GUARDCAP

# Reflections & Insight

QUARTER THREE 2021

## “Half the trouble in life is caused by pretending there isn’t any.”

–Edith Wharton, The House of Mirth

Looking at markets around the world in the second quarter of 2021, you would be forgiven for thinking that everything was a bit boring: stock markets rose gently for the fifth consecutive quarter (admittedly starting at a low point in March 2020); the bond market settled down after some excitement early in the year; corporate bond spreads (a measure of stress in companies generally) remained very low and there were few corporate defaults; and the dispersion of returns between so-called value and growth stocks was less visible, suggesting a sort of market equilibrium.

What does all this mean? We have to remember that markets exist to price today what something will be worth in the future. This litany of moderation could be seen as confirmation that a brave new post-pandemic world is upon us, characterised by investment in new technologies, building resilience into supply chains and creating a non-inflationary golden-era. Or it could be seen as complacency – signs of a head fake.

Examining the ‘golden era’ hypothesis, we have a number of exhibits to consider. First, economic growth will be spectacular this year and this will feed through to corporate earnings. Second, because the average consumer has been able to save large sums of money during the pandemic, partly financed by governmental generosity and partly by increases in asset values, the spending impulse has legs and will underpin growth over the next year or two. Third, employment prospects are excellent, with shortages of workers in many key sectors. Fourth, and partly because workers are in short supply, there will be a boom in capital investment which will kick start productivity. Growth in this measure is critical, as it is one of the few ways in which rapid growth does not embed inflation in the system. Fifth, most governments have abandoned austerity and are set to dole out fiscal largesse for the time being, albeit at the cost of burgeoning debt.

This all sounds pretty good and markets are behaving as if this is the core scenario. To make sense, the thesis also requires a belief that markets are not overvalued, that short interest rates are anchored close to zero and that the quantity of debt out there doesn’t matter. Of course, it also posits that the pandemic is behind us.

The case for the opposition doesn’t argue with the growth position. There is a theory that an economy can only grow at a particular rate for any length of time without encountering economic headwinds, including inflation and supply difficulties. Most of the developed economies will grow at rates above this ‘speed limit’ for the rest of this

year and for the next two. Herein lies the problem for the head fake folks. Their argument is that the growth will create inflation and that it is already evident in commodity prices and in many other areas. It is true that productivity always rises when an economy comes out of recession, but the question is whether this is a cyclical phenomenon or the harbinger of a brave new world. Head fakers, prone to pessimism, would argue that we are simply experiencing a normal exit from recession, that the economy is being run too hot and that interest rates will need to rise. This will, in turn, hurt asset values.

## A Financial Game of Thrones

Proponents of both camps are participants in a financial Game of Thrones, currently experiencing an unexpected cease-fire. Activity and its corollary, commercial opportunity, are what drive the vast majority of views to which unfortunate investors are exposed. When commentators are motivated to encourage action, it is hardly surprising that positions taken need to be clear and invite action. If you are a golden era voter, you use any weakness in markets to add risk. If you support the head fake movement, any rise is an opportunity to take risk off the table.

All of which raises the question – is there another way of looking at this? The starting point of our analysis is that the price of everything in financial markets has been distorted by the actions of central banks pursuing policies to avoid a complete financial and societal breakdown.

The world was woefully unprepared for a pandemic, but in developed countries at least, has handled the economic fallout very successfully. Of course, it is a different tale in poor countries. Our solipsism may yet come to haunt us.

Markets have now convinced themselves that the pandemic is a thing of the past and have been going through an adjustment upwards to reflect what might be termed 'peak post-pandemic optimism'. The sense of calm evident in the opening litany of this review is very unusual, and such equipoise is rarely long-lived.

Central banks are worrying about inflation, and there have been rumblings that interest rates might have to rise sooner than the market expected at the beginning of the year. Nevertheless, for most market players, the timing of any first increase is beyond any time horizon which matters – maybe in the first quarter of 2023. We have seen from the example of Japan that inflation can be very difficult to ignite even when your policies are reckless. The same is true of the recovery from the Great Financial Crisis of 2008, where the austerity measures put in place were partly in response to inflationary fears, but inflation never materialised.

The inflationary outlook today is quite poor in the short run. A year ago, prices had fallen sharply, so the base effects lead to unflattering comparisons. At the same time, supply bottlenecks are causing problems, particularly at ports where transportation costs are rising sharply and goods from lower-cost-producing countries are not getting through. These short-term effects will be resolved, however, so the medium-term inflation outlook is relatively benign. We should also note that inflation is a lagging statistic – it reflects pressures in the system which are visible in advance. Rising inflation always lags the start of an economic recovery, usually by several years.

The next piece of the puzzle is productivity, as we have already discussed. You do not have to be an extremist to posit significant headwinds to inflation arising from a revival of corporate capital spending. Again, this always happens in a recovery. We have the additional complication today that nobody really understands what will happen to labour markets as government furlough schemes are unwound. It would not be unreasonable to assume that current tightness will ease somewhat. In any event, an acceleration of investment in technology would manifestly lower costs. New technology is about replacing people with machines and replacing travel with better communications. This could also lead to the offshoring of white-collar employment where trade barriers are irrelevant.

## Measuring Momentum

These factors together suggest a cyclical bounce in inflation for now but fading sharply next year. It is also worth noting that despite the stimulus packages on offer, most notably in the US, the fiscal thrust next year will be negative. This measures the momentum of government spending, which will slow down while still being colossal.

In the longer run, the main factors at play are the huge increase in debt and deteriorating demographics.

There is much academic work that shows that real per capita GDP starts to decelerate as debt levels in a country increase. The rationale for this is that the government debt multiplier is negative rather than positive and so increases in the level of debt do not flow into the economy on a one-for-one basis. The debt may be in the form of transfers, which might not be spent (witness the huge rise in furlough savings), or it may be invested inefficiently in a project which suits a political rather than economic objective (HS2?). While this research feels counterintuitive, evidence for its veracity

abounds. If things work as they have in the past, this is a disinflationary force.

Demographic pressures will also weigh on inflation. Population growth in the developed world has fallen sharply during the pandemic from already low levels. While this might be expected to lead to a shortage of workers, the dominant effect, as seen in Japan (where population shrinkage is underway), is that a combination of excess capacity and labour-saving investment far outweighs the labour effect.

The evidence on the longer-term inflation outlook points to a rather moderate result. Given that all prices, including bonds, are distorted, the markets are not sending much of a signal about inflation, and it could be argued that greater volatility in interest rates would send more effective signals to central banks about the outlook. Nervousness about the economic risks prevails for now, though.

## Markets Muddling Through

So, is there a middle way? For most of the modern era, markets have 'muddled through', with an upward trend, but having periodic breathers as bad news takes centre stage. It still seems to us that this is the most likely outturn and that scepticism and caution are the appropriate responses.

For portfolios, the implications are that growth may fade a little next year and thereafter, with markets perhaps being disappointed by corporate earnings. In these circumstances, significant setbacks will be tempered by very easy and cheap money which will limit any multiple compression in stock markets. Once again, the pendulum is likely to swing in favour of companies that don't have to stretch too hard to deliver growth – a factor that will be scarce in the muddle-through world. Quite apart from the risk of being wrong, the list of worries remains long: industries being disrupted by new technology; greater levels of regulation, partly in response; geopolitical concerns (US/China/Taiwan); and not least, another chapter in the pandemic saga.

## Storm Clouds Ahead?

So once again, we continue to be mindful of possible storm clouds on the horizon, while also being aware that the timing of their arrival is near impossible to predict. For this reason, we are maintaining substantial and diversified equity content in our portfolios but will be prepared to react quickly to any change in the investment weather.

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