GUARDIAN CAPITAL

Reflections & Insight

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The new decade begins next year, according to the intellectual purists. The more simple minded, among which we count ourselves, think that the start of 2020 seems like a good moment to look back at the last ten years and forward to the next.

It has been a decade of historically loose monetary policy and that has been the primary underpin to the returns generated by risky assets, such as equities. At the start of the period, the world was recovering from the shock of the financial crisis, and Central Banks around the world were developing the experiment known as quantitative easing. Off and on, but more on than off, this has been the defining economic policy of the decade. To understand the scale of the intervention, the example of the Bank of England is instructive. Its balance sheet expanded to the point where it represented 30% of the size of the entire UK economy in 2019. By contrast, it reached 18% just after the Second World War and 20% (its previous high) in 1730. What we have seen globally is unprecedented.

Where exits from very loose policy have been tried – 2011 in the Eurozone and the fourth quarter of 2018 in the US, crises have followed. Monetary orthodoxy holds that interest rates should have been on a gentle upward trajectory as unemployment has shrunk, in order to head off the threat of inflation. Inflation, though, has been the dog that didn't bark. The generally sluggish nature of the post 2008 recovery has allowed employment to recover without triggering any alarm bells, suggesting that there was plenty of spare capacity in most economies – indeed, productivity growth has been unnaturally weak, and companies in general have not embarked on major capital spending programs, which would indicate strain.

For the most part, this monetary generosity has had its flipside in the shape of austerity, although that has begun to crack, of course, beginning with Trump's spending stimulus and now spreading elsewhere.

The broad message, though, is that this past decade—the only one not to have experienced a recession in the past century, has seen very unusual economic and financial conditions which have turned a lot of conventional thinking on its head.

What has this meant for returns? Global equities have generated an annualized return of 9.5% in US dollars (11.6% in GBP, 11.7% in CAD[1]). There has been a contrast, with the technological hegemony of the US reflected in stock prices and leading to a return there of 13.6% annualized (USD)[2]. At the other end of the spectrum, Emerging Markets, which have still produced the fastest economic growth, generated a return of only 3.7% per annum, on average (USD)[3]. Returns from fixed income have been respectable, with 10-year rates in the US falling from 3.9% to 1.9%. Cash, of course, has been awful.

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[1]MSCI World Index; [2]S&P 500; [3]MSCI Emerging Markets Index

Putting all this together, earnings for US stocks have risen by 10% p.a., but revenues have been much more sluggish, reflecting low economic growth. The gap between sales and earnings growth is the consequence of rising margins, bolstered by a lower tax rate, but also by companies borrowing at low rates, and by the benign influence of plentiful labour and some pricing flexibility.

Disruption has become a watchword for entrenched commercial interests. Lavishly financed disruptors with no endowment costs have taken on incumbents across a range of industries. To a large extent, these unicorns are also beneficiaries of the generous monetary environment, which has allowed loss-making enterprises to stay alive much more cheaply and for much longer than in the past. Nevertheless, any investor who does not factor the risk of further disruption into strategy has drunk some Kool Aid.

China accounted for about 14% of the global economy ten years ago and now accounts for close to 20%, adjusted for purchasing power parity. It is now almost as important in determining the health of the global economy as the US and is continuing to grow, albeit at probably only half the rate of the headlines. Nevertheless, every six or seven years, China adds something the size of Germany to global output. In the decade ahead, it will generate the lion's share of the growth produced by the global economy and will be instrumental in how the developed world navigates the economic currents.

Something of a Microcosm

The last year (2019) is something of a microcosm of the last decade: low rates, sluggish economic activity and lacklustre earnings. Once again, it was the US that led the equity market pack, posting one of the best performances of the last half century. Indeed, the more highly valued the country in 2019, the better its market performed (with one or two low valued exceptions, like Russia). This might suggest to an observer that there is no point in trying to identify assets which are good value, when it is the monetary environment which is driving returns. The PE ratio of the US market increased by four percentage points last year and even this disguises the fact that returns were highly dependent on the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix, Google).

If we accept that the last ten years was unusual, what are the chances that conditions will remain the same over the next ten?

It has been tempting at many points over the last ten years to call time on current conditions but that would have been wrong. A consistent approach to taking risk in portfolios has been the correct strategy for the last decade. As time passes, though, the tension in the global economy builds. Debt has grown and by most measures exceeds that outstanding at the start of the Great Financial Crisis. In the corporate sector, the quality of that debt has also been deteriorating. Many countries are signaling the end of fiscal austerity and will themselves be returning to markets to borrow. Shorter term indicators suggest that investors have become very bullish (a bad sign, usually) and that there is growing optimism about the global economy, with a recovery in China, stabilization in the Eurozone and a resurgent consumer in the US.

A Movie We Have Seen Before

This is a movie we have seen before during the current cycle. Usually, the optimism causes a selloff in bonds as markets fear inflation, the data then come through more sluggishly than forecast and the market adjusts. There is no reason to assume that the monetary environment is set to become any less stimulative from a policy perspective. Even if the economy were going gangbusters, the raft of geopolitical uncertainty would stay the policymaker's hand. Dark developments in the Middle East, a US election cycle and the risk of growing nationalism in Europe all argue for generosity. Nor is inflation a clear threat. 2020 therefore looks like a tradeoff between geopolitical uncertainty and reasonable data, with markets grinding higher.

Longer term, the major policy risk is inflation. Having been dormant for so long, most commentators have declared it irrelevant, with the preferred analytical tool (known as the Phillips Curve) manifestly not working. This posits a relationship between unemployment and inflation – the lower the former, the higher the latter, in simple terms. This has the satisfactory feel of academic rigour and common sense. So much for that. The reasons it has not been working are complex. The length and sluggish nature of the recovery has encouraged companies to postpone adding capacity, seeking labour instead. Labour participation rates have risen everywhere as those who had left the workforce, or were discouraged, have been tempted back into work. This might be because savings no longer yield anything, pushing retirees to seek extra income; because employment patterns are more flexible, helping those with families or any number of other factors. Nevertheless, there is a finite supply of labour and once it is running dry, wage rates will rise and at that point companies will respond to the need to add capacity by increasing capital spending.

Acts Like a Speed Limit

Demographics will also have a major impact on what happens. With population growth very low in the developed world (and in China), this acts like a speed limit for economic growth, and may accelerate the need to increase capital to replace labour. This is already visible in Japan and will become more noticeable in Europe and the US over the next decade. It will also be positive for particular sectors involving products and services required by the 'grey' economy.

Because of the risk to the recovery of rising rates, Central banks may well be slow to respond and inflation could become a problem. This is not a forecast, but at some point, either economic normality reasserts itself or we will see a continuation of current conditions, which will build further tension in the system. It is nonetheless unlikely that we will navigate the next decade without a recession, and given the amount of debt in the global economy, it could be deep. At least Central banks and policymakers have developed a set of tools to mitigate the impact of a deep downturn.

This is where the role of China (and maybe India) will be pivotal. Just as the Chinese policy response was very helpful in dampening the declines in the global economy in 2008, so it will be more important the next time around. We have to hope that the policy aims of the US and China are broadly aligned should such circumstances arise, or China could use its leverage to cause severe damage to the developed world economy. If the current hawks remain at the controls in the US, with the subtext that they believe they are in a millennial battle for global supremacy, this would not be helpful, and is why a resolution to the trade dispute is highly desirable over and above its (relatively limited) economic impact.

The Drumbeat for Action

Regulation of the control of data is likely to rise up the agenda over the next ten years and could take the shine off some of the tech names which have been so important to markets in the last ten. The underlying disruptive wave, however, will not stop. Security of data is likely to be a major problem as new technologies level the playing field between good and bad actors in the IT world.

Climate change may be a divisive topic, but the scientific evidence is not encouraging for the deniers. Our political systems are peculiarly ill adapted to deal with problems of long duration and progress on change is therefore much slower than it needs to be. Economic growth is becoming less carbon intensive, but emissions are still rising and will continue to do so on current projections. If even the moderate scenarios are correct, the implications for migration, economic hardship and natural disaster are difficult to comprehend. Changes in behaviour to address climate concerns are likely to be disruptive to many industries and could be deflationary, as activity is cut back. The drumbeat for action will only grow louder, and as investors, we must be live to that, while acknowledging that this could be the major influence on us all over the medium-term.

BREXIT can wait. Most of us in the UK are exhausted by the process and either unrealistically optimistic or darkly pessimistic about the eventual outcome. There will be a lull for a while, so there will be time to revisit the topic, although it will have decade-long implications.

$1.5 Trillion of Dry Powder Available

Finally, a word on those who do the investing. Markets are increasingly dominated by participants who are not investors. Instead of being interested in the corporations in which they invest, many market ‘players’ simply rent some of the characteristics of a business for a short space of time. This suite of techniques has a variety of names, from ‘smart beta’ to ‘factor investing’, but its main characteristic is to distance the asset owner from the asset. That has a bearing on how companies relate to their shareholders, making it increasingly difficult to work out what they want, and also making the underlying performance of the business less correlated to its share price. When this is combined with the rise of passive investing, it is perhaps not surprising that those investors who want exposure to the underlying business in which they are investing are increasingly turning to alternative assets like private equity. There is currently over $1.5 trillion of dry powder available for investment in private equity transactions. This is a meaningful percentage of the stock market and its growth and deployment is likely to be a feature of the next decade.

It is also worth pointing out that the last decade was not all bad. Child and maternal mortality fell sharply, particularly in the poorest nations, while the global population growth rate has started to fall and is forecast to be zero by the end of the century, reducing the strain on global resources.

This brief tour d’horizon of a handful of topics which might see airtime in these reviews is not meant to be comprehensive, but it is noteworthy that ten years ago our core assumption (in fact quite wrong) was that economic normality would reassert itself once economies had healed from the damage wrought by the Great Financial Crisis. We look forward to seeing how wrong these thoughts are in ten years’ time.

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