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Reflections and Insights*

“Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.”

– WARREN BUFFETT

Another quarter goes by and markets rack up another excellent performance against a mixed economic background and a geopolitical horror show. Just to give a flavour of market strength, global equities (MSCI World Index¹) rose by nearly 7% and, so far this year, have returned nearly 19% in US dollar terms. The US market

notched up its 43rd fresh high of the year, as the usual suspects continued to power ahead. Emerging markets joined in the fun, for once, following the unveiling of a significant stimulus package in Beijing; and the MSCI Emerging Markets Index² went up nearly 9%, making it a 17% rise in total this year (in US dollar terms).

Following cuts in Europe, the Federal Reserve cut interest rates by 50 basis points, and this helped to underpin the robust market performance. Such a large cut is unusual at the start of an easing cycle and was justified (or at least explained) because inflation has been relatively well-behaved despite reasonably good economic numbers. This is the investor's dream state, known as a soft landing. Interest rates can fall without the inconvenience of economic activity slowing unduly. Market participants are now certain that there will be no 'technical' recession, and the sunlit uplands of equities frolicking in fine weather await.

And yet... the conundrum is that there is still uncertainty. Economic activity is fine and is unlikely to generate anything that looks recessionary across the spectrum, but it is not firing on all cylinders. We have commented

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before that cycles of tightening monetary policy have lagging effects, usually around two and a half years after the first rise in interest rates. That time is about now. In fact, employment in areas like manufacturing is weakening a little and sales and profitability at small companies are struggling. On the other hand, non-cyclical employment (areas like government, healthcare, and education) remains strong, so much so that significant wage rises are being agreed in these sectors in many countries. Further, large companies, led by the information technology/artificial intelligence (AI) behemoths, are shooting the lights out in terms of sales and profits. These huge (and monopolistic) businesses have been the main beneficiaries of the generous fiscal stimulus implicit in Bidenomics. We have a two-tier system. Winner takes almost all.

STIMULUS THEN AND NOW

The second impetus in the quarter came in the announcement of significant stimulus in China. A series of measures was announced in both credit and monetary measures, which amounted to an injection of liquidity of around 7% of GDP. To give a comparison, the stimulus which helped pull the world out of its slump in 2009 was about 12% of GDP. So, this is a big package, but not the biggest there has ever been. Furthermore, China faces headwinds it did not in 2009. There is a large overhang of unsold, debt-laden real estate, Foreign Direct Investment has turned negative and the demographic tailwind is now a headwind. Add to that the hostility towards China in US and EU political posturing, and it seems unlikely that these Chinese measures can do more than arrest the problems in Chinese markets. Nevertheless, there has been a spectacular run in Chinese risk assets towards the end of the quarter and it will be interesting to see whether investors thought China was uninvestable because its markets were underperforming or because of government interference in corporate life and economic nationalism.

For investors who have gone with the flow, things have been great, and all the more so if they also had a contrarian position on China. This is splendid, but what happens next?

CHOOSE YOUR PATH

It may come as a shock to readers of these reviews, but the reality is that most possible outcomes can be made with equal conviction. The chosen path, therefore, is mostly a question of prejudice, confirmation bias and the disposition of the forecaster. These reviews, over time, have tended to be in the 'muddle through' camp – things rarely turn out as well as the optimists expect or as badly as the pessimists fear. Very occasionally, we see extremes which require us to get off the fence. 2008 was one such (for obvious reasons), followed by a quick hop to the other side in 2009. 2022 was another, when interest rates and inflation took off. The question now is whether this is yet another.

Melting up

To start with, the case for the melt-up. This ugly cliché is the opposite of a meltdown, but its intended meaning is clear:

- 1. We are in a new technological era.** AI is a general-purpose technology (like electric power) which will unlock a productivity miracle and the potential growth rate of the global economy has, therefore, been badly underestimated. Optimism extends to healthcare where anti-obesity medication will start to turn the tide on cardiovascular illness and reduce societal costs. The speed of adoption of new technologies is unprecedented and so the effects will likely be felt quickly;
- 2. Markets have become less cyclical,** in part because of Point 1 and can, therefore, justify much higher valuations because growth is both higher and more stable than in the past. Also, the winners have monopolistic business models;
- 3. Because this is a story about productivity,** inflation should remain subdued, which means interest rates could stay low and the resulting liquidity would be the fuel which keeps markets rising;
- 4. The creative destruction of capitalism** will reallocate labour from work which can be automated to work which is more creative and rewarding.

Once you start down this path, there are many further steps which reinforce the basic premise. The thesis can be summed up as ‘this time it’s different.’

Fence sitter?

The case for sitting on the fence is somewhat more prosaic:

1. **‘This time it’s different’** are the four (or five if you’re pedantic) most dangerous words in finance. The tech bubble of 2000 was the most recent egregious example of similar thinking, but minor variants of the theme echo through financial history.
2. **Nothing grows up to the sky.** The ability of the world to grow in aggregate is constrained by resources. At a corporate level, it can be affected by competition, regulation, arrogance and mismanagement, or simply the limits of market share. How much of global advertising spend can be captured by Google, for example?
3. **Valuations may not matter in predicting turning points in markets,** but they are quite good predictors of subsequent five-year returns. On that basis, the market is predicting modest returns from here, albeit more or less in line with historical averages, which aren’t bad. The more expensive bits of the market contain a lot of belief, while other parts have been consigned unjustly to the dustbin of disruption.
4. **Debt levels matter.** There is lots of evidence that high debt acts as a brake on growth. The world is as indebted today as it has ever been and, at some point, this could create problems by pushing interest rates up. Geopolitics is ugly. Does it really not matter?

And so on. As you can observe, where you sit is a matter of theology as much as of fact.

IT’S ALL RELATIVE

This review continues to expect a muddle-through scenario. The global economy is

puttering along, relatively feebly in Europe and relatively robustly in the US. The huge increase in debt, driven by the response to COVID, on top of the response to the Great Financial Crisis in 2008, has confused the picture. This expansion of debt (both through Quantitative Easing and fiscal largesse) is the main reason why the expected recession has yet to appear, despite high interest rates. Monetary policy may be permanently weakened by changes in the structure of household debt – for example 30-year fixed-rate mortgages. Indeed, interest rates are likely to drop further, more in the feeble areas than in the robust spots. Equity markets are bipolar, parts are full of expectation and ripe for disappointment, while others appear to offer good value without being exposed to the disruptive risks in case AI turns out to be a productivity miracle.

As ever, the soundest advice is to stay diversified across markets and asset classes. The risk of a major recession is small, but markets are already priced to reflect that. There is, of course, significant geopolitical risk, which is where the greatest uncertainty lies, but, across the decades, this risk has waxed and waned. It is nothing new even if it feels close to home. Expected returns from risk assets are probably close to their historical averages. That means the possibility of equity returns in the 5-6% area (after inflation) and somewhat lower returns from bonds and cash. It is worth reminding readers that these are very respectable returns, even when they don’t arrive in a neat bomb pattern.

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Endnotes

- 1 The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.
- 2 The MSCI Emerging Markets Index captures mid- and large-cap representation across 27 Emerging Markets countries.

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