Hope, fantasy and…reality

More people are more upbeat – at least about the economy – now than in the past few dark years. There are some emerging signs of stronger growth in UK, and the wider economic picture is marginally better than a few years ago – even though the debt levels and youth unemployment remain stubbornly high. But risks and bubbles abound and our hopes have been dashed many times these last five years. Have we really reached the turning point "from rescue to recovery" as George Osborne claims? Which strategic risks demand our attention? What are the big trends that are fundamentally transforming our lives more quickly than perhaps we realise?

We are constantly adjusting - often during discussion with clients - the risk profiles associated with each of 10 major risk/economic scenarios:

- One of the 'lowest' likelihood profiles is the 'good - healthy growth' scenario.

- The most likely ('high risk') scenario is 'Muddle on – more of the same with crises; flat/slow growth'.

- Next are the 'medium risk' scenarios: 'China shock' - which continues to rise and is now 'medium-high'; 'European Depression – downward spiral, risks to democracy, social order, current model of EU'; 'Eurozone: Major Adjustment'; 'Major UK crisis in the next 5 years'; ' Currency Wars'; 'Major geopolitical shock', eg: Middle East: Syria, regional conflict, Sunni-Shia, Iran, Israel; 'Major cyber attack/disruption'; 'Catastrophic natural disaster – pandemic'.

- Amongst the 'low risk' scenarios are those that could escalate rapidly to 'high' risk - 'eurozone break up' is especially topical.

- Finally there are the 'inevitable at some stage' known catastrophic risks (including earthquake, tsunami, nuclear accident or worse) and unknown black swan disasters.

Something bigger?

Upbeat or not, there is more than enough to fill the regular quarterly or monthly strategic risk and opportunity brainstorming updates that we conduct with various organisations. Each come to their own hope-fantasy-reality judgements, and they find the discipline of formally re-prioritising the top risks and opportunities on a regular basis to be invaluable. A culture of getting all opinions, including wild cards, regularly out and on the table opens minds and develops a top-level cohesion that makes boards much better able to respond when things turn really nasty. The ebb and flow of discussion is always business relevant and instructive. We have never attended a meeting where some crucial final judgements and calls have not been adjusted - often significantly - from opening positions.

Within a few days of the Chancellor's Mansion House talk around accelerating UK economic recovery, headlines took another turn for the worse - stock and money markets in turmoil, ructions galore. Cyprus, Greece, and other Peripherals were once again inciting the jitters, key european debt yields were heading back up, UK borrowing and inflation data increased, and - just as Bernanke called the QE taper - Chinese bubbles threatened to trump all the other bad news. Was all this just short-term volatility that is inevitable at this stage of crisis-recovery, or are these signs of something bigger - major relapse or worse?

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Our current assessment is that this is short-term volatility - very much in line with our most likely scenario ‘muddle on - more of the same with crises’. QE has to end sometime. The Fed’s decision to scale back and end QE means that the world’s number one economy is getting better - good news. Given the unprecedented scale and duration of this round of QE, it is inevitable that there will be big impacts around the world after all these years of cheap money. It is cold turkey and detox time. The withdrawal process could threaten to undo all the good if not handled and timed right, but as the Bank for International Settlements, the central bankers’ central bank, says pulling the money back is needed to get back to normal - which raises the question of whether or not they have created a ‘new normal’.

In another respect we are in a ‘new normal’ – pro-longed crisis with potential for quite sudden escalation to major crisis level.   There are so many moving parts in today’s ‘slo mo’ enduring crisis and inter-connections with other risks -eg China shock or emerging markets crisis - that we reckon there is approaching 50% chance of a big - down from catastrophic, but still very serious - crisis such as ‘major eurozone adjustment’ or a deep UK economic relapse. Both events would trigger serious political and social developments - that said, unlikely to reach MoneyWeek’s ‘end of Britain’ doomsday scenario level.

A finance sector boss recently said his top three worries were the Eurozone, China, then a major UK economic drama. How worried was he? “Big time” he said.

President Hollande has said the eurozone crisis is over. He is deluded, and France is in worse health than most. Many eurozone problem nation primary accounts and deficits may be better than a few years ago, but the major underlying causes and issues are no better. The eurozone remains paralysed and in recession, and economic weakness has moved from the periphery to the core. Its banks have ducked the US/UK tough medicine approach and banking union proceeds at snail’s pace, yet 75% of eurozone businesses are bank-financed. Jeremy Warner might well be right - the eurozone is an epic slow motion crash that remains on track. What has probably changed though is that a major eurozone adjustment into different euro blocs now looks more likely than a general and very disorderly break-up.

China being China, it is perhaps the biggest unknown. Robert Peston is not pulling any punches when he links massive debt and credit crunch in China with other concurrent convergent economic issues...”us in the rich West not yet out of the recovery room...prospect of tumbling asset prices, widespread bankruptcies and crippling of banking and wider financial systems...maybe the Chinese exception will continue, but the lesson of 500 years of capitalism would suggest otherwise”.

In UK it is great that a million new jobs have been created. There are some stunning British company success stories and encouraging research and development news too. But we now pay £43bn servicing our growing debt, the welfare leviathan - up 15% under the coalition, social security and tax credits now £220bn - continues out of control. Overall manufacturing and finance sector figures are not encouraging, British banks remain a danger to the real economy and Mervyn King talks about ‘the work of a generation’. Stephen King of HSBC says UK has just lost one decade and is about to enter a second. He is also far from alone when he castigates the increasing rich-poor divide and social and intergenerational disharmony. He is spot on about the need for some kind of social contract to help younger generations.

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Companies and countries are both very short-term focused. Things may look better for a while but we should be wary of false dawns. There are plenty of wise figures saying that another big crisis may be building – the Bank of England's warning about the significant numbers of households that will be affected by rising interest rates in the not distant future should certainly be taken seriously.

Behind the excessive attention being paid to short term economic data and trends, a slow motion fundamental transformation of most Western societies is quietly passing the point of no return. We are witnessing a multiple global economic crisis that is morphing into a political-social-economic crisis of historical proportion. We should expect some alarming instability in some surprising countries - it will not just be in the obvious front-line nations. Both France and the US, for example, will likely face greater political and social challenges than for generations in the next ten years.

In UK we may now be in the recovery room, but we are not heading back fast to previous health and societal lifestyles. This might be good in as much as providing us with the opportunity and hope to forge a much better and more cohesive society - our reserves of experience and adaptability combined with fast-developing intellectual and scientific resources should give us an edge.

We should be hopeful for the future. But it is fantasy to expect a less painful next-stage recovery. The reality is the pain will increase first - substantially. To-date the pain has not been fairly shared – according to Stephanie Flanders the bottom fifth have lost more from cuts to tax credits and benefits since 2010 than the top fifth, and not just as a share of net income but in cash terms. This must change. History relates, sadly, that all too often it needs burning platforms to shatter old mindsets and to enable us to come together in more effective ways for the common good. We must standby for higher taxes, inflation, debt yields and interest rates; a smaller state and worsening public services. Hopefully for us in UK without many burning platforms - though it would be prudent to be prepared.

It will be interesting to see which countries rise most successfully to the challenges of this generation. Our bets are on the UK – assuming that we get round to tackling some of the systemic issues that we have ducked so far. We have the history and experience, diversity fit for this century, and reserves of drive and character to be thought leaders and role models. Bigger change and problems than most expect may be coming. Some things, including our niche for getting it right in the nick of time and handling of big crises, hopefully will not change - whatever those doom mongers say.

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