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World Economic and Market Outlook

Regime Change Rules the World

INTRODUCTION



The approach taken in these Outlook pieces tries to take a longer-term view of structural thematic change in the global economy and the investment implications of these. We have always argued that investors should avoid market noise, that investment is a risk management exercise and that, especially at times of uncertainty, investors need to analyse markets in terms of the three market risk drivers. The first of these is economic fundamentals, the second valuation, and the third is shorter term in nature looking at market sentiment. Investment regimes can be highly important drivers of the return profile of financial assets. During the 1970s the world lived through an inflationary regime which changed with the appointment of Paul Volcker to chair the US Federal Reserve, whose tough inflation fighting credentials altered long-term inflation expectations, but only after instigating an economic downturn through sharply higher interest rates to achieve this. The question for investors now is whether the long-term investment regime has changed from that prevailing pre the pandemic.

CHALLENGES ALTER

The global economy was still assimilating the aftershocks of the Covid-19 pandemic through supply chain disruptions when the Ukraine crisis hit. The problems facing the global economy are very different from the past 30 years where economic downturns have been caused by demand shocks. Monetary authorities and more recently governments have become more adept and developed expertise in dealing with demand shocks, aggressively reducing interest rates and then the adoption of unconventional monetary policies including negative interest rates and quantitative easing. Governments realised the limitations of a reliance on monetary policy alone in a severe demand downturn by putting in place a very significant fiscal response to the pandemic.

The type of problems facing the global economy now are very different as they involve supply shocks rather than demand shocks and the type of policies needed to deal with this are likely to be very different. Thus the policy refinements in place to deal with economic downturns may

not work in the current scenario. Central banks are currently grappling how to deal with elevated levels of inflation and whereas traditional 60/40 (equities and bond) portfolios could cope with demand shocks as the bond element of portfolios rose in value, this type of strategy does not work in a supply shock as bonds and equities become correlated in a higher inflation environment. Equities suffer because of the higher discount rate applied to future corporate earnings, while bonds suffer due to the impact of higher inflation and interest rates on the nominal returns offered. Thus, bonds do not dampen down portfolio volatility at a time of rising inflation. This correlation during supply shocks makes portfolio construction difficult and is currently accentuated as safe assets entered this period expensively valued. To some degree central banker's optimism on the economy reflects their new role as "investor relations professionals" for their respective economies rather than objective commentators and they may fear causing panic in the markets if a more realistic approach to the problems in the global economy is detailed. Pressure for higher fiscal spending will continue with, for example, increased defence spending a given due to the Ukraine crisis and measures to alleviate the effects of higher energy and food inflation will be expensive but potentially necessary by governments to avoid a longer-term inflationary spiral.

The other aspect of regime change occurring is at the geo-political level. Geo-political tensions have now risen to an unprecedented level in the post Cold War period and the so called peace dividend the world enjoyed after the fall of the Berlin Wall is likely to dissipate over time. It is clear that tensions between the West and East will continue for many years as China looks to evolve its status as a global superpower, while Russia under Putin seeks to re-assert its authority as a global political and military force. As a result of this, globalisation is likely to be in decline for many years as countries and companies come to terms with the necessity of food and energy security and the problems caused by a reliance on distant supply chains. Re-shoring is likely to be inflationary in nature, removing the benefits to consumers of cheaply produced manufacturing goods to some degree. The impact of 'greenflation' is also being felt with energy majors encouraged by investors to reduce their output of fossil fuels. BP in their most recent results trumpeted how they would be reducing fossil fuel production 40% by 2030 compared with 2019 levels. This underinvestment in oil and other natural resources partly explains the higher prices prevailing today and why these supply shortages are likely to persist going forward.

For the decade following the GFC (Global Financial Crisis) returns from equities were supported by positive macroeconomic fundamentals including

attractive valuations entering the post crisis period, high growth rates in corporate profits, a lack of adverse and disruptive supply shocks, a reduction in both nominal and real interest rates at both the short and long end of the curve, together with stable geo-politics. As a result, most traditional portfolios holding equities and bonds (even in varying degrees) have delivered returns well ahead of inflation.

After the initial severe stock market downturn in the first 6-8 weeks of the pandemic, policy actions by central banks and governments on an unprecedented scale (significantly dwarfing the level of stimulus applied during the Financial Crisis) supercharged market returns from the second quarter of 2020 through much of 2021. Although economic support measures were clearly necessary to counter the contractionary effects of government lockdowns, the post pandemic economic environment is likely to be less favourable for investors than the immediate recovery period from the GFC. As discussed earlier, the chief factor behind this is that the world is now coping with supply side, rather than demand side, problems.

RETURN DRIVERS ALTER

Many of the fundamental factors coming out of the Financial Crisis for investors are no longer present. The pandemic saw one of the fastest bear market collapses in equity values and an equally rapid rebound which meant that even by the summer of 2020 equity valuations were further elevated despite 2020 being a more difficult year for corporate earnings. While debates continue about the current effectiveness of this valuation model, the US stock market looking at the CAPE (cyclically adjusted earnings) entered the year close to an all time high. As a result of this, most commentators expected, unsurprisingly, that returns from equities would be much lower over the next few years, as the market had front run prospects for economic recovery and was not pricing in implications of tighter monetary policy and higher bond yields if they occurred.

Many investors would not realise that the chief driver of returns of all financial assets, not just equities and bonds, but property values including residential and more esoteric investment options such as fine wine or art, have all been driven by the long-term decline in what economists call

R^* or the short-term equilibrium interest rate. In other words, the falling discount rate applied to future profits or dividend streams has lifted the value of all financial assets and potentially to a greater level than markets had factored in. With governments in the West having moved to an expansionary fiscal stance, and the further impact of the green energy revolution, the world pre-Ukraine was already entering a period of higher inflation than had occurred in the post GFC period with, as a result, a rise in R^* likely to impact on the value of all financial assets. Much of the market returns in the post crisis period have been as a result of multiple expansion rather than driven by increases in corporate profitability and the market rating was likely to come under pressure pre-Ukraine and with the prospect of higher levels of inflation this pressure is only likely to increase in future years.

US RESPONSE

The US Federal Reserve has made a significant pivot on interest rates. In December, many commentators were only predicting 2-3 rate increases this year, all of which would only be 25bp. The consensus view in the market now is for six or seven rate hikes and that some of these may be at a 50bp level. Earlier this year investors, perhaps complacently, had merely pulled forward US rate hike expectations without adjusting the longer-term terminal rate at which US interest rates would peak. Warning signs had been flagged pre-Ukraine when, for example, John Williams at the New York Fed had commented on the overheating in the US jobs market and the necessity to reign this back. Further comments by US monetary officials have only emphasised this and some US Federal Reserve Board members are now calling for higher terminal rates than the previously expected level of 2.5%. It is clear from the rhetoric from the US Federal Reserve that taming inflation is now the number one priority of the US central bank, and this will have implications for asset pricing and potentially levels of global economic activity. If inflation does prove to be persistent and the US stays on track to reduce inflationary pressures in the system, the possibility of a more severe economic downturn will increase, and the current supply chain issues make delivering a soft economic landing hard to achieve.

CHINA AND RUSSIA DYNAMIC



Investors have become used to enjoying the benefits of the so called peace dividend which provided a favourable backdrop for globalisation for much of the period following the fall of the Berlin Wall. In more recent years the rise of China as an economic super power and its desire to play an increased role on the world stage has heightened geo-political tensions especially in the South China Seas and Pacific regions. While China had increasingly integrated into the global economic and financial system Vladimir Putin's Russia had taken the opposite course with a fortress Russia policy reducing the country's reliance on Western economic investment through building up large levels of foreign exchange reserves, together with low import dependency. Whether expansion beyond Russia's current borders was a long term plan or not, Putin clearly was preparing the country for a siege mentality and explains why living standards for ordinary Russians had lagged most emerging markets, especially compared to China and other parts of Asia over the past decade. Russia's place in the so-called fast growing 'Bric' economies had increasingly been questioned and today its assault on Ukraine is likely to alter not only the longer-term prospects for the country's economic development while Putin remains in power but it could also remake our world.

UKRAINE-KNOWN & UNKNOWN UNKNOWNNS

In today's febrile environment, former US Defence Secretary, Donald Rumsfeld's notion of known unknowns and unknown unknowns rings very true. Today it is impossible to be definitive about the wider ramifications for the global economy, although certain touch points or problems are already evident. The invasion occurred roughly two years after the start of the pandemic and is a further economic shock. As discussed, the early stages of the pandemic were dominated by demand shock issues caused by government lockdowns and other health related measures termed as non-pharmaceutical interventions to limit the spread of the pandemic both in

terms of number of infections and the timing of these. The aftershocks of the pandemic were still being felt in terms of supply side issues and the labour market, with these being accentuated by the invasion, especially in certain commodities including oil, gas, grain, and uranium which are heavily reliant on either Russia or Ukraine in terms of global output.

UKRAINE – SECONDARY IMPACTS

A first derivative impact of the invasion is, for European economies in particular, to bear the brunt of Ukrainian refugees fleeing their war-torn country. There are also likely to be second derivative impacts, none of which are well understood at present, which will emerge. An example of this is the implications of what is likely to be a worsening global food crisis where North African countries in particular are heavily dependent on grain from the affected region to feed their populations. Egypt has already been forced into a significant devaluation of its currency and other North African countries are likely to follow suit. As living standards in these countries are hit, the wave of refugees attempting to enter Europe from Africa is only likely to increase. This is an example of the second derivative impact of the Ukraine crisis which has not yet been factored into mainstream economic thinking. The fiscal cost for Europe in particular of this new refugee crisis is likely to be significant and place further strains on local infrastructure including health care, schooling, and housing at a time when none of these were in a particularly satisfactory condition.

Today Russia and Ukraine only account for around 2% of global output in world trade. Due to the policies adopted by Putin, FDI investment in Russia is only around 1.5% at a maximum of the global total. Both countries are not widely integrated into global finance, certainly at the headline level. The importance of both economies to the world is in their positions in the supply chain with many essential commodities including cereals, fertilisers, gas, oil, and vital metals, and these prices have already soared. In fact, Tesla in China have already raised the price of their electric vehicles due to the increased levels of cost in battery production, namely inputs of nickel and lithium.

The shock waves for the global economy will be different across different countries. The headline impact on the US will be relatively low with estimates

of around a 1% hit to GDP, but the impact on the Eurozone is likely to be much higher than this. Inflation globally will also be higher and this has implications for both monetary policy and consumer demand. Pre Ukraine the cost of essentials such as energy and food was already rising at a more rapid pace than the wider inflation bucket and this has only accelerated in recent weeks. This will reduce the real income of consumers by far more than the decline in headline gross domestic product numbers and is likely to impact more severely on the poorest elements of the population. It also has implications for the emerging world due to the necessity of consumers there to spend a higher level of their disposable income on essentials. Food poverty has implications for political stability in these countries and potentially if for a refugee crisis to worsen across the wider world. The impact will be higher for countries which are net energy and food importers. Within emerging markets, current account deficit countries are always higher beta investment options and today those which are also net commodity importers could face economic stress. Perhaps ironically the longer the conflict goes on the worse will be disruptions to the supply chain, and at the geo-political level the potential involvement of China in the conflict, even in a soft non-military form would have further implications. Embargos of energy imports from Russia will have a much more limited impact on the United States, a net energy exporter, than on Europe which has increased its dependency on Russia for oil and gas in recent years.

While at the headline level the economic impact, certainly at the direct level from the Ukraine crisis, is much smaller than that from Covid-19 the ability of both central banks and governments to deal with this are far more limited. The one sector of the global economy which has emerged from the pandemic with higher levels of debt is at the government or country level and this may limit the desire or ability of countries to put in place fiscal measures to mitigate the effect of rising energy bills or food prices on their populations. Once again the second derivative impact of this became clear just over a week ago when Egypt was forced into an unexpected currency devaluation. Whilst the terms of trade for commodity exporters have improved, those for commodity importers are likely to deteriorate markedly especially if combined with current account deficits. The timing of the shock has been unfortunate as a full recovery from Covid-19 has yet to occur. Other geo-political implications concerning national security at the military, energy, and food levels have yet to be fully analysed but it is clear that the implications will be both negative for growth and negative for inflation.

INFLATION & INTEREST RATES



Even pre the invasion it had become clear that the measures put in place by central banks and governments to mitigate the worst effects of the pandemic had worked perhaps too well. For many years in the post crisis period, central banks have grappled with the problem of too low inflation and have endeavoured to put in place policies to encourage a return to the desired level of price stability outlined in inflation targeting policies by developed world and some emerging market central banks. In the developed world this often equated to an inflation rate of circa 2%. Financial markets had benefitted from and grown accustomed to a world described by former US Treasury Secretary Lawrence Summers as one of 'secular stagnation' which reflected an era of demand deficiency which saw a decade long period of policy responses whose side effect was beneficial for holders of financial assets. The measures in place resulted in a decline in the equilibrium rate of interest boosting market valuation levels due to an excess of global savings seeking a home. Demand efficiency also resulted in a weakness in labour markets accentuated further by the trend of globalisation. Workers everywhere feared an offshoring of jobs resulting in muted wage demands as job security became an ever important issue even with trade unions. Their share of gross domestic product, or in other words the total compensation of employees given as a percent of GDP, fell to record lows and it has taken a pandemic to alter the situation. Previous pandemics had seen a rise in real wages, but this from all periods starting with the Black Death in medieval times was due to the death of a significant proportion of the working population. While this has not occurred, it seems that there have been significant levels of retirements and other workers exiting the labour force, resulting in significant wage pressures in certain industries. For example, it has recently been reported warehousing staff are seeing 20% wage rises in most locations.

FED – BEHIND THE CURVE

As 2021 evolved it became clear that the US Fed in particular were well behind the curve in recognising the increase in inflationary pressures and during the fourth quarter began a pivot on interest rate strategy. The most recent Board meeting of the Fed announced plans for six small rate

increases by the end of the year and did not rule out some of these being higher than the previously assumed 25bp. The revised policy stance should not be that surprising if looking at a labour market which is now tighter in the States than at any point in history. The vacancy to unemployment ratio remains in unprecedented territory with quits at near record levels and wage growth of at least 6%, a trend which is accelerating at the current time. Forecasts by the US Federal Reserve are for a further tightening in labour market conditions resulting in a decline to a 3.5% unemployment rate up until the end of 2024. Historically this level of unemployment, due to the necessity of significant monetary tightening, has often resulted in a recession a few years down the line. The Fed's forecast of a strong labour market does not go hand in hand with its expectations of slowing inflation as labour market tightness suggests continued inflationary pressures from this part of the economy. For many businesses wages are the largest component of costs which makes the Fed's expectations of a fall over the next couple of years to a 2% inflation rate hard to achieve.

Typically, central banks have reduced inflationary expectations by raising interest rates and any upward move in the equilibrium rate of interest or R^* would be negative for financial assets as well as the real economy. Historically, it has been necessary to raise interest rates to a higher level than the rate of inflation to slow the economy, and even with the forecast level of rate rises, real interest rates will still be negative by the year end. Whether the Federal Reserve will be jolted into a more aggressive monetary tightening to get the real rate of interest positive is something that is not yet factored into equity prices. The central base case outlined by Fed Chair Jay Powell for a soft landing will not be easy to achieve in today's world of supply side shocks and comments by some US Federal Reserve Board members suggest they believe that inflation cannot be tamed in the States without a rise in unemployment.

POTENTIAL FOR ECB TENSION

The European economy, while being behind the United States in terms of recovery, is also suffering from heightened inflationary pressures and the Ukraine crisis has accelerated these relative to the United States. Tensions could well mount within the ECB as some northern European members such as the Bundesbank would have concerns about the negative real

interest rates imposed on their savers if inflation accelerates to the 5%, 6%, or 7% level. It seems likely that the ECB, despite protestations to the contrary, will be forced to raise interest rates this year and this could once again re-ignite tensions within the Eurozone bond market with Italian and Spanish spreads widening versus Germany. The Ukraine crisis makes the relative recovery of Europe versus other parts of the developed world less likely in terms of not only direct economic impact from higher energy and commodity prices, but also the likely central bank response to heightened levels of inflation. Some peripheral European countries are still faced with persistently high levels of youth unemployment.

GLOBALISATION IN REVERSE

Globally governments will consider the geo-political implications of Ukraine and Russia. In the developed world there will be attempts to shorten supply chains and possible disruption and this is likely to also emerge the other way where autocracies fearful of sanctions and other economic penalties imposed by the West will try to reduce their dependence on Western financial markets and end consumers. This has already been seen in the fortress Russia policy adopted by Putin and perhaps makes clearer the ultimate end objectives of China's Dual Circulation Strategy where President Xi is looking to build a dynamic internally driven Chinese economy where consumption is not dependent on the West.

CENTRAL BANKS REFOCUS

The disinflationary period which emerged post Volcker was a benign one for financial markets as central banks did not need to put in place unpopular and economically damaging policies to contain inflationary threats. The US central bank in particular has awoken to the long term de-stabilising effects of higher inflation and the concerns about this in the wider US population have been demonstrated by the collapse in support

for the Democrats in opinion polls, which has resulted in the highly unusual step of Democrat politicians calling for higher interest rates in the States. The US Federal Reserve had already recognised that high levels of inflation were deeply negative for long-term economic expansion and had stated that subduing inflationary pressures was necessary for the extended economic cycle necessary to achieve their aims of not just full employment but increased levels of participation in the US labour market. As a result it seems likely that firstly in the States and also in other developed markets monetary policy will continue to be targeted at controlling inflation and inflationary expectations, even if the short term consequences for economic activity are unpleasant. It remains to be seen whether governments are prepared to use their fiscal resources to try and protect the most vulnerable elements of the population from the high levels of inflation prevailing in essential goods, namely energy and food costs.

For emerging markets fiscal subsidies are generally difficult to maintain at times of economic stress and many emerging countries had already reduced the level of fuel and food subsidies which is a factor behind why there has not been wider contagion throughout emerging markets from the crisis to date. The necessary policies to deal with these problems may well need a coordinated global response which is more likely to be led by the United States under Biden, than it would have been under Trump. The focus on energy security will encourage a faster shift towards renewables but this will involve short term costs and there will be a significant time lag before self-sufficiency in renewables is achieved for the majority of countries. Governments already grappling with higher levels of debt will now have to divert further spending towards energy and collective defence strategy.

THE EFFECTS OF GLOBALISATION AND HOW REGIME CHANGE IS REVERSING IT

Overall, Globalisation has benefitted the world population, although there have been individual winners and losers. For Western consumers, overall, there has been access to cheaper goods and even in some cases services and the ability through globalisation to avoid potential ESG related tensions as the labour conditions in faraway countries are less easily monitored. To

a degree, the production of cheap goods has exploited conditions that would not be tolerated in the developed world both in terms of the labour force and pollution.

Europe has dealt with both its environmental issues and to some degree energy cost issues by becoming reliant on Russia for energy. At the turn of the year Russia supplied roughly one third of Europe's oil, 45% of its imported gas, and nearly half its coal. As a consequence, sanctioning Russia's largest earner of hard currency is economically and politically difficult to impose without causing severe hardship to domestic European populations.

As discussed in a number of previous Outlooks, offshoring has reduced inflation rates in the developed world as the cost of manufactured goods has fallen in real terms. The Covid-19 pandemic has re-ignited concerns over the implications of far off supply chains. Shortages have resulted in companies seeking to shorten these by bringing production back on shore. This in itself has been inflationary in its nature and will only be accelerated by the current crisis.

The US led the world in relocating manufacturing offshore, primarily to Asia, bringing down prices by utilising cheap labour. This was a win for US consumers, though not necessarily US workers, but did benefit the overall global economy as it promoted growth in emerging nations as populations were able to move from a dependence on subsistence agriculture to one of regular income streams through factory work. For example, the garment trade in Bangladesh has attracted much criticism but has resulted in the level of income for women being much higher than in other Muslim countries as women are often the chief breadwinners in Bangladesh households. Globalisation has boosted living standards in emerging nations, while allowing Western companies to become more competitive and providing low priced goods to consumers in these countries. The pandemic induced shutdown of manufacturing capacity combined with the effects of stimulus measures which increased demand has contributed to the elevated levels of inflation prevalent today.

Ignoring security threats, Europe has been happy to increase its reliance on other countries' energy production, primarily Russian, closing down nuclear power plants, gas fields, and also happy to ignore other potentially environmentally damaging sources of domestically produced fossil fuel such as fracking. In 2016 around 30% of natural gas consumed by the European Union came from Russia, but by early 2021 was closer to 50%. Europe focused on climate and other green solutions by outsourcing

energy supply and the ramifications of this are being felt today and are likely to be long lasting.



The first country to significantly benefit from offshoring was Japan where the US in particular was keen to rebuild the economy in a non-militaristic form after World War II. As the lure of lower manufacturing cost bases grew, a large scale shift to China began in the mid 1990s and has since evolved to countries such as Vietnam, Bangladesh, and Pakistan, raising overall living standards in these countries. This has fuelled the domestic consumption story which still is at the centre of most emerging market investment strategies. The downside of this was especially seen in the States and resulted in vastly lower real wages and fewer protection for manufacturing workers in the post GFC period, factors highlighted in a previous Outlook titled 'If Globalisation is So Good, Why is it Unpopular?'

Globalisation was also a significant factor in the low level of inflation experienced in the US and other Western countries over the past 30 years. Within inflation baskets, service sector inflation has outstripped that of durable and non-durable manufactured goods as these are the elements most susceptible to downward pricing pressure through globalisation. As manufacturing was hollowed out in the west, real wages came under pressure. Globalisation has limited the ability of workers to demand wage rises and has been a driver of the record share of GDP going to the owners of capital. It is fair to assume that most companies maximise profit. Globalisation has allowed many companies to implement this ruthlessly by locating production where costs are lowest. The importance of the fair treatment of all stakeholders has increased with the focus on ESG, but it is the implications and consequences of the pandemic and the Ukraine crisis which are likely to move the dial furthest in this regard.

This reliance on foreign energy in the case of Europe and foreign workers in the case of the United States was encouraged by the benign geo-political environment that has been in place since the fall of the Berlin Wall. This has allowed the production of goods and supply of services to benefit from improvements in transportation and communication without political hindrance. This period had coincided with the reduction in economic or military strength of many autocracies driven by the fall of the USSR, a trend now in reverse since Putin in Russia and Xi in China who have cemented their stranglehold on power turning their respective roles into "jobs for life". With the US the only other world superpower, which economically benefitted from increased levels of globalisation at the overall level, conflict was discouraged even though it is most dominant both economically and militarily. The geo-political regime change now occurring is likely to disrupt

both trains of thought to the detriment of overall living standards and the resultant economic responses to these threats are likely to result in less benign conditions for economies and financial asset prices going forward. A move away from globalisation will naturally produce individual winners and losers, but overall will have a negative impact on both economic growth and inflation at the overall level.

OVERVIEW

The primary driver for global financial markets in 2022 will be the behaviour of inflation especially in the United States. The annual rate of US price inflation has now risen to 7% and may reach 8.5% by the end of the first quarter when numbers are finally published. Market expectations remain that inflation will fall to around the 2% level sometime during 2023. In the UK, prices rose over 6% in the 12 months to February and the Bank of England has warned inflation could hit double digits later this year due to rising energy prices. Even in the European Union, a traditionally lower inflation economy, the rate has risen to above 6%. Central banks, in a response to the disinflationary forces from the Global Financial Crisis had targeted policies to get inflation higher, but clearly did not expect the outcome now being seen. This urgency behind inflation has been caused by various economic shocks connected to the pandemic, mostly supply side issues. However, the unprecedented level of fiscal support to economies meant that, compared to other recessions when supply might have been disrupted, demand remained strong, adding to inflationary pressures. For the major global economies Japan is the only one where inflation rates remain below central bank inflation targets.

Central banks, especially the US Federal Reserve, were initially relaxed about the rise in inflation believing it was driven mainly by temporary factors, with supply chain disruptions firmly pinned on the impact of Covid-19 and therefore expected to rapidly dissipate. Thus, there was a consensus view that inflation would drop sharply in 2022 and embedded inflation expectations would not rise. The US Federal Reserve which has a dual mandate to promote both growth while containing inflation focused on the former and had the desire to raise employment to at least pre pandemic levels. Even when the newly implemented (August 2020) average inflation target was exceeded by last summer the Fed continued

with its huge programme of asset purchases. In January this programme was still running at \$60bn a month despite the fact the emergency measures to support the US economy could no longer be rationally justified. The Fed pivot means net asset purchases should stop by the end of the first quarter. The Fed implemented its first rate rise in March, despite tensions in Ukraine, and the dilemma for the US Federal Reserve is that, even if growth slows, inflation will remain above targeted levels for a good while. Stickier elements of inflation such as rent, wages, and parts of the service sector are now showing price rises well in excess of US central bank targets, suggesting even if supply chain pressures ease, inflation will not fall rapidly. Clearly a risk for financial markets is that higher inflation expectations become embedded in public opinion leading to larger wage demands and an inflationary price spiral. Whilst US corporates in the decade post the Financial Crisis have been reluctant to raise wages, over the last six months this has not been the case due to the tightness of US labour supply. The Fed seems to be in the process of trying to gradually alter interest rate expectations, such as a statement post the last meeting that they expected six further rate rises this year, in an attempt to anchor inflationary expectations without causing stock market disruption which might impact on the real economy.

The inflation question has reignited debate between monetarist and non-monetarist (Keynesian) economists. For example, Lawrence Summers previously an advocate of 'secular stagnation' has argued for a while that US fiscal policy boosted aggregate demand which when combined with the pandemic driven supply constraints was always going to lead to sharply higher inflation. The global economy had seen loose monetary policy applied for a decade post the GFC without igniting inflationary pressures, but these measures when combined with a level of fiscal response unprecedented in peace time has, according to some economists, significantly altered the inflation outlook. Secular stagnation is the polar opposite of what Summers argues is occurring today, where aggregate demand fell significantly short of aggregate supply forcing a long-term downward trend in real interest rates. This decline in the equilibrium rate of interest or R^* has, according to many market commentators, been the most important driver of returns in this bull market where multiple expansion has accounted for the majority of equity gains post the Financial Crisis. Professor Summers has explained that whereas the response by the Obama administration to the Financial Crisis in fiscal terms was about half as large as the shortfall in output, the measures put in place in the United States post the pandemic including the original proposed Biden stimulus is three times as large as the shortfall, or in other words six times as large relative to the size of the output gap as occurred in the post GFC period. The question then for equity markets is whether monetary and fiscal policy will need to be adjusted on a dramatic scale to

address the problem to ensure inflation expectations do not rise sharply. Thus the attitude of the Federal Reserve in how to deal with the problem will be vitally important for the course of equity markets over the next number of years. While, to date, Biden's fiscal plans have been partially blocked by Congress, it remains huge relative to the output gap in peace time America.

In his latest commentary on inflation and monetary policy on 21st March this year Fed Chair Powell admitted the rise in inflation has been much greater and more persistent than the Fed and other forecasters expected. He promised to "adjust policy as needed in order to ensure a return to price stability with a strong job market...inflation is much too high. We have the necessary tools and we will use them to restore price stability". The definition of a return to price stability is vitally important for markets in terms of whether the Fed will seek to return the average rate of inflation to the 2% level from the 2012 period when inflation targets became objective or the period since August 2020 when average inflation targeting became the new Fed framework. Markets are currently assuming the Fed will more rapidly raise rates to a neutral level of around 2.5% but the question then is whether the Fed will be able to stop its path of tightening or will need to go further. A view by the central bank that the current supply side shocks have only led to a one-off adjustment in the price level would result in a very different market outcome to one in which the Federal Reserve decides that inflation expectations have become detached from its 2% objective. To date markets have been willing to believe that inflation may rise substantially in the short term but further out looking at 5-10 year inflation expectations numbers will return to the Fed's 2% long run target. In other words, the forward looking 5 year 5 year forward inflation rate has not moved markedly away from the Fed's 2% objective. The answer to this question will determine whether the pandemic and Ukraine crisis has marked a permanent turning point for asset markets.

The past decade has been a benign period for holders of financial assets, with stock markets led by growth stocks, especially large cap US technology names. In the decade ending 31st December 2021 total returns on US equities have averaged 13.7% p.a. whilst the Nasdaq has delivered a remarkable 21.4% p.a. Global equity markets have delivered over 9% in US\$ terms over the decade. Looking at bond markets US Treasuries have delivered positive returns of 3.0% p.a., a major factor why standard 60-40 equity bond portfolios, often in the form of so-called managed funds, have performed consistently well. Even risk parity funds which ensure the volatility of equities does not dominate returns and look to reduce equity exposure in favour of bonds when volatility rise have delivered excellent returns. This is because, as discussed earlier, market setbacks in the post financial crisis

period have been entirely caused by concerns surrounding demand rather than supply shocks. A world driven by supply rather than demand shocks may herald a very different investment regime than has prevailed in the past 30 years, in which the risks of far less benign returns from financial assets have risen considerably.

The past decade had seen high growth rates in both corporate earnings and dividends, well ahead of nominal GDP or inflation. The extent of the valuation re-rating can be seen by looking at the Shiller CAPE (an acronym for the Cyclically-Adjusted Price-to-Earnings Ratio. The ratio is calculated by dividing a company's stock price by the average of the company's earnings for the last ten years, adjusted for inflation) which then (2011) stood at 20x compared to 40x today, leaving plenty of room for equity prices to rise relative to earnings and dividends. This is the market re-rating which has driven the bulk of equity gains and is true whether or not investors believe the CAPE is an accurate reflection of valuation risk in the market.

The global economy also benefitted from an absence of supply shocks aided by stable geo-politics. **Geo-politics is the second area of regime change** which is now affecting global economies and stock markets. The late 1970s and 1980s had seen geopolitical crisis often resulting from oil price spikes proceeding recessions. Over the past decade the main shock to oil prices were downwards due to the increased supply resulting from US fracking. Most importantly for asset prices the long-term downward trend in nominal and real interest rates actually accelerated compared to the previous post Volcker period. Long term bond yields were depressed by central banks in the developed world adopting QE, something referred to in previous Outlooks as "Welfare for the Wealthy". This combined with the decline in equilibrium short term real interest rate which in an era of secular stagnation became negative drove the upward re-pricing of equity markets, the reduced discount rate favoured long duration assets such as equities in the US and Chinese technology sectors.

As stated in the opening paragraphs of this Outlook investors need to isolate themselves from market noise and focus on what we argue are the three long term drivers of equity markets. The first of these are fundamentals which have now become much less supportive. In terms of valuation, coming out of the pandemic, unlike the period coming out of the Financial Crisis, equity markets were at high rather than low valuation levels. Concerns over inequality have also resulted in a change in policy by most governments who now aim to raise the minimum wage and share of wages in national income which could put pressure on corporate profitability. Higher levels of fiscal policy, which the aftershocks of Ukraine mean are likely to remain

expansionary for a number of years due to higher defence and energy security spending, also suggest a higher level for neutral interest rates and the impact of a green or clean energy revolution will only add to these pressures.



The third factor investors need to consider is short term market sentiment and this had undoubtedly become overly bearish in the immediate post invasion period, and with markets so oversold any hint of a peace settlement was and remains likely to drive a short term rebound in equity markets. However, once the euphoria from this if it occurs passes, investors will return to looking at economic fundamentals and valuations which argue for a more cautious and selective approach with lower returns than have occurred over the previous decade as asset prices adjust so the new investment regimes of higher inflation and heightened geo-political tensions over the next few years. This is not to say equity prices will necessarily be negative, but markets are more likely to derate than rerate upwards so for returns to be positive this effect will need to be offset by earnings growth. Longer term, if the previously discussed secular disinflationary forces reassert as forward inflation rates currently imply (the 3 Ds of debt, demographics, and disruption) the outlook for asset prices will remain positive over medium to longer term periods. However, if higher inflation expectations become embedded and there is a return to the economic environment of the 1970s or 1980s investors could face a challenging decade.

Graham O'Neill

Director of Investment Policy
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