Ten Seconds Into 2022. Possibilities and Strategies.

Long horizon

The COVID crisis has been with us for about 2 years now. It is but the most recent in a random distribution of crises that punctuate our history. Generally, life progresses until it is interrupted by biological, environmental, or political crises, which end when the number of hosts, inhabitants or combatants is sufficiently depleted. That or human ingenuity finds technological or diplomatic solutions.

There is an optimal population size below which land and resources are adequate and beyond which we begin to denude the environment. The sharp acceleration in global growth and consumption have led us to this moment when we realize that the current trend in environmental degradation is not sustainable.

There is an optimal population size below which collaboration leads to growth and beyond which tensions lead to fracture. The size of the habitat and the efficiency of communications are factors. For a given size of the physical habitat, communications allow both collaboration and competition. At that point when the dynamics of competition dominate that of collaboration, the population must migrate or expand into a greater space or face political or social crises.

Foreign policy is usually influenced by the exigencies of domestic politics. Liberal democracies are particularly susceptible, but autocracies are not spared. Electoral competition as much as chauvinism drives national representatives into complex engagement strategies.

That climate change is the consequence of human activity is moot. Solar and planetary factors including seismic activity are also factors in global temperature, but the anthropogenic impact has dominated in the last century. Sharp accelerations in fossil fuel use in the 1950s precipitated accelerations in global temperatures with long lags of some 30 years. This lag has shortened to about a decade as temperatures continue to rise with fossil fuel use.

Studies regarding climate change focus on trends and averages but do not focus sufficient attention on ‘noise’ or the random fluctuations of actual data around averages. This is a risky oversight as sufficiently frequent spikes above certain thresholds can have cumulative and long-term effects on the environment. The current and expected response to climate change will likely be insufficient. The result in the long term will be a radical reduction in land and resources able to support human habitation. Competition for land and resources could increase the risk of conflict. Volatile climatic conditions are conducive to biological mutation both good and bad.

Capitalism tends to unequal outcomes. Whereas physical resources are finite and exhaustible, technology is not. Owners of labour can only accumulate a limited amount of intellectual property. Owners of companies can accumulate intellectual capital without bound. Thus, owners of capital compound their returns and can pass this wealth to their progeny. A capitalist economy thus naturally tends exponentially towards greater wealth inequality. Progressive taxation and fiscal policy can slow this tendency but cannot stop it. In the past, a well-defined ruling class made for clear targets for revolution. The distributed nature of wealth provides no clear targets for revolution. Discontent will find alternative avenues for expression.

Alternative socioeconomic organizations such as communism have largely failed. The brand practiced by China is an amalgamation of capitalism with socialist/communist features. Many contradictions remain unresolved and represents a structural weakness. The information deficiency which led to suboptimal outcomes for central planning from the early to late 20th century has receded through technology. Central planning may theoretically be efficient and viable if we ignore certain practicalities. An enlightened central planner faces less asymmetric and imperfect information than has hobbled past attempts at central planning. The question of whether a practical example exists today remains unanswered. China comes closest but the informational deficiency remains insurmountable at the present time.

Democracy is the most robust political system. Crises and deficiencies of diverse origins plague all societies. Monarchy presents a highly visible and obvious target for blame. Single party communist or socialist societies also present a single target for the allocation of blame. These create the risk or opportunity of regime change and discontinuity. Democracy, by presenting multiple alternative targets for blame preserve the system at the expense of specific governments.

Similarly, capitalism places the rewards and blame on the individual thus diverting such from the system. For this reason, capitalism is robust. This is especially true when capitalism is coupled with democracy. The more diverse the ownership of capital and power, the more robust is the system. Social mobility across capital and power increase robustness. Entrenchment reduces robustness.

In the very long run, democracy is the asymptotic equilibrium of history. In shorter time frames, cycles are likely. Democratic capitalism has dominated in the last 100 years and with the end of communism has arguably peaked. Power and money have become increasingly entrenched reducing the robustness of the system. When crises can no longer be ascribed to actors but to the system, democratic capitalism will recede. Democratic capitalism will only be restored when its once forgotten rewards are remembered and balanced against its costs. Until that time, society may experiment with and cycle through various social systems.

Medium horizon.

Almost half a century of benign inflation may finally give way to rising prices. Substitution of robustness for efficiency for practical reasons or political ones may extend the durability of this trend. Fiscal expediencies of redistribution and state support in times of economic stress when monetary policy is at its limits or otherwise constrained could exacerbate matters. The complexity of the financial system could add to policy errors and create a negative feedback loop where policy meant to cool instead serves to stimulate.

Inflation hits hardest the poorest who have no buffers and who tend to face the most volatile consumption baskets. The unequal distribution of wealth means that greater numbers will suffer disproportionately from high inflation.

Governments who fail to address the inflation problem will find themselves out of government. Also, there is the risk that policy makers no longer understand how the economy or society responds to policy, and that their efforts are ineffective or amplify the problem.
An accidental policy in response to a financial crisis may succeed in quenching inflation but it is difficult to rely on serendipity.

Environmentally sustainable policies, goods and services cost more. While costs will fall as more eco-friendly output is produced, costs will rise relative to the old non-eco-friendly output simply because of non-commercial constraints and factors in the production function. The investment in transition is also inflationary even if it is temporary. The scale of the investment necessary could make the transitory period quite long and the cost impact significant.

Almost half a century of falling interest rates has the effect of inflating the value of income streams and thus asset prices. Long duration assets like equities and real estate rise as interest rates fall. The future trajectory of interest rates will have a profound effect on such long duration assets. Rising rates will increase debt service costs. Demand for assets might also fall if fiscal budgets were financed with more progressive tax codes which transfer wealth and income from high savings rate individuals to low savings rate individuals.

Robustness X Efficiency = a constant. The world economy has spent multiple decades improving efficiency at the cost of reduced robustness. At some stage, circumstances can conspire to reverse the trend. In the financial industry, it was the 2007/8 crisi which reversed the trend. Years of deregulation and innovation in shadow banking led to substantial improvements in the efficiency of financial intermediation at the cost of increasing fragility. The mortgage crisis afflicted securitization markets, then structured credit, before infecting the formal banking system. The regulatory response, begun in 2008, continues to be felt today. The financial system is better capitalized and structured to withstand shocks, rather than to deliver optimal returns on capital.

Industrial supply chains have been increasingly optimized for maximum efficiency and just-in-time delivery. With the COVID pandemic and disrupted supply chains triggering transient shortages and other frictions, businesses are reorganizing themselves for more robust production and delivery, integrating supply chains, securing supply of materials and intermediate products, often at the expense of cost and capital efficiency. This is likely just the beginning and will present many diverse investment opportunities.

Investment strategy.

Always buy that which, in future, people want to have. In the last 40 years, buying future cash flows, real or promised was attractive, as inflation and interest rates were low and falling. Buying cash flow generating assets such as real estate, bonds and equities was profitable. Buying diversely and indiscriminately had little cost as entire asset types rose in monetary value.

If inflation does in fact take hold, and if interest rates rise, then a new strategy is required. Fixed income will very likely lose money. Floating rate debt is preferred but even then, the fixed spread over the floating rate will be eroded by a higher discount rate. Debt instruments may be created with coupons that step up at a fixed rate to compensate for inflation and rising rates. Richer capital structures may emerge to address the needs of investors with different risk and return targets.

Real estate rents are often indexed to inflation. The business risk of leasing premises will rise and may encourage some businesses to buy their premises. The ability of real estate to collateralize the issuance of debt at fixed rates is also attractive.

Under high inflation, value stocks outperform growth stocks. Income oriented, high dividend paying stocks also suffer. Volatility tends to be higher.

A more progressive fiscal policy, the shoring up of supply chains, the strengthening of balance sheets, will make capital relatively scarcer. The provision of capital will offer a higher premium.

Inflation erodes the value of cash. This is obvious. However, as it erodes the value of all cash flow generating assets, and assets represent a leveraged exposure to interest rate sensitivity, the unlevered nature and the optionality of cash will be valuable. Having cash as interest rates and inflation rise effectively put one in a Dutch auction of over-supplied fungible assets with dry powder to spare.

Market timing and a gamble. The virtues of falling interest rates are manifold. Central banks should seek to maximize the time interest rates spend falling. Given that most central banks are close to their zero bounds on interest rates, a strategy could be sought to raise rates quickly and when the impact is expected to be least painful. Inflation provides such cover. Fiscal policy could provide support while monetary policy is sharply reversed. Interest rates would be raised significantly to levels which allow for a multi-year fade. This is a risky strategy and difficult to execute. Volcker did it in the early 1980s and left it to Greenspan to reap the rewards in the two decades after.

There may be opportunities arising from investing in non ESG businesses which trade at discount to market or fair value. The influx of capital into ESG investments has created an ESG premium and an ESG discount. Thermal coal, alcohol, and energy businesses present attractive commercial opportunities. The profits from a portfolio directed at such negative ESG investments could be entirely directed to philanthropy. In some cases, activist strategies for improving the ESG profiles of such companies or aiding their transition, can lead to correlated positive impact and commercial outcomes. Opportunities as yet unexplored such as seeking outcome payers to pay for an orderly liquidation strategy, might emerge.

One last thing.

We appear to be in the middle of a multi-year inflexion point already underway. To sow in the hope of harvesting within this inflexion is a strategy ambitious and fraught. Some tactical and higher frequency investors such as traders and hedge funds will find this environment conducive. To longer term investors, recognizing the prevailing regime can allow them to focus on sowing to harvest further in the future. Self-awareness is increasingly important in investing today.