

Ten Seconds Into The Future

2022 10

Current Observations:

On the positive side of the ledger:

- Economic growth is still strong.
- Household & bank balance sheets are strong.
- Corporate balance sheets are fairly strong.
- Fiscal policy is still fairly expansionary.
- Green capex momentum is strong.
- Equities are fairly valued.

On the negative side:

- Inflation is persistent.
- Central banks are tightening.
- Governments are over borrowed.
- Interest rates are rising.
- Fixed income is expensive.
- Financial system liquidity is stressed.
- Financial conditions are tight.

Expectations, Risks and Opportunities:

On the positive side of the ledger:

- Inflation may fade.
- Central banks may pivot.
- Economic slowdown may be shallow and short.

On the negative side:

- Fiscal policy will need to tighten.
- Credit costs may continue rising.
- Leverage may be less available.

- Economic growth is expected to slow.
- Valuations mean revert and overshoot.

Geopolitics and other distractions:

On the positive side:

- Emerging markets ex China have young populations.

On the negative side:

- China's increasingly a one-man rule system.
- China v USA rivalry continues.
- Globally, mercantilism likely to continue.
- Weak European economic growth is a risk to social stability.
- US partisan politics likely to remain tense.
- Russia Ukraine war yet unresolved.

The last 12 years saw an acceleration in monetary accommodation as central banks worked to bail out the financial sector, developed a taste for QE, and supported the economy while inflation remained benign enough to allow them to do so with impunity.

Fiscal policy has been restrained since 2013 after the initial surge of bailouts during the 2008 financial crisis. Discipline was maintained until broken by the global COVID pandemic in 2020.

These fiscal and monetary impulses have driven demand beyond supply capacity resulting in a surge in inflation. Long term inflationary forces have made it hard for inflation to fade as quickly as expected and has left central banks reacting rather than preempting.

Tightening monetary conditions too late and too slowly may require central banks to remain more hawkish for longer and risk inciting recession.

Higher interest rates put pressure on highly indebted governments to reign in budgets. Monetary tightening is likely to be followed by fiscal tightening albeit with a lag. (Interest rates will likely peak when this happens, and, this should be driven not by a central bank pivot to dovishness but from tighter fiscal budgeting.)

The current bear sentiment in markets will eventually abate, if they haven't already. However, the future is likely to face a) less availability of leverage, b) higher equilibrium interest rates, c) higher overall cost of debt and equity, and consequently also, lower operating margins, and slower earnings growth.

Long term equity returns are likely to remain positive in nominal terms and perhaps barely in real terms. If we didn't believe this, we would not be in this business. However, lower expected returns and heightened volatility (from disparate factors from slimmer margins to heightened geopolitical and climate risks) mean equity allocations should be reduced, all things being equal. The trouble is that the same challenges plague corporate debt markets. At some level, yields will present attractive returns but until then duration needs to be hedged leaving meagre spread returns even with the recent spread widening.

Assets have cheapened from acutely expensive valuations but even when they revert to near long term averages, the historical tendency to overshoot whether when rising or falling means that assets may cheapen further.

This analysis doesn't really consider the deeper implications of geopolitics and demography. Slow growth amid rising inflation does not foster an environment for cooperation and fraternité.