TS Lombard

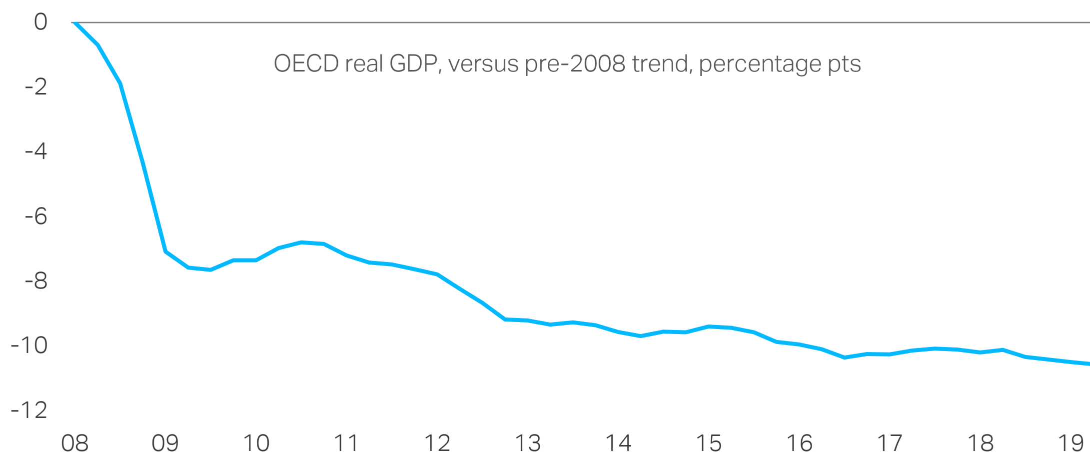
Macro Picture

NEW MEDIOCRE

Dario Perkins

The global expansion is now the longest in modern history. But this impressive record masks low and patchy growth, dismal productivity and clear polarization. Central banks only seem capable of periodically reviving asset prices and generating short bursts of 'reflation'. Secular stagnation is also contagious, with the US dollar playing a central role.

Chart 1: Secular stagnation in the OECD



Source: OECD, TS Lombard

UNUSUAL CYCLE

The longest global expansion in modern history is also the weakest. In fact, looking beyond its duration, the post-2009 economic cycle is better characterized by: (i) several short bursts of stop-start global activity; (ii) permanent output losses; (iii) low productivity and low wages (despite low unemployment); (iv) rising debt levels; (v) increased inequality and polarization.

BAD EQUILIBRIUM

Economists like to debate whether the slowdown is structural or due to deficient demand, but this distinction is no longer helpful. Many of the features of the New Mediocre feed on each other, producing a bad equilibrium. While the United States is better placed than some other parts of the world, secular stagnation seems contagious. The strong dollar spreads the pain.

MONETARY LIMITS

Central banks are set to ease policy again, which should keep financial conditions loose and revive asset prices. Perhaps the authorities can even extend the global cycle (again). But the limits to monetary action are becomingly increasingly clear and the policy focus will eventually shift to other areas, especially fiscal actions. Until then, bond yields will remain chronically low.

NEW MEDIOCRE

Welcome to what is officially now the longest US expansion in modern history. Other parts of the world such as Australia, China and India have achieved even longer periods without recession, thanks to economic cycles that began in the 1990s. Following one of the worst financial crises in history, this long record of unbroken global growth is clearly something to celebrate. Yet once we look beyond its duration, the other features of this global cycle are much less impressive. Average growth rates are well down on historical averages, which means the large output losses that accumulated during the Great Recession have become permanent scars. In fact, rather than return to pre-2008 trends, global growth has been stuck in a series of mini stop-go cycles, which has kept investors entertained, but has not been sufficient to break the world out of its persistent rut. The 'New Mediocre' for the global economy, as the IMF calls it, is also a world of low inflation, subdued wages and dismal productivity. Long-term interest rates have fallen to their lowest levels in centuries and while this has been good news for asset prices – which have duly 'rerated' – it has added to rising inequality and polarization. Global debt has increased further, particularly in sectors and countries that dodged the worst of the subprime crisis.

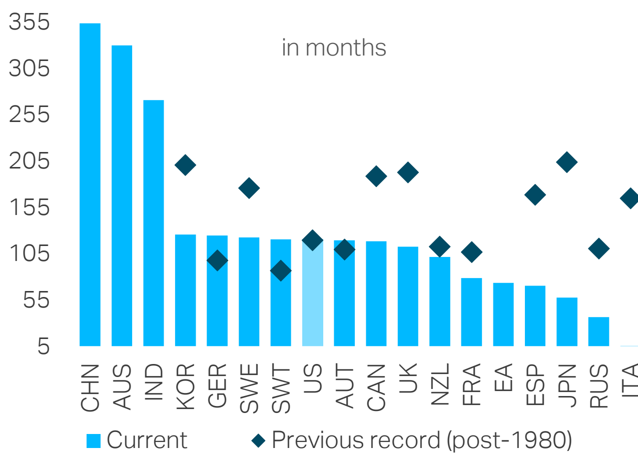
Low interest rates suggest the world continues to struggle with an excessive desire to save. Secular forces ('secular stagnation') are clearly a crucial part of the story. The world's population is slowing and starting to age, having passed an important demographic inflexion point. And after a brief Dotcom-related revival in the 1990s, productivity has resumed its long-term 'megatrend' deterioration, a problem that was apparent even before the subprime crash. Though technological progress has continued in the new digital era, a relatively small group of companies seem to be capturing most of the benefits, which means diffusion to the wider economy has slowed. With demographics and technology playing critical roles, it is easy to understand why policymakers are struggling to reverse this rut. In fact, the world seems to be stuck in a 'bad equilibrium', in which the main features of the New Mediocre actually reinforce each other. Weak productivity hurts wages and low wages damage productivity. Low interest rates undermine productivity and poor productivity erodes the return on capital. Easy financial conditions encourage the build-up of debt, which makes it even harder to raise interest rates. There is also evidence that secular stagnation is 'contagious', with the US unable to escape the deflationary draught from Europe and Japan. The strong dollar spreads the pain to the EMs.

The global economy recently completed another of its mini-cycles, swinging from 'reflation' to possible recession and putting the world back where it was in early-2016 (the last time policymakers were panicking about the macro outlook). Central banks are again responding, adding fresh monetary stimulus. While these actions should help to ease financial conditions and boost asset prices (again), it is increasingly clear that monetary stimulus will not be sufficient to break the New Mediocre. It seems inevitable that fiscal policy will eventually take over. Yet so far, only the Chinese have been willing to use the State's balance sheet in this way, which is probably why China's policy cycle has become such an important source of marginal demand - Chinese stimulus remains much more effective at boosting global activity than anything the ECB or BoJ have tried (which amount to a series of competitive devaluations). But, while the consensus on fiscal policy is shifting, it is hard to see anything radical happening until the world economy is already in a new recession. This means global growth and inflation will remain structurally low and another temporary burst of reflation is the best investors can hope for.

1. UNUSUAL CYCLE

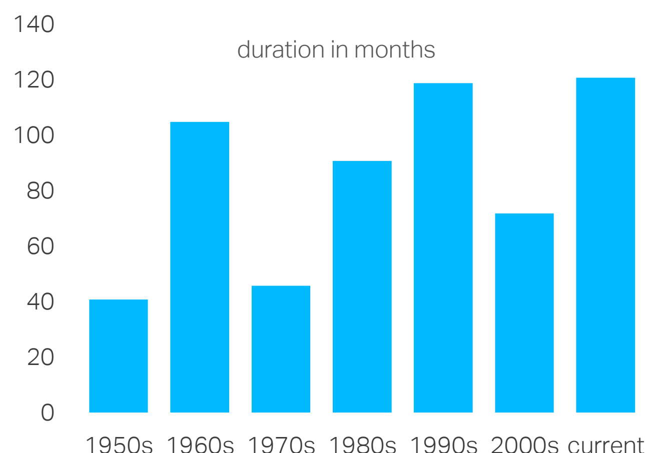
Investors can expect lots of media stories this month celebrating 'the longest expansion in history'. This is because, according to the way the NBER defines the cycle, July 2019 marks the 121st consecutive month of US expansion, beating the previous record (120) set in the 1990s. Still, if you're an investor based in China, Australia or India, countries that dodged the global collapse in 2008 and have avoided recession for more than three decades, this new US record won't seem particularly impressive. And it turns out the longest US expansion in modern history (records start in 1857) is also one of the weakest. Real GDP growth has averaged 2.2 per cent since 2009, compared to 3.2 per cent in the 1990s and almost 5 per cent in the 1960s. Still, the United States isn't alone in producing historically poor annual growth rates – most OECD countries find themselves in a similar situation (Chart 6). The IMF calls this the 'New Mediocre'.

Chart 2: US expansion in context



Source: TS Lombard

Chart 3: US expansions



Source: NBER, TS Lombard

Another "pause/un-pause" expansion

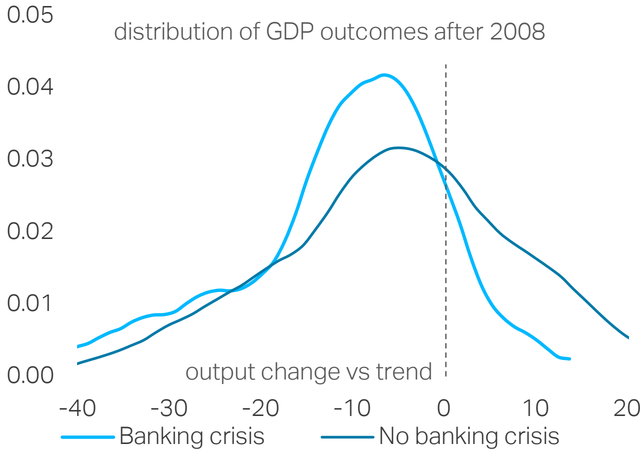
On one level, it is surprising that the subprime crash, the steepest, most-synchronized economic downturn in history, didn't produce a more vigorous economic recovery. Policymakers, particularly on the monetary side, have made unprecedented efforts to try to force the global economy out of its rut. Yet, rather than reach 'escape velocity' (a phrase that was popular in the early phases of this cycle), global activity has stumbled through a series of mini-cycles – short bursts of 'reflation', followed by quick downturns and renewed anxiety about recession. For all the excitement this has bought investors, it means global growth and inflation have spent much of the last decade bumping around at fairly low levels. This is not an entirely new feature of the modern economy. Alan Greenspan noted something similar in the early 2000s, when he described a US economy experiencing a 'pause/un-pause' cycle of growth.

Permanent output losses

Low, patchy growth means the global economy has failed to return to pre-2008 trends – i.e. the world has experienced permanent output losses. While countries that suffered banking crises fared worse than those that didn't, this theme has played out in most parts of the world. On average, countries that had a banking crisis have seen GDP drop by 7% compared to pre-2008 trends, whereas output is 4% lower in those that avoided a crash. As we might expect, the picture is more mixed for EMs than DMs, with a wider distribution of outcomes (Chart 5). Dismal productivity explains much of this deterioration. Even as global unemployment rates have

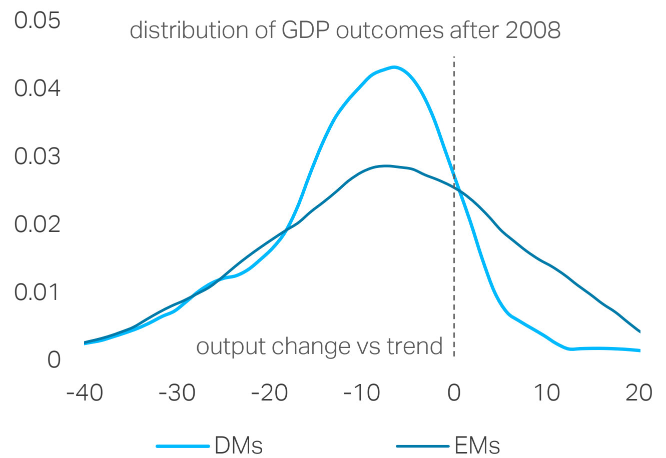
declined steadily since 2009, reaching multi-decade lows in the US and parts of Europe, output per hour has slumped, producing some of the lowest readings ever recorded. Bank of England data suggests this has been the weakest decade for productivity since the Industrial Revolution.

Chart 4: Crisis countries suffered most



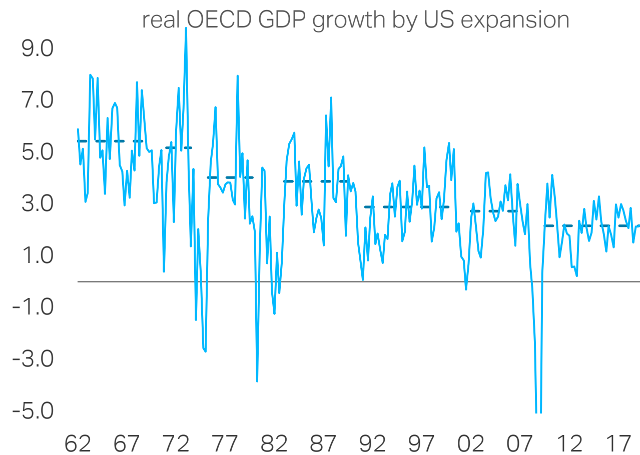
Source: IMF World Economic Outlook

Chart 5: DMs suffered more than EMs



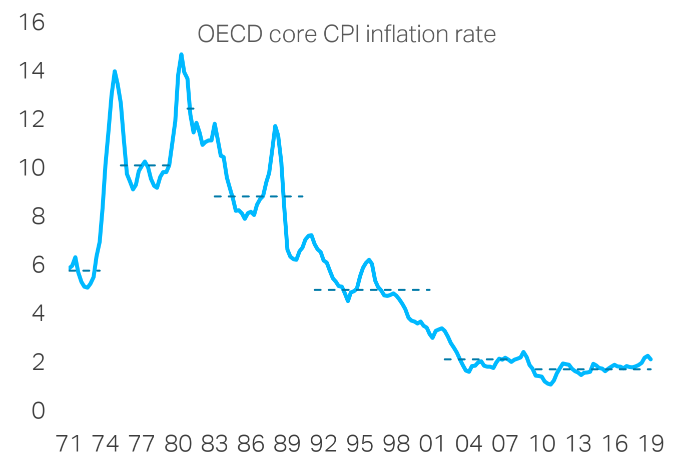
Source: IMF World Economic Outlook

Chart 6: Weakest expansion on record



Source: OECD, TS Lombard

Chart 7: Low-inflation environment



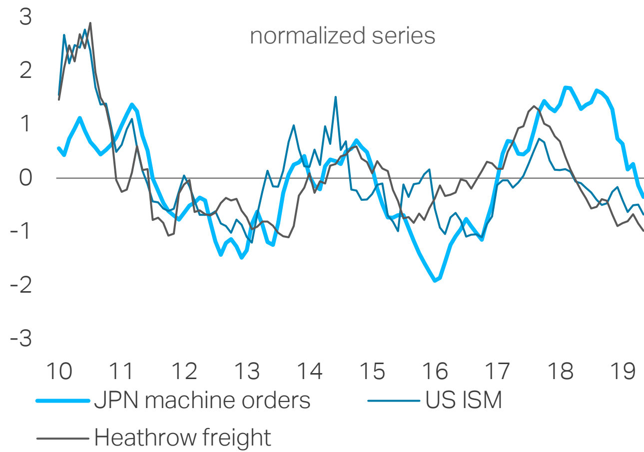
Source: OECD, TS Lombard

Low nominal world

The 'new mediocre' is an environment of low interest rates and modest price gains. Despite a concerted effort to force inflation higher, most central banks have been undershooting their 2% targets for at least a decade (sometimes two decades). Bond yields have dropped to the lowest levels in centuries. Last month, German 10-year interest rates hit their lowest ever levels, while a rising share of global debt is trading at negative rates – which means investors are prepared to pay to lend governments their money (or they are expecting offsetting capital gains to prevent an otherwise guaranteed loss). Denmark now has negative yields across its entire curve – all the way out to 30 years. Subdued wages seem to be an important part of the story. Despite impressively low unemployment across the OECD, there has been no real sign of a Phillips-curve-driven spiral between wages and prices. Perhaps the rate of economic expansion is just

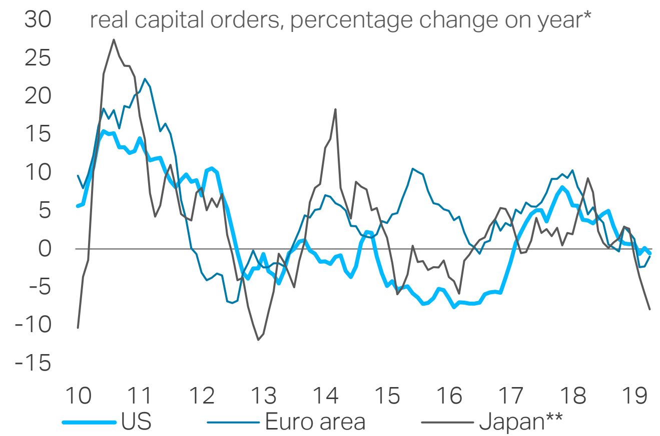
as important as the level of unemployment when it comes to inflationary pressures, with the stop-start nature of this cycle not sufficient to generate sustained 'overheating'.

Chart 10: Stop-go global industrial cycle



Source: Datastream, Heathrow, TS Lombard

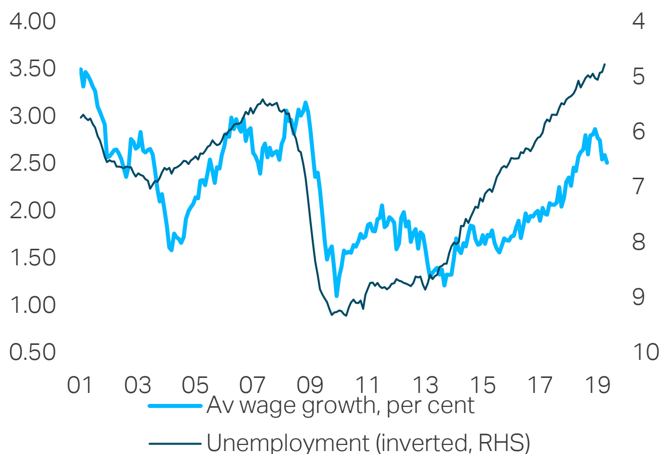
Chart 11: Stop-go global capex cycle



Source: TS Lombard estimates, *smoothed, **capital shipments

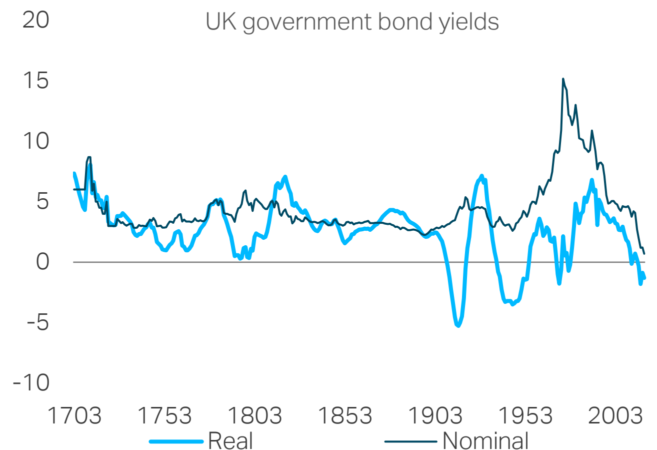
The New Mediocre is also a world of inequality and polarization. Wages have fallen short of productivity in many countries, which means the corporate share of output has risen at the expense of workers. Inequality – both between workers and between companies – has widened. The corporate sector has become increasingly 'winner-takes-all', dominated by a relatively small number of superstars. These companies have become hugely profitable and are able to pay decent wages, while a 'fat tail' of productivity laggards have struggled, seemingly dependent on cheap labour and rising indebtedness. Low interest rates have arguably made this situation worse. Not only have asset prices 'rerated' on the basis of a lower discount rate, but easy financial conditions have kept even the most inefficient companies in business, the so-called 'zombies'. In fact, global debt levels have continued to rise, particularly in countries and sectors that were not at the epicentre of the 2008 crash – China, US corporates, Canada and other DMs.

Chart 9: Broken G7 Phillips curve



Source: TS Lombard estimates

Chart 8: Historical bond yields



Source: Bank of England, TS Lombard

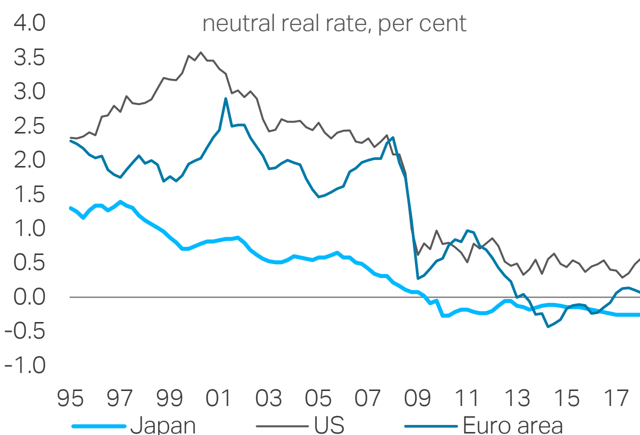
So to summarize the main features of New Mediocre, we have:

- An unusually long but slow economic expansion;
- Permanent output losses in most countries after the subprime crash;
- Subdued wages despite low and declining unemployment rates;
- Historically dismal productivity but high corporate margins (in aggregate);
- Extremely subdued inflation despite interest rates at unprecedented lows;
- Rising inequality among both workers and corporations;
- Rising debt levels, especially in countries that avoided the 2008 crash.

2. BAD EQUILIBRIUM

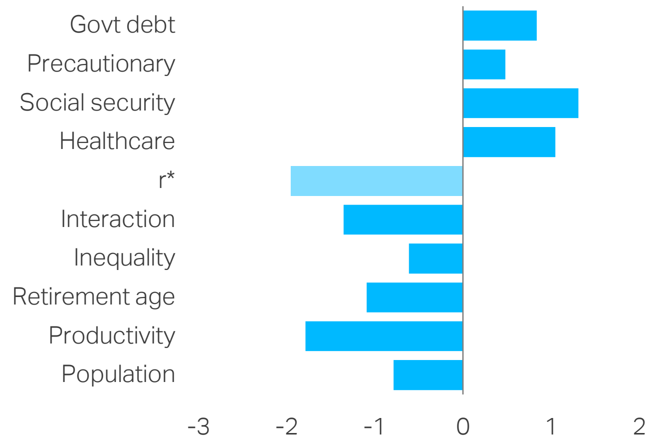
Of all the symptoms of the New Mediocre, the collapse in long-term interest rates is perhaps the defining feature of the era. While some commentators blame central banks for excessively loose monetary policy, the authorities prefer to cite structural explanations. These days, most central bankers subscribe to Larry Summers' secular stagnation hypothesis. This is the idea that long-term shifts in the desire to save and invest have pulled down 'equilibrium' interest rates to historically low levels, meaning central banks must accommodate these shifts or live with permanently deficient demand. Note also that it is the *desire* to save and invest that matters, not the realized level. For the world as a whole (a closed system), savings must equal investment. But if the world is trying to save more than it invests, interest rates must drop to close the identity.

Chart 12: Falling equilibrium interest rates



Source: US Federal Reserve, Bank of Japan

Chart 13: Decomposing the drop in r*



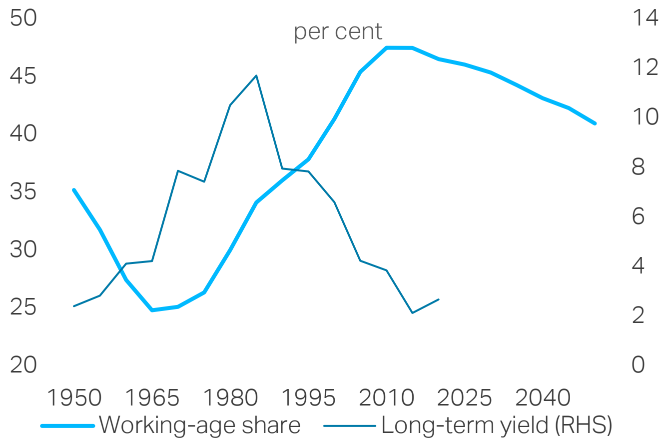
Source: Lukasz-Summers (2019)

Excess saving

Most of the academic literature on secular stagnation argues equilibrium interest rates have been falling for decades, a trend that comfortably pre-dates the global financial crisis. Larry Summers recently co-authored an influential study with the Bank of England that tries to identify the main secular forces that have driven equilibrium rates down, estimating their relative contributions. They found that three forces have been particularly important: (i) Demographic shifts; (ii) Declining total-factor productivity, and (iii) Rising inequality. Chart 13, which reproduces

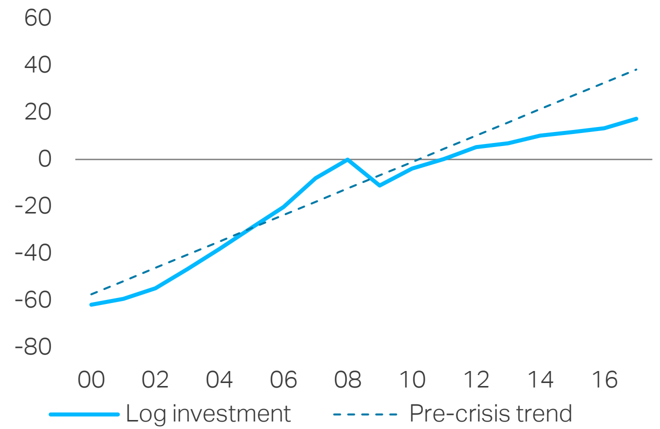
the Lukasz-Summers results, shows long-term interest rates in the OECD would have dropped even more substantially since the 1970s had it not been for offsetting shifts in fiscal policy (notably higher spending on old-age healthcare, social security and rising government debt).

Chart 14: Demographics and bond yields



Source: United Nations, Datastream

Chart 15: OECD investment slump

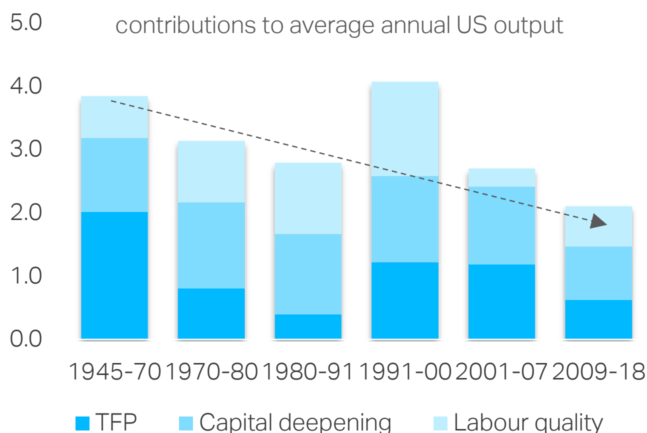


Source: IMF World Economic Outlook

Demographic drag

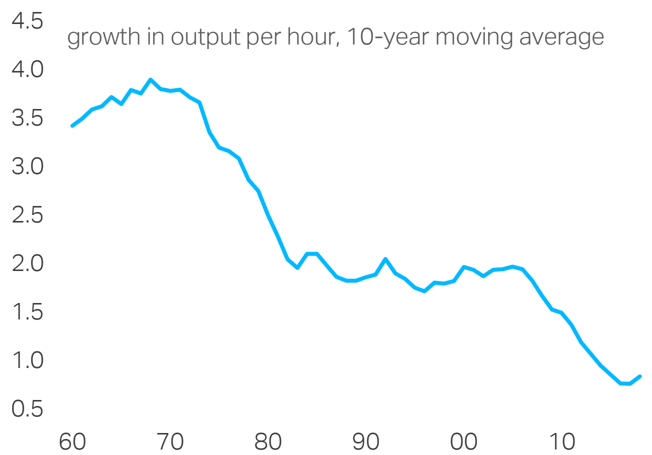
In terms of demographics, Summers argues that rising longevity has forced people to save more for their retirement, which has influenced the balance between desired savings and investment. But we prefer Charles Goodhart's analysis of demographics, which places more emphasis on what has been happening in developing nations (the Lukasz-Summers model looks at the OECD countries in isolation). As Goodhart points out, not only did dependency ratios in developed nations decline rapidly after the 1970s, as the baby-boomers entered prime-working age, but the world also absorbed a massive supply of new workers from China, Eastern Europe and other emerging economies. To illustrate, the number of working-age people increased from 685 million in 1990 to 763 million in 2014, while the number of people added to the global labour force from China and Eastern Europe jumped from 820 million to 1.1 billion. Goodhart believes globalization and demographics combined to create a glut of labour, which reduced wages, destroyed trade unions in Developed countries and lowered inflation and interest rates.

Chart 17: US growth accounting



Source: San Francisco Federal Reserve

Chart 16: OECD productivity slump

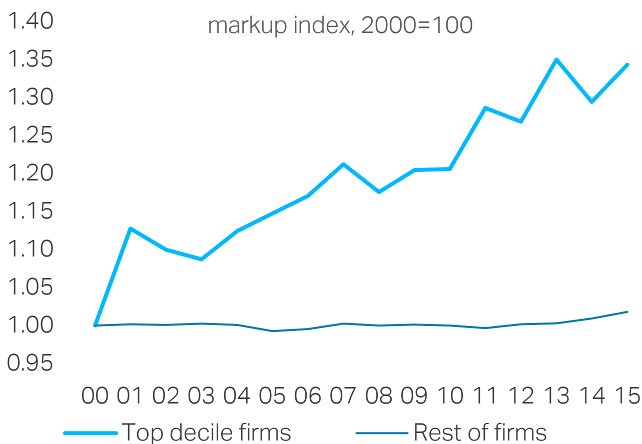


Source: OECD, TS Lombard estimates

Investment weakness

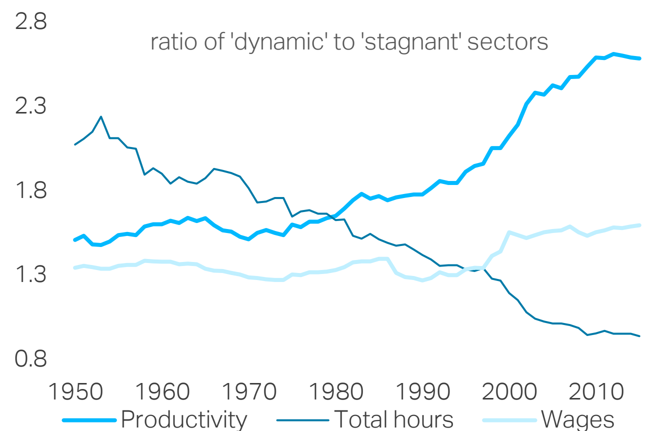
With a massive increase in the supply of labour internationally, many companies in developed economies became less inclined to invest, substituting capital for cheap labour. OECD investment rates have been stuck at low levels, which has hurt productivity – another major contributor to secular stagnation. Indeed, simple 'growth accounting' shows weak total factor productivity has played a pivotal role in the global slump. Chart 16 provides estimates for the United States, based on the Federal Reserve Bank of San Francisco's model. If we exclude the brief revival in productivity that took place during the Dotcom tech boom, US productivity – arguably the technological frontier for the global economy – has been deteriorating steadily since the 1960s. Some economists, including Robert Gordon (and even the IMF) believe this deterioration is part of a long-term 'megatrend' that has permanently dimmed growth prospects.

Chart 18: Divergence in corporate profits



Source: IMF World Economic Outlook

Chart 19: 'Dual' US corporate sector



Source: Servaas Storm (2017)

Technological diffusion has slowed

The link between technology and productivity has become controversial in recent years. Despite continued rapid innovation in new digital technologies, there is no real sign that this is boosting output, either in the United States or elsewhere. Tech enthusiasts blame data problems – the digital economy is inherently difficult to measure because: (i) transactions are usually unobservable, (ii) the technologies are scalable at zero or negligible cost, and: (iii) new services are often free to end-users, or paid for in nonmonetary terms (by users giving up their time). We have a lot of sympathy for these arguments, especially as the national accounts are under-recording digital deflation, but we are also in the minority. The consensus, at least among policymakers and statisticians, is that measurement errors are not a big part of the slowdown.

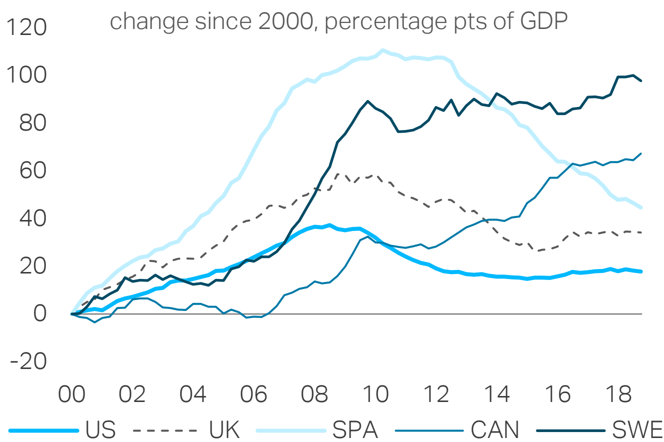
Putting aside measurement issues, the bigger problem with recent technological progress is that diffusion to the wider economy has slowed down. This means a relatively small number of companies, particularly the tech 'superstars' such as the FANGs, are capturing most of the efficiency gains. A number of recent academic studies show the gap between the superstars and the rest of the economy has widened, with a long fat tail of inefficient productivity laggards. But there isn't a great deal of consensus about what is causing this. The optimists believe diffusion will eventually pick up, as the laggards catch the superstars. This was certainly what happened with previous waves of technology, including the industrial revolutions. But there are also reasons to think this time might be different. The digital economy seems increasingly 'winner-takes-all', thanks in particular to the dominant role of intangible capital. This means more

of the capital stock is scalable, and exhibits synergies and spillovers, so leading firms can pull away from their competition, scaling up over their intangible assets, assimilating knowledge from rivals, and combining intangibles in a way that laggards cannot.

'Dualism' rules

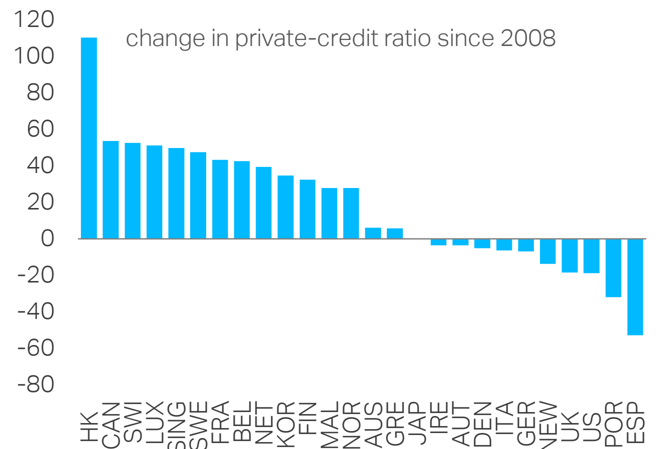
The combination of a glut of cheap international labour and slower technological diffusion also explains rising inequality. While the superstars have invested heavily in tech, securing high profit margins, rapid productivity gains and paying relatively high wages, the non-superstars have had to grow their businesses by adding lower-wage workers and taking on more debt. This has produced a new form of 'dualism', not just within the United States, but between countries. The rise in aggregate US profit margins hides a massive shift in the distribution of earnings. 'Mean' margins have risen but most companies (and the 'modal' margin) are no more profitable than they were 30 years ago. Meanwhile, the United States – which has more superstars than other parts of the world – has increasingly outperformed other developing nations, particularly the Euro area and Japan. We also see these relative shifts in equity markets, where the FANGS have outperformed other domestic sectors and the US (in aggregate) has outperformed other DMs.

Chart 20: Private-sector credit



Source: BIS, TS Lombard

Chart 21: Debt divergence



Source: BIS, TS Lombard

The New Mediocre is self-sustaining

By emphasising 'secular' themes (i.e. demographics, productivity and inequality) it is tempting to believe the New Mediocre is essentially a supply-side problem. Yet the distinction between demand and supply isn't particularly helpful because many of the underlying causes and symptoms of secular stagnation interact and reinforce each other. Most economists have revised down their estimates of potential GDP since the early 2000s, but history shows these models have no real predictive power: they are just moving averages of actual output. A sustained period of low growth always prompt economists to downgrade their estimates of 'potential', even if inflation remains low. There might be good reasons for these revisions – e.g. weak demand hurts investment, which damages supply potential – but this isn't particularly helpful to anyone hoping to make economic forecasts (or predict asset-price returns).

Regardless of whether 'demand' or 'supply' is to blame, the most crucial thing about the New Mediocre is that it is extremely hard to escape. To see why, consider the following:

(i) If 'equilibrium' interest rates become very low in some countries, central banks might not be able to accommodate these moves and stimulate demand. Both Japan and parts of Europe seem stuck at the lower bound, struggling to ease policy further;

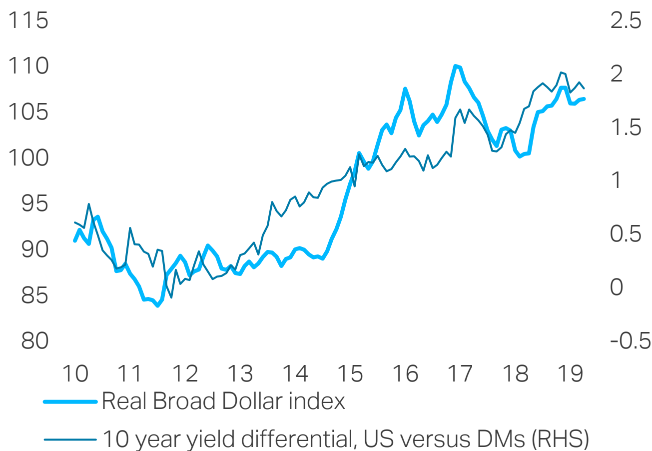
(ii) Low productivity erodes the return on capital, which reduces long-term interest rates. But low interest rates can also hurt productivity, by keeping otherwise unprofitable firms alive and widening the gap between superstars and laggards;

(iii) Low interest rates encourage the build-up of debt, which in turn makes it harder for central banks to raise interest rates even if the outlook improves. US corporates have been the most striking example of this trend since 2008, but we see the same theme in other developed nations (see Charts 20 and 21).

(iv) Most economists agree that low productivity must depress wages (if workers are paid based on how much they contribute) but there is also evidence that low wages undermine productivity. Companies have been less inclined to invest in labour-saving equipment when they have a plentiful supply of low-wage workers.

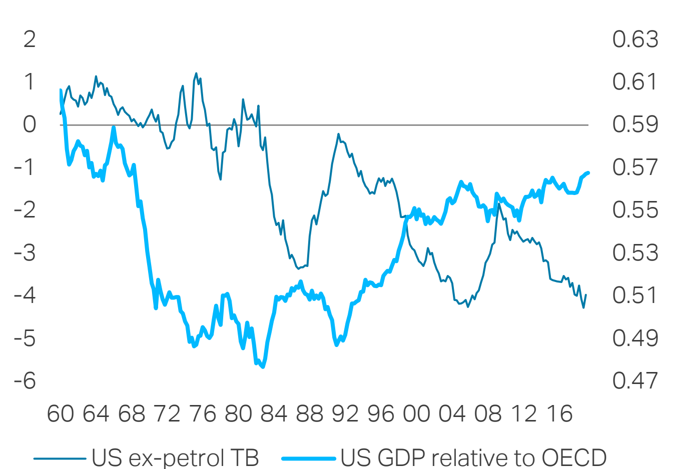
(v) Exchange-rate moves can spread secular stagnation around the world. In particular, central bank easing in Japan and Europe has produced an over-valued US dollar, which has been a major drag on the United States and those countries (especially EMs) that have borrowed in America's currency. There is now a growing recognition that secular stagnation can be 'contagious' across countries.

Chart 22: Global deflationary spillovers



Source: Federal Reserve, TS Lombard

Chart 23: Oil conceals wider US deficit



Source: OECD, national sources, TS Lombard, TB: trade balance

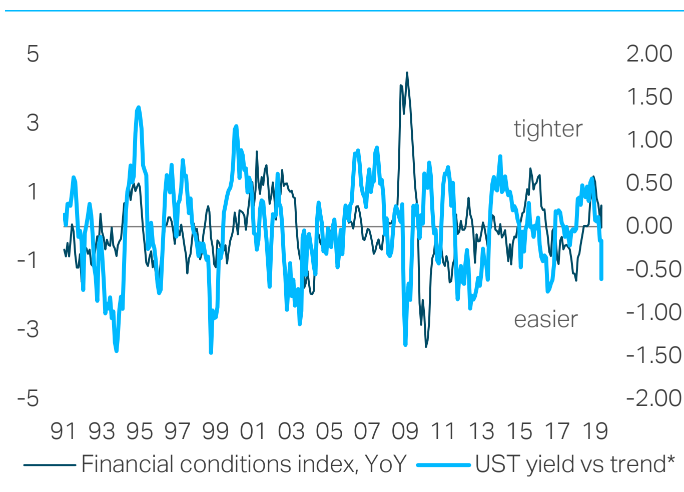
Secular stagnation is 'contagious'

Many economists have been surprised by the persistent weakness of the US economy. While the United States has performed better than many other developed nations, the country has not been able to break away entirely from weakness elsewhere. This seems odd because, if we restrict our attention to what was happening domestically, the US dealt with many of its pre-2008 macro 'imbalances' rather quickly. By 2014, house prices were recovering, banks had cut their leverage aggressively and were in good shape to lend, households had reduced their debt significantly (debt servicing ratios were the lowest they had been in decades) and even if banks were reluctant to lend, US companies had easy access to funding in capital markets. Yet as soon

as investors started to talk about 'decoupling' between the US and the rest of the world, the dollar surged to its highest levels since the 1980s, which prevented a large US breakout.

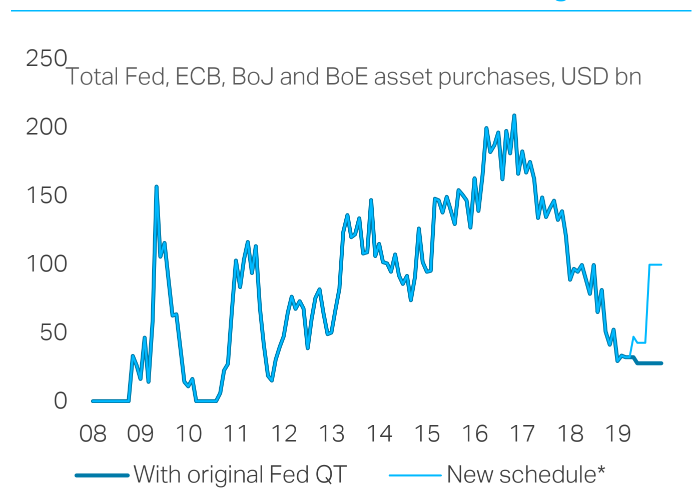
The impact of the strong dollar isn't immediately evident in the US current account, but this is mainly because America has slashed its dependency on foreign oil. If we exclude the surplus in petroleum products, we see a more material widening in the US deficit – more than traditional growth differentials would have implied (Chart 23). The appreciation in the exchange rate, by reducing import prices and undermining export demand, spread deflationary pressures from the rest of the world to the United States. In fact, recent studies of secular stagnation have started to investigate these 'open economy' issues in more detail, showing that large cross-border capital flows are an important propagation channel. This is a particularly significant where countries have tried to deal with secular stagnation by devaluing their currencies, as the Bank of Japan and ECB have been doing. Where dollar appreciation is involved, there is also a broader international angle since much of the world borrows in USD rather than in domestic currencies. We examined these issues in a previous macro picture, showing how the value of the dollar is now critical to overall world trade, international supply chains, and global financial conditions.

Chart 24: Financial conditions have eased



Source: Bloomberg, *trend from simple HP filter

Chart 25: Central banks back in the QE game



Source: TS Lombard estimates, *includes ECB QE and Fed twist

3. MONETARY LIMITS

The current global slowdown is just the latest reminder about how hard it is to break out of the New Mediocre. Despite widespread chatter about 'reflation' and hopes for an end to secular stagnation in 2017-18, the world economy finds itself back where it was in mid 2016 – facing recession risk, disinflation and negative yields. Once again, investors are wondering whether global policymakers are running out on ammunition. Yet the world's central banks are clearly not ready to give up on their objectives. Officials in most countries have already flipped back towards adding fresh stimulus, with the Federal Reserve likely to cut interest rates during the summer and the ECB thinking about how to restart QE (it needs to relax its self-imposed rules).

Easing to provide financial boost

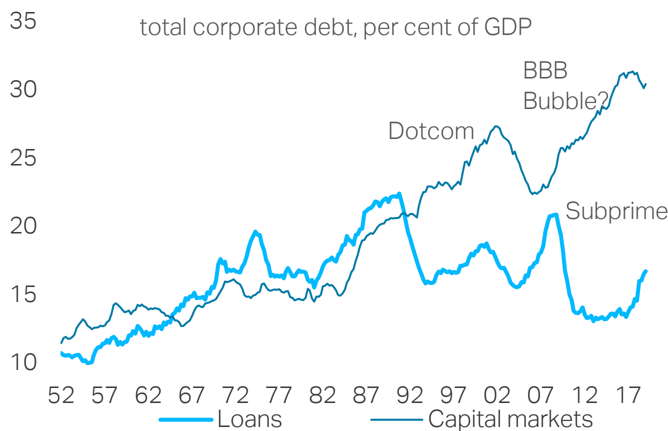
Since monetary policy has repeatedly failed to achieve anything beyond short bursts of activity and temporary periods of reflation, it is not surprising many investors are sceptical about what this latest round of easing will achieve. Yet, so far, markets have responded well to the prospect of interest-rate cuts and QE. Credit conditions have eased since the start of the year, which

broke a potentially dangerous feedback loop between financial markets and the real economy in late 2018. Stock markets have been prepared to 'look through' weak macro data in the expectation that policymakers can put a floor under global growth. Now, of course, central banks need to validate market expectations in order to prevent another episode of market turbulence. But while keeping financial conditions loose and supporting asset prices might help to extend the global economic expansion, it is not a 'game changer' for the New Mediocre.

Storing up future problems?

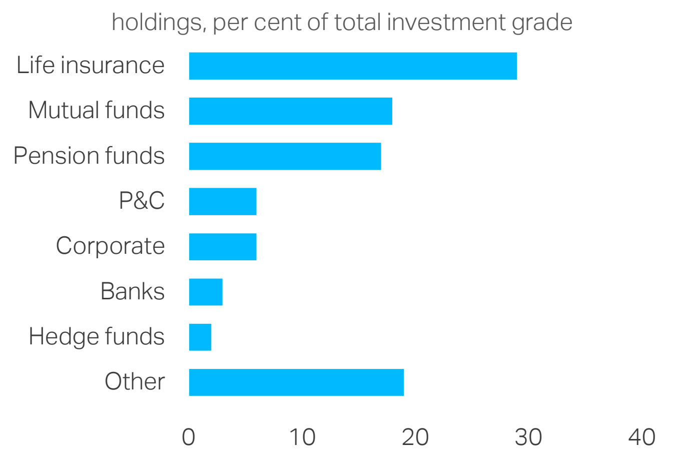
There is also a danger that another round of monetary stimulus could store up problems for the future. For many, the continued rise in global debt is an obvious area for concern. Yet there is no magic level for what constitutes a sustainable amount of debt and, in fact, recent research suggests the rate of change in debt is more important than the absolute level. For developed nations, we are most worried about US corporate debt. This was also a consensus worry in 2018, but the prospect of monetary stimulus has since revived the search for yield, causing credit spreads to narrow. If central banks are successful in adding a couple more years to the expansion and US corporates continue to increase their leverage during this time, we are likely to see an even nastier recession. But there is nothing inevitable about this forecast and, for now at least, central banks seem prepared to live with these risks and defer the problem.

Chart 26: Capital markets boost US debts



Source: Federal Reserve, TS Lombard

Chart 27: 'Buy-side' holds these securities



Source: IMF Global Financial Stability Report

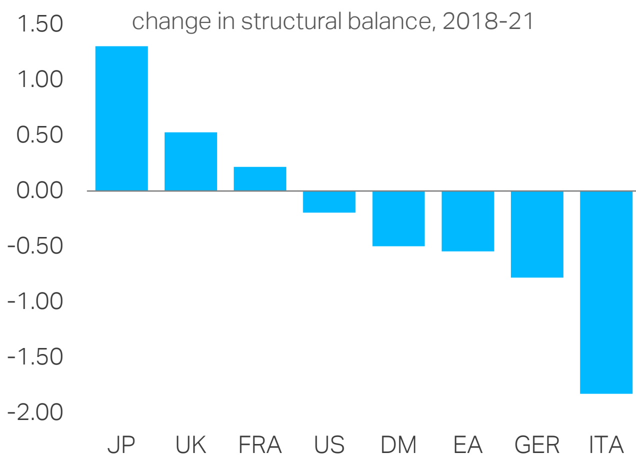
Fiscal policy will eventually take over

If monetary policy cannot solve the New Mediocre, it seems inevitable that fiscal policy will eventually take over. This would repeat the long 'super cycle' in macro policy. After the Great Depression – the last time secular stagnation became a popular theme – the authorities realized that monetary policy was like 'pushing on a string'. They could pull on the string to reduce inflation, but they could not force inflation higher using only monetary instruments. The consensus among policymakers is again moving in this direction, with the austerity of the last decade giving way to fiscal leniency. But, according to the latest IMF projections, we are still talking about only a modest fiscal easing over the next few years. Unfortunately, it seems it is will take a much nastier global downturn to force a more vigorous response.

Would fiscal stimulus work? Larry Summers (and the rest of the literature on secular stagnation) is very much in favour of a fiscal solution. With bond yields at current levels, it should be easy to find public infrastructure projects with positive net returns. If there is a glut of savings relative to investment, then raising global capex is the obvious way to break the New Mediocre and restore

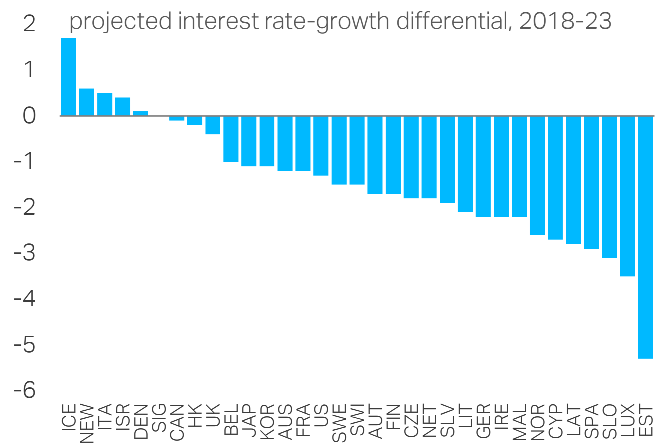
more 'normal' interest rates. Japan's experience with fiscal policy in the 1990s wasn't particularly encouraging but perhaps there are more positive lessons from China's recent experimentation with MMT-type policies. Many investors have puzzled over China's apparent leadership of the global industrial cycle. Every time the Chinese have eased or tightened government policy, these policies have had a disproportionately powerful impact on the rest of the world. But this makes sense in a world of secular stagnation. Chinese fiscal stimulus is unambiguously a net positive for global demand, whereas the policies pursued in Europe and Japan – monetary stimulus and exchange rate devaluation – have stolen demand from other countries. With the Chinese increasingly nervous about playing this role, the question now is how quickly other nations will be prepared to use their state balance sheets to revive global demand.

Chart 28: Modest fiscal easing



Source: IMF Fiscal Monitor

Chart 29: But most countries could do more



Source: IMF, TS Lombard

Bottom line

Our analysis of the New Mediocre has a number of implications for investors:

(i) Central banks will help loosen financial conditions and raise asset prices (they are now doing this again) but they can't break the world out of its continued funk;

(ii) The limits to monetary policy are particularly clear in Europe and Japan. But the strong dollar spreads secular stagnation to the US and even to the EMs;

(iii) China is the only major economy not engaged in competitive devaluation – this is why it has been such an important marginal source of global demand;

(iv) With low wage growth and rising inequality, the political backlash against the New Mediocre will continue to grow, especially if there is another recession;

(v) Fiscal policy will eventually take over (but this isn't happening yet);

(vi) Wider technological diffusion would help, but there is no sign of this (both within the United States and between the US and other developed nations);

(vii) Until there is a much larger fiscal response, long-term yields are likely to remain structurally low. Tech/non-tech equity divergence should also persist.

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