and higher prices,"* the ECB says. This goes to the very heart of the matter – deglobalisation, war, fragmentation... it's a new inflationary paradigm. ECB Executive Board member Isabel Schnabel put it succinctly: *"Underlying price pressures can prove much stickier than volatile commodity prices...the disinflation process is projected to slow significantly." "The 'last mile' before we reach our inflation target may well be the hardest,"* Bundesbank head Nagel said, echoing comments from many other central bankers, not least the central bank of central banks, the Bank for International Settlements.

Inflation will be lower in 2024, but not low enough for central banks to declare victory. Even if they begin to tacitly accept higher inflation, they will need to accept a higher r-star, or neutral rate of interest into the bargain.

6. Bank of Japan:
fighting the tide no more?

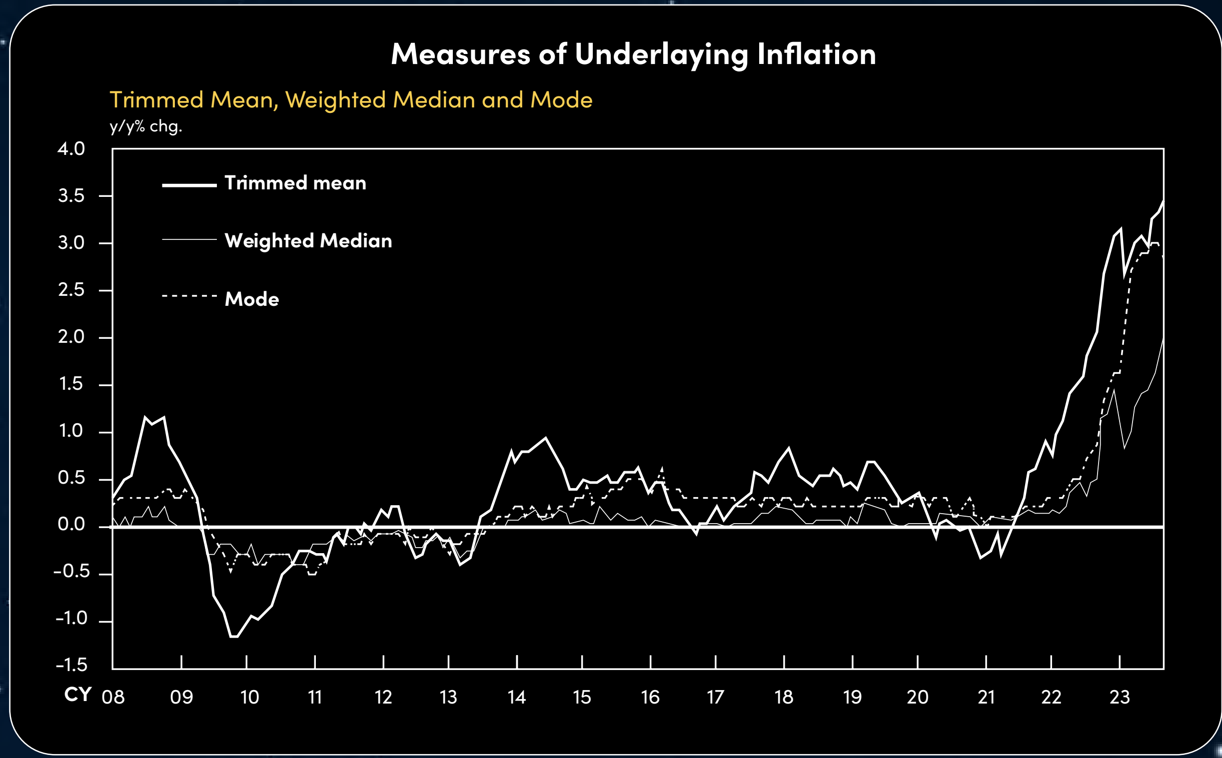
The Bank of Japan has been lurking all year, the spectre of policy normalisation hanging over markets throughout 2023 without ever really becoming manifest.

It's been in go-slow mode. The BoJ sort of tweaked its yield curve control policy at the end of October, only redefining the 1% cap as a loose "upper bound" rather than an absolute cap. The BoJ had earlier raised the ceiling from 0.5% to 1% in July and markets had been waiting for the next move. But it's been painfully slow to exit YCC and ultra-loose monetary policy. Governor Ueda is right to point out unwinding ultra-loose policy is a "serious challenge". The risks are that this becomes more disorderly in 2024 as it scrambles to catch up with the other three global systemically important central banks – the Fed, ECB and Bank of England. These head into 2024 essentially on pause – they are waiting to see what happens next with the data – this could signify a cut down the line, but have not yet signalled they won't consider another hike.

Does the BoJ finally normalise policy in 2024? Surely it does. The BoJ has repeatedly said it will maintain ultra-loose policy until inflation hits 2% on a sustainable basis and it is close to reaching this point as per its own reading – the weighted median y/y reading has risen to 2%. Japan's headline monthly core inflation reading has remained above the BoJ's target for 18 months. Wage setting behaviour is changing.

YCC cannot survive much longer. Japan is chucking billions of dollars to prop up the JGB market in an unsustainable fashion. It has also been burning FX reserves to stem the depreciation in the yen. And it can no longer hide behind soft inflation.

There is of course a concern that a sharp repricing will result in quick sales of debt and other assets, resulting in contagion across other asset classes – Japanese equities and the yen would be among them. An interest rate shock – which abandoning YCC would cause – will expose undesirable levels of leverage on many a corporate balance sheet. It could send shockwaves through global interest rate markets. The effects could be worsened if it comes as US quantitative tightening really starts to put the squeeze on global liquidity. And Japanese investors own a lot of foreign assets. If Japanese bonds start offering a decent yield, we should expect a fair amount of repatriation; i.e. selling of dollar or euro or whatever denominated assets. The BoJ will be a significant force in supporting global bond yields in 2024.



Inflation is rising and becoming more entrenched; the BoJ cannot stand still for long

7. Central banks fight for control:
Tacit vs explicit

Inflation will be down towards more comfortable levels – the big shock is over. But the last stretch – the last few yards to 2% - will prove the hardest because we are now in a new inflationary paradigm... this will inevitably lead to discussion and ultimately implementation of a kind of tacit or explicit acceptance that inflation will be higher for longer. As the Bank for International Settlements put it, the last mile will be the hardest. The theme at Jackson Hole - Structural Shifts in the Global Economy – was something of a tell. Deglobalisation, climate change, ageing populations, war – all are more inflationary. The genie is out of the bottle.

A future British government should raise the Bank of England's inflation target from 2% to 3% to give it more room for manoeuvre during economic downturns. So says the Resolution Foundation, in a report in that lays out how to create a more sustainable macroeconomic framework for the UK.

The rationale is to escape the debt ratchet – higher nominal rates in good times mean you can cut more in the bad. It's been coming. We've heard mutterings about allowing central banks to raise their inflation targets and for I've been saying for a while now that CBs will either explicitly or implicitly need to accept they are not going back to 2%. Probably the tacit acceptance will just become de facto policy. Former Bank of Japan Governor Shirakawa wrote in article for the IMF earlier this year on inflation targeting, urging "now that we know its limitations, the time is ripe to reconsider the intellectual foundation on which we have relied for the past 30 years and renew our framework for monetary policy". This was just one example of the debate. Many though still think abandoning would be disastrous. For what it's worth, Shirakawa was sceptical of the merits of raising the inflation target. Certainly, in the current cycle it will be tough to admit it without allowing expectations to run free again – this is already happening somewhat as the Fed and others signal they are at the peak in rates. Jason Furman, an economic policy professor at Harvard argued that the Fed should shift to a higher target range for inflation. Nobel laureate Paul Krugman agreed. The Fed is not being led down this road just yet. *"We think it's really important that we do stick to a 2% inflation target and not consider changing it,"* Powell said in his semi-annual testimony to the U.S. Senate Banking Committee. The obvious risk for central banks is that raising the inflation target would unleash a new wave of inflationary pressures, just as – I would argue – the introduction of the doctrine of average inflation targeting did in 2020. The 2% inflation target *"really anchors inflation"* because *"the modern belief is that people's expectations about inflation actually have a real effect on inflation. If you expect inflation to go up 5% then it will,"* he said. Or as the IMF puts

it in more academic terms, "empirical analysis uncovers an increasing role of near-term inflation expectations for inflation dynamics".

The Resolution Foundation report argues it would ideally need to be done in coordination with other central banks. This of course is an absolute must – the consensus around 2% is widely held. Bond markets are nothing if not global in nature and deeply correlated in practice. We will need a new Plaza-type agreement to shift from 2% to 3% and absorb the implications of such a move. I think CBs have already tacitly accepted they are not going back to 2%; the process now involves normalising this idea to the extent that it is not radical when it becomes official policy. If they have not accepted it they are deluding themselves. If central banks accept that the last mile to 2% is beyond them, then what of policy decisions? If CBs adopt a symmetrical approach to this tacit policy shift, then they would tend to be earlier to cut rates in 2024, and do so with greater vigour. Central banks are however explicitly committed to the 2% target still, which supports the theory that they will remain 'higher for longer'. Just how high and how long is the unknown. For me the higher for longer mantra fits with the tacit acceptance of higher inflation – they won't keep hiking until it breaks, but they are in no hurry to cut because that would entail the tacit becoming the explicit acceptance of a higher inflation target – and they are not ready for this step yet.

8. The Fight For Cash:
CBDCs take flight

Timeo Danaos et dona ferentes

Central banks have not been very good at forecasting of late. This has led to policy mistakes, which they will come to blame partly at least on their inability to properly monitor the economy under the current system. The answer to this straw man argument is the need for a CBDC where flows can be analysed in real time. Many components are already in place for CBDCs. The New York Fed has been trialling tokenized deposits in combination with a CBDC for several months; several other countries have also launched trials.

The Bank for International Settlements says about two dozen central banks will have their own CBDCs by 2030.

This is not the place to get into a discussion over whether or not CBDCs are a 'good thing' or not. What's interesting is the way they have been caught up in a broader cultural battle between two sides with differing views on what our society should be like. *"One of the things we're going to ban in Florida this year is the idea of a central bank digital currency,"* Governor Ron DeSantis said. A UK Parliament report makes that point that CBDCs are a solution "in search of a problem". "We have yet to hear a convincing case for why the UK needs a retail CBDC," the report concludes.

In the post-pandemic world – where fears about state control and people being 'nudged' to behave a certain way – CBDCs are a totem of the overreach of the system. Perhaps only cash sets you free to spend as you like; governments could stop you spending on certain goods or services if they have control of the digital cash in your digital wallet. Republican presidential contender Vivek Ramaswamy decried CBDCs as a "trojan horse of the Great Reset" that would lead to a Chinese-style social credit system. The Bank of England and Treasury have been candid: "The digital pound would not be anonymous because the ability to identify and verify users is needed to prevent financial crime."

The politicisation of a rather technical area of our payments architecture points to the wider conflict in the battle for ideas; or the 'culture wars' for wont of a better phrase.

Whilst there seems to be no real appetite among central banks and governments to replace existing payment rails at the moment, it undoubtedly holds a place in the imagination of many. This in turn could be supportive for alternative – anonymous –currencies. Like Bitcoin.

9. UK Election:
fight for Brexit Island

"You have sat too long here for any good you have been doing. Depart, I say, and let us have done with you. In the name of God, go".

MPs would take umbrage at being compared to the Rump Parliament of 1653, but Oliver Cromwell's words may accurately reflect the view of the British electorate towards the rump of Boris Johnson's Conservative regime. Polling data and several by-elections indicate Labour is a shoo-in for the next election, which is likely to take place at the end of the year.

There are all sorts of reasons why Labour is in the lead but at the end of 13 years of Tory rule, ultimately, it's a case of the inexorable march of time.

This is not just any election – it's a battle for the heart and soul of a country that has exited the European Union and is still struggling to come to terms with the decision. Or rather, it is still trying to figure out what to do next. The brief foray into Trussonomics betrayed just how difficult it is to go against establishment thinking. And even the Labour manifesto is hardly revolutionary. I think we have to take Labour victory as a fait accompli.

So, what would a Labour government mean?

The first question for the market relates to the current situation: what is it like now and what could realistically change with a new government?
For starters, Covid and the war in Ukraine have upended global value chains and left Britain with one of the worst inflation environments since the Second World War. Growth has been extremely sluggish and Brexit looms eternally – a majority (57%) now say they would rejoin.

The current high debt, high inflation and high tax structure leaves little room to spend more. In a sense the current Tory regime already embodies those 'market-unfriendly' policies that people might normally associate with Labour. Tax has not been higher since WW2. Liz Truss and Kwasi Kwarteng found out, to their cost, the risks in doing anything trickle-down. The landscape is so very different today and industrial policy is back on the agenda.

Although Labour has pared back plans to borrow and invest £28bn a year through to 2030 for its 'green prosperity plan', it would seem likely – though far from certain – that a Labour government with a working majority would be inclined towards setting more of an industrial policy than the current Conservative regime. Leaving detailed figures aside, we can see Labour taking a more activist approach – something akin to the Bidenomics industrial policy in the US. This would suggest more borrowing, which all else equal could push up gilt yields.

However, given the sluggish economic growth at the moment, markets may actually like to see Downing Street going down this route – boosting productivity (the Holy Grail for any government) and increasing capital investment, and infrastructure spending is exactly the sort of thing that could boost growth and, importantly for traders, increase company valuations. I think the thing to realise is that we are into a new paradigm of higher government spending & borrowing, which means persistently higher inflation and interest rates. The good news is that this may be spent on the big stuff that we need to be more productive and raise living standards. More details on policy and spending will be important.

And going back to the title of this chapter, what of Europe? Does the Rejoiner camp rally if Labour wins? Long-term, that ought to have some right tail risk for sterling but I don't see Britain rejoining the EU for a long time, despite what the polls say. It is not a priority for Starmer and would be a huge distraction that would instantly split the electorate. On the Scottish side, a big win for Labour in taking seats off the SNP could help to push Scottish independence further off the table, which on a very small tail-risk point of view is sterling-positive net of other factors.

How does the stock market react to elections?

Markets always prefer certainty – so the stock market has tended to do better when results are easily predicted and not really close. Time will tell, with Labour so far out in the polls right now, whether this time falls into the easy-to-predict or too-close-to-call camps. In '97 the stock market in Britain rose before, during and after the election campaign. In 2010, a rally fizzled because of the uncertainty – in the end, no party won outright and we got the Coalition.

But studies show markets prefer a Tory government. A study in the Stock Market Almanac looking elections from 1945 to 2010 showed UK equities tended to rise by around 10% in the years of Tory election wins and fall almost 6% in years when Labour won the most seats.

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10. Net Zero:
fighting back against the zealots

And the LORD spake unto Noah ...

"Get rid of all the green crap" –

Actually, it was: *"And let them make me a sanctuary; that I may dwell among them."* But David Cameron's quip seems more appropriate in 2024. As governments and corporations are finding out, you can build it, but they may not come.

Britain has already pushed back its timeline for banning ICE cars with Rishi Sunak announcing a series of u-turns on net zero pledges. Meanwhile Germany has found itself newly hooked on coal... the path to net zero is nothing like as straightforward as the great and good have tried to tell us.

2023 saw the rise of "anti-net zero populism" and I think that 2024 will see more push back against the climate zealots as the realities of inflation and war become more pressing than fancy aspirations. Politically, the authorities will find it harder to bring electorates with them on net zero; it'll be a case of pocket-book politics, the kitchen table winning out over the globalist agenda for 15-minute, meat-free cities.

This will most show up in ESG investing, which is losing its lustre somewhat. Investors have yanked funds from ESG investments – partly it's political and partly it's just mechanical as tech stocks – which have scored high on ESG tables and have been hit by rising rates. At least 165 bills and resolutions against ESG investment criteria were introduced in 37 states between January and June 2023, according to a report from Pleiades Strategy. Who knows where a Trump victory might leave ESG in the US. The impact is not theoretical. The era of cheap money and financing for green energy is coming to an end despite Biden's $370bn in Inflation Reduction Act cash to decarbonise the world's largest economy. For example, offshore wind giant Ørsted abandoned two projects designed to deliver 2.2 gigawatts of power to New Jersey. a $3bn carbon capture and storage project was cancelled by Navigator CO_2. Ford delayed its $12bn investment in EVs because of a "flatter growth curve that we're seeing relative to what the industry expected and we expected", whilst rival GM ditched plans to build 400,000 EVs by the middle of next year. In Europe, oil majors like Shell, BP and Total have shelved or pushed back climate pledges.

These are examples of demand leading supply: you can build it, but they might not come. It's not that the climate agenda has lost – it's just facing increasing pushback. Partly it's because of inflation, partly it's a symptom of the culture wars; indeed it's a prime example of the wider theme underpinning this essay: conflict.

11. De-dollarisaion or re-dollarisation:
a new front on the currency wars.

There are perennial, emblematic themes about the dollar – on a cyclical level, it's usually the least ugly sister in times of strife; whilst structurally everyone hails/wails about the imminent death of the dollar. So, which, if any, is true? Both can be false and true at the same time: Schrodinger's currency.

For multipolarity gaining traction in the world read decline of the dollar, which would be bad for inflation dynamics also. The expansion of the BRICS, the Chinese-brokered Saudi-Iran deal, Russian oil being washed in the East... it's all pointing to division and an end of the Pax Americana. The death of the dollar has been talked about many times before and it's never happened. I don't think it's much different today, but we are already seeing change. Fragmentation can happen in two ways: gradually, and then suddenly. The dollar accounts for about 60% of global foreign reserves – not much down on 67% twenty years ago and that is mainly down to the euro. And in recent years it's jumped back up in terms of its role in international payments. Dollar usage in global payments rose to a record in 2023, according to Swift. Almost half (46%) of all Swift FX transactions involved the dollar, whilst the euro's share fell to record low; and the yuan's exceeded 3%. This speaks of re-dollarization rather than de-dollarization.

Challenging the dollar's dominance is not the same as replacement – one is happening, the other is impossible. But the challenge is what we are talking about here – the change in the dynamic and increase in 'fragmentation'.

Dollar hegemony was good for trade and for inflation. "For example, the ability of central banks to act as the 'conductor of the international orchestra' as noted by Keynes, or even firms being able to invoice in their domestic currencies, which made import prices more stable," ECB chief Christine Lagarde noted last year in a speech referenced above on multipolarity. At the same time, Western payments infrastructure became dominant.

New trade patterns mean change for payments and international currency reserves. For instance, trade relations have undergone radical shifts in the last two decades. China has increased over 130-fold its bilateral trade in goods with emerging markets and developing economies. It is also now the world's top exporter. Research shows, hardly surprisingly, significant correlation between a country's trade with China and its holdings of renminbi as reserves. More yuan means fewer dollars, it being a zero-sum game. "New trade patterns may also lead to new alliances," warned Lagarde.

De-dollarisation is marginal for now, but it reflects the shift to a multi-polar world, and it could be happening faster than many people think. But this doesn't mean the dollar gets weaker. Nothing will replace the dollar like for like, but a direct replacement is not a requirement for the dollar to gradually lose its hegemony. Forces of geopolitical instability, headwinds to trade and global growth, as well as rising Treasury yields could push the dollar higher still in 2024. Reports of the dollar's death are greatly exaggerated but it may be like the frog in the saucepan of boiling water: we may not know until it's already cooked.

12. Fighting for the idea of Europe

Suella Braverman, the former UK home secretary – whose sacking, so emblematic of the ideological battle, saw the return of David Cameron that we mentioned at the very start of this essay – voiced the view of the European right: "Multiculturalism makes no demands of the incomer to integrate. It has failed."

Since the October 7th slaughter of Israelis old wounds have been exposed and fresh battlelines are being drawn. For the right, it's betrayed something they feared was happening – that millions of people had come to Europe who don't share its values. The migrant crisis in Europe is not new – since at least 2015 and Merkel's open arms welcome to 1m migrants the simmering tensions have been threatening to boil over. The rise of right-wing parties has been partly at least down to the increase in migration from Africa and the Middle East – as well as stagnant economic growth and a sense that many are being 'left behind'. The fault lines revealed by the Oct 7th attacks are only widening: mainstream politicians are hardening their attitudes; whilst the right is exploiting the gaps.

In Germany the AfD has seen a surge in support and is targeting a string of elections next year to cement its gains. It's polling on about 22% of the national vote – making it the second most popular party behind the CDU. Efforts by Berlin to cast the group as extremist seem unlikely to dent their appeal. Polling in April showed France would elect nationalist Marine Le Pen over Macron; and latest data indicates no lack in support for her Rassemblement National party, formerly known as the Front National. Italy has already voted in a right-wing party with its roots in anti-immigrant policies. The government approved a budget for 2024 that aims to encourage families to have more children – a hark back to the fascist days of presenting medals to women for having lots of babies.

Across Europe the mood has shifted. In October, three Swedish right-wing parties agreed to form a government with the support of the Sweden Democrats, which is doggedly anti-immigration and anti-multiculturalism. The far-right is entering government in Finland too. Greece's conservatives won in June amid a notable shift to the right. The Spartans party saw its support rise to 4.7 percent within days of adding a jailed MP from the neo-Nazi Golden Daw party to its ranks, and secured 13 seats in parliament. This is hardly the post-war liberal consensus that most people grew up with in Europe.

And in late November, right-wing Geer Wilders won the Dutch elections resoundingly. He's dialled down some of his rhetoric of late but has previously called for a ban on mosques and the koran. The hard right is closer to power across Europe than it has been for a long time. In 2024, with European Parliamentary elections due to take place in June, will see further advances as the fight for the idea of Europe reaches new ferocity. This will cast the European project in fresh light and ultimately embodies the theme we have explored in these pages: emergence of a powerful, growing multipolarity.

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