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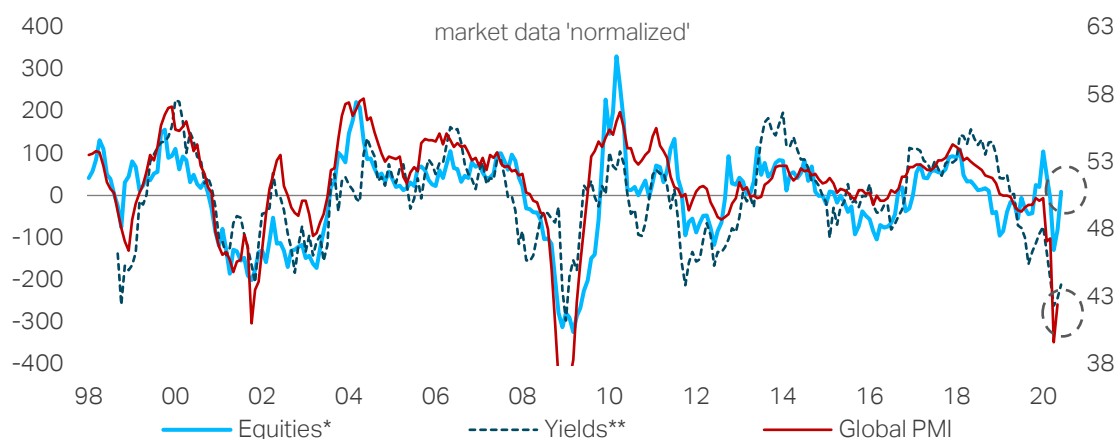
Macro Picture

MACRO VS MARKETS

Dario Perkins

There is a major disconnect between risk assets and the real economy. Central bank 'liquidity' and the lower discount rate do not fully explain this. The gap between Wall Street and Main Street also highlights deeper disparities, which are compounding secular stagnation. Monetary policy has no solution, which could mean dismal long-term returns.

Chart 1: Wall street versus Main Street



Source: DataStream, TS Lombard, *YoY change, **difference from two-year moving average

BIG DISCONNECT

Despite the recent wobble, risk assets (esp. US equities) have broken away from fundamentals, shaking off the continued health crisis and deep global recession. Popular explanations – Asian buying, retail flows, central bank “liquidity” and the lower discount rate – do not justify this move. We think the bear market will return, with the end of the lockdown exposing underlying problems.

REALITY CHECK

The historical relationship between stock markets and GDP is notoriously weak – as the bulls like to point out – but that doesn't mean investors can ignore a serious economic slump, even if they expect interest rates to stay low. Improving macro data should help to support confidence in the near term, but the global economy is unlikely to recover quickly from the COVID-19 recession.

MIND THE GAP

The extreme divergence between stock markets and the real economy highlights underlying social tensions and income/wealth inequalities, which compound secular stagnation. Central banks can't solve these problems – instead, the over-reliance on monetary policy makes them worse. But unless policymakers can break secular stagnation, market returns are set to slump.

MARKETS VS MACRO

It is remarkable the US stock market is broadly flat from the start of the year, despite a deadly global pandemic, depression-levels of unemployment, the steepest GDP declines in history and now growing social unrest. Of course, there has been no shortage of pundits attempting to back-fit narratives to explain this disconnect. Some of these explanations have focused on trading 'flows' – such as the dominance of 'out-of-hours' Asian buying and unusually heavy retail demand (including from an army of new Robinhood investors, who display a particularly acute fear-of-missing-out). Others have focused on the sectoral breakdown of the stock market, highlighting the continued outperformance of companies that seem less exposed to COVID-19 (particularly the large US tech firms). Yet the most popular explanation – as always – blames the central banks (especially the Fed). Monetary policymakers, their critics point out, have added huge amounts of 'liquidity' to markets, creating an artificial trading environment. Yet, while there is no doubt central banks have played an important role in 2020, averting a financial crisis in March, it is a stretch to believe their actions can explain current market valuations. Moreover, even continued policy support doesn't rule out a further relapse in global equities.

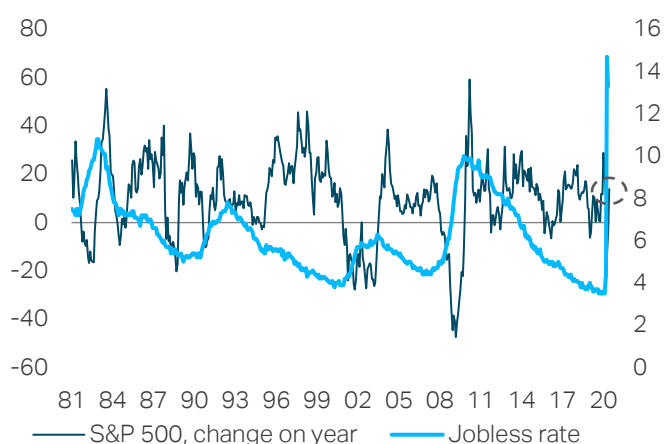
The idea that stock markets are "disconnected" from the real economy is not a new sensation – it is a narrative that has dominated investor commentary for the last decade. As the equity bulls like to point out, there is no reason why stock-market returns should track GDP – this has never been the case historically, either through time or for a cross-section of developed markets (the "DMS effect"). Financial markets are supposed to be forward-looking and should ignore short-term disruption, especially in an environment where long-term interest rates are trending lower. Sustained reductions in interest rates raise the discounted value of future dividends and make equities more attractive versus bonds. So the most optimistic take on the current equity-GDP disconnect is to assume investors are 'looking-through' the macro downturn while focusing on the prospect of even lower interest rates in the future. In the short term, macro data will reinforce this optimism, as lockdowns ease and global demand rebounds. Yet we suspect equity bulls are underestimating the ultimate severity and persistence of the COVID-19 recession, which will become clear only when the official lockdown period has ended (i.e. by the autumn). With only a partial recovery in private spending and unemployment set to remain high, corporate earnings will disappoint and the credit cycle will sour. We think this will trigger further turbulence in financial markets, reviving the equity bear market – with or without a second wave of the virus.

While the gap between 'Wall Street and Main Street' is unlikely to stay as extreme as what we see today, it is exposing deeper underlying inequalities in income and wealth – disparities that have widened over the past decade and look set to increase further in response to COVID-19. Policymakers have typically ignored these distributional issues, believing they were irrelevant to underlying trends in inflation and output. Yet a growing body of academic research suggests inequality is making secular stagnation worse, by creating powerful feedback loops. As income and wealth become more concentrated at the top of the distribution – households and businesses that are less inclined to spend – savings increase and equilibrium interest rates fall. This inflates asset prices and encourages the most vulnerable parts of the economy to increase their leverage, locking the world into a low interest-rate trap. Central banks didn't cause these problems – they reflect globalization, new technologies and declining worker power – but it is clear monetary policy has no solutions. So an important issue for the 2020s is whether the fiscal authorities will try to tackle these problems. Many investors fear such interventions, but it is important to remember that most of the market "rerating" associated with secular stagnation has already taken place, which means long-term returns are set to slump unless growth improves.

1. BIG DISCONNECT

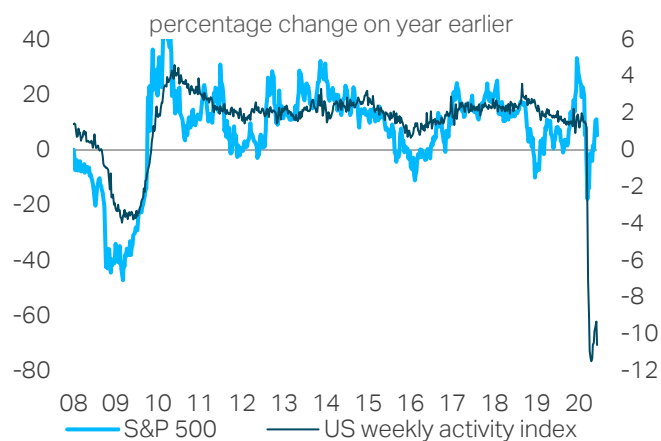
Many of our clients are worried about a 'huge disconnect' between financial markets and the global economy. Even as GDP has contracted at a pace that is unrivalled in modern history – Bank of England data show the biggest decline since the Great Frost of 1709 – and unemployment has surged all over the world, financial conditions have steadily improved, credit spreads have narrowed, and global stock markets have reversed much of their Q1 declines. The divergence between asset prices and 'real life' seems particularly alarming for US equities. Even with recent anxiety about a 'second wave' of the virus, the S&P 500 has retraced 90% of its 2020 losses and currently sits at December 2019 levels. Back then, the consensus outlook was exceedingly dull, with most investors expecting a steady Goldilocks macro environment. While the divergence in other asset classes is less extreme – commodities, bonds and credit better reflect the weakness in global demand – sentiment has also recovered from the March lows.

Chart 2: Equity bounce despite record jobless



Source: Datastream

Chart 3: Stocks ignore horrible GDP decline



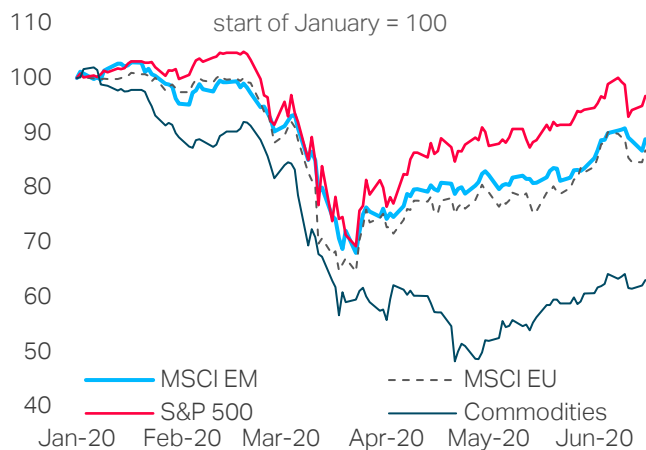
Source: NY Fed, Datastream

The unloved rally

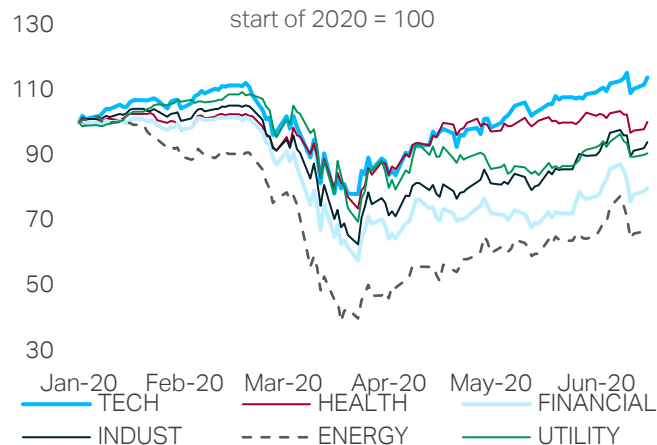
We didn't expect the large bounce in equities that occurred between March and June, now the strongest 50-day rally in history (US stocks are up around 40% from the lows). There are three particularly puzzling aspects to this powerful recovery: (i) the macro outlook has evolved largely as we expected (in fact, economic activity has deteriorated even more than we imagined); (ii) global COVID-19 infection rates have declined more slowly than many experts had hoped, staying elevated in the US/UK and reaccelerating in some other countries (notably Iran and Bulgaria); (iii) Institutional investors – including the majority of our clients – remain decidedly bearish about the fundamental outlook, both in terms of the macroeconomic impact of the crisis and the possibility of a 'second wave' of COVID-19 infections. Investor surveys continue to highlight widespread pessimism, with 78% of respondents in the latest BoAML Fund Manager Survey saying they think the stock market is overvalued, a record high.

In the initial stages of the stock-market bounce, many investors said they were reluctantly buying equities because the returns on all other asset classes – especially government bonds – were effectively zero (known in the industry as 'TINA' – There Is No Alternative). This broadly matched what we were seeing on a 'sectoral' level, where the best performing parts of the market were those that seemed less vulnerable to the COVID-19 recession. Defensives such as healthcare and utilities performed well, while the big US tech superstars – which stood to gain market share as an increasing proportion of retail and entertainment moved online – tightened

their grip on US equity indices. Chart 6 shows the FANGs now dominate the US stock market to an even greater extent than they did before COVID-19, with their share of the index now comfortably exceeding the tech sector's dominance during the Dotcom bubble.

Chart 4: Asset-class divergence


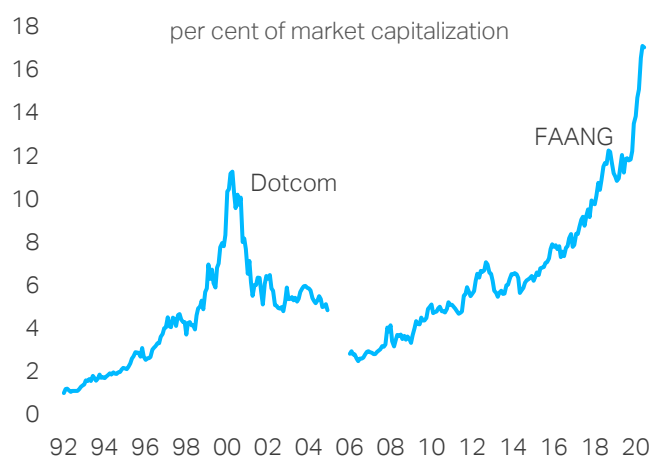
Source: Datastream

Chart 5: US sector divergence


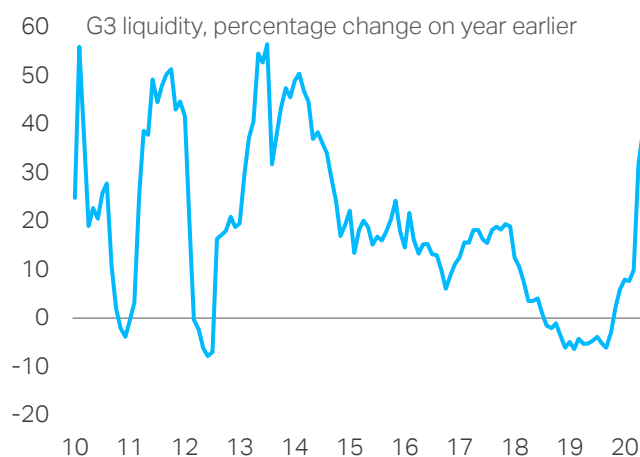
Source: Datastream

Who was doing the buying?

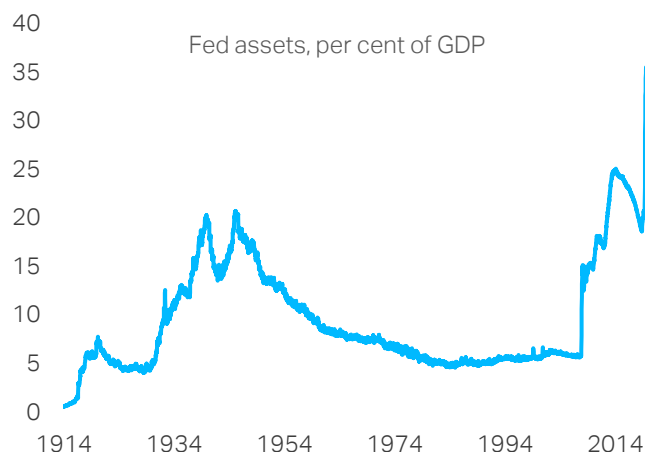
While defensives and tech initially outperformed, the stock-market rally eventually became less discriminate. The bid for US stocks was broadening. Understandably, attention shifted away from the sectoral breakdown of the market to the question of 'who' was doing the buying. Some commentators pointed out that most of the momentum in US stocks was taking place 'out of hours', when the domestic market was closed. They suspected the marginal demand was coming from overseas, especially from Asian and European buyers (buying US stocks in different time zones). Yet this is hardly a new phenomenon – it is the 'Overnight Drift', which was widely documented long before anyone had heard of COVID-19 ([see this Fed study](#)). Popular conspiracy theories, such as "foreign powers" trying to influence the upcoming US election, seem unfounded. In fact, the Overnight Drift doesn't necessarily reflect foreign buying at all. After all, the majority of market-moving news – including corporate earnings reports and most of the major macro data releases – takes place outside of regular US trading hours.

Chart 6: Historic US tech domination


Source: Datastream, TS Lombard

Chart 7: Central banks add "liquidity"


Source: TS Lombard estimates, based on bank reserves

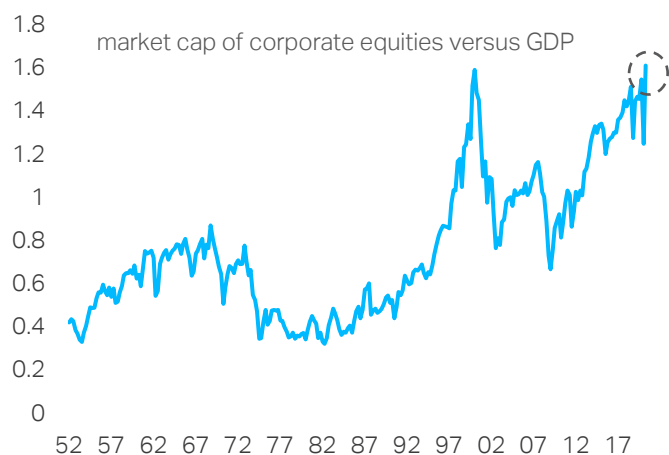
Chart 8: Don't fight the Fed?


Source: Federal Reserve, TS Lombard

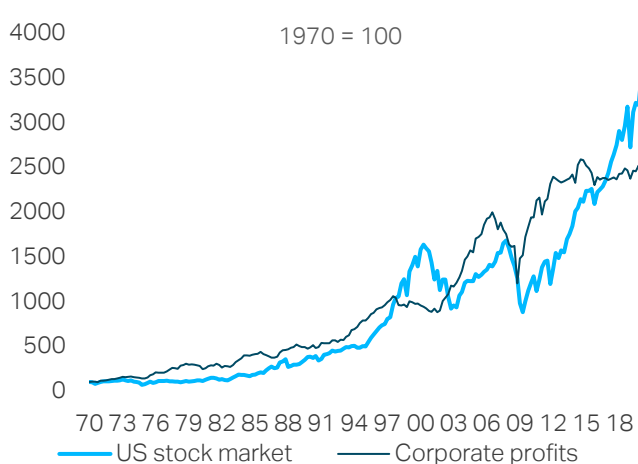
Chart 9: Market bounce reflects money surge?


Source: Federal Reserve, TS Lombard

In recent months, a new 'buyer' has emerged, with widespread reports of heavy retail investment in US stocks, particularly from a growing army of participants who now have free access to [Robinhood trading platforms](#). The financial press have been full of stories about "Millennial investors" who were determined not to miss out on the 'buying opportunity of their lifetimes' and had piled their cash into some of America's best-known companies, including tech giants and – more recently – companies that have been facing severe credit problems. While this narrative is appealing, especially as it contrasts to the outright bearishness of traditional institutional investors – the data suggest Robinhood activity is small relative to overall market turnover.

Chart 10: The bears' favourite valuation metric


Source: Datastream, Federal Reserve, TS Lombard

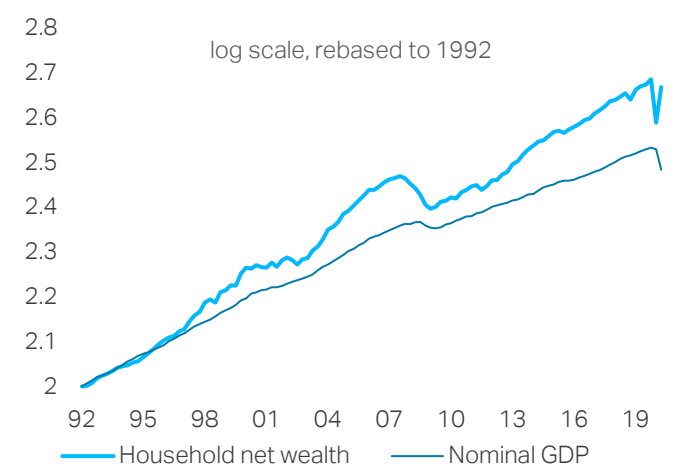
Chart 11: Though the bears like this one too


Source: Datastream, TS Lombard

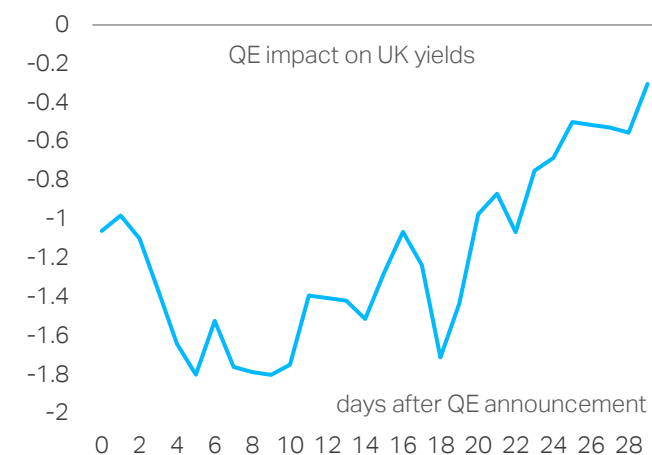
Central bank interventions

Regardless of who was doing the buying, there is no question the global policy response to COVID-19 has had a powerful impact on the way many investors have perceived the economic fallout from the pandemic. As we explained in [an earlier Macro Picture](#), central banks – especially the Federal Reserve – played a critical role. Having learnt from what happened during the 2008 crash, the authorities acted decisively to address systemic risks in the financial system and break potentially powerful feedback loops between the deteriorating macro outlook and tighter financial conditions. It is not a stretch to say policymakers prevented an outright financial crash

in March, by intervening to stop a dangerous run on what officials call the 'market-based system of credit provision' (aka the shadow banking system). To the extent markets were becoming dysfunction and starting to price-in extreme tail risks, this policy intervention justifies a bounce in asset values. But it doesn't explain why the stock market has rallied all the way back to pre-pandemic valuations, especially as we still face a serious recession and extreme uncertainty.

Chart 12: Another proxy for market exuberance


Source: BEA, Federal Reserve, TS Lombard

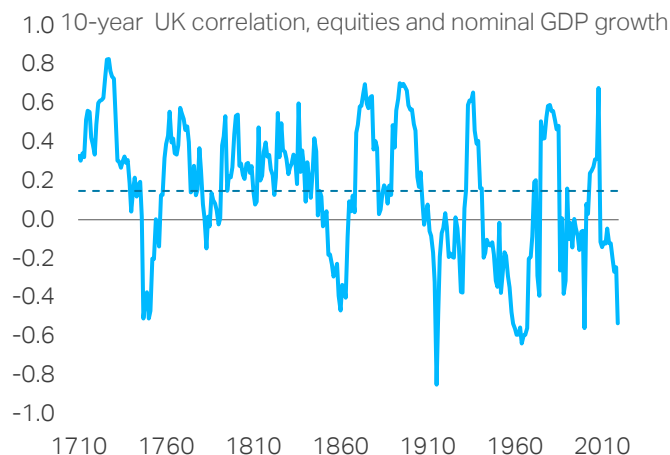
Chart 13: QE impact wears off quickly


Source: Vlieghe speech, Bank of England

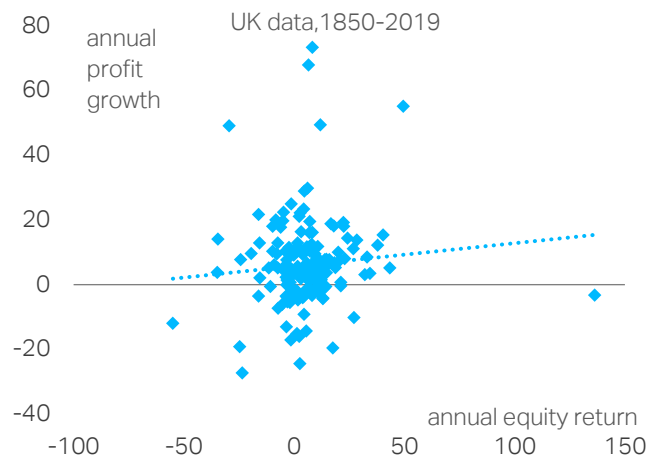
Blame "liquidity"?

Whenever there is a perceived disconnect between financial markets and the real economy, there is always a strong temptation to blame central-bank "liquidity". The monetary authorities have expanded their balance sheets massively in 2020, which seems to support this narrative. Through policies such as QE, investors sell their government bonds to central banks and can use the cash they receive to purchase riskier assets such as equities, which bids up their prices (the so-called 'portfolio balance effect'). Of course, this is not a new idea – critics have accused central banks of inflating asset prices with their "liquidity" for much of the last decade. We see this clearly in some of the permabears' favourite valuation metrics, such as the ratio of stock prices to nominal GDP or the level of equities versus corporate profits (Charts 10 and 11), which have diverged continuously since the global financial crisis. For those commentators who blame central banks for the divergence between financial markets and the real economy, the authorities' response to COVID-19 is part of this longer-running theme. Right now they are particularly keen to highlight the data on the US money supply, which is surging. Chart 9 shows the stock market rally is much less impressive compared to the level of M2.

We suspect there is too much focus on quantity-based measures of central bank stimulus, especially as true liquidity is endogenous to investor confidence and risk appetite. The evidence that QE permanently reduces long-term interest rates and elicits 'portfolio balance effects' that 'artificially inflate' asset prices is actually pretty flaky – especially when we are talking about a theme that has lasted for more than a decade. Most QE research relies on unreliable 'event studies', while more thoughtful analysis show the 'announcement' effects from QE wear off quickly (see the [Gertian Vlieghe's findings](#), Chart 13). It is also important to remember that while central banks such as the Fed have been adding liquidity by purchasing government securities, national treasuries have been withdrawing it, running large fiscal deficits and issuing new debt.

Chart 14: Not a strong historical link


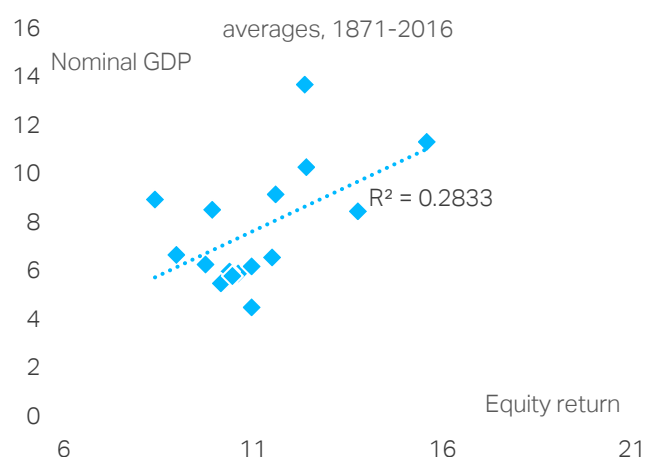
Source: Bank of England database, TS Lombard estimates

Chart 15: Correlation is weak for profits too


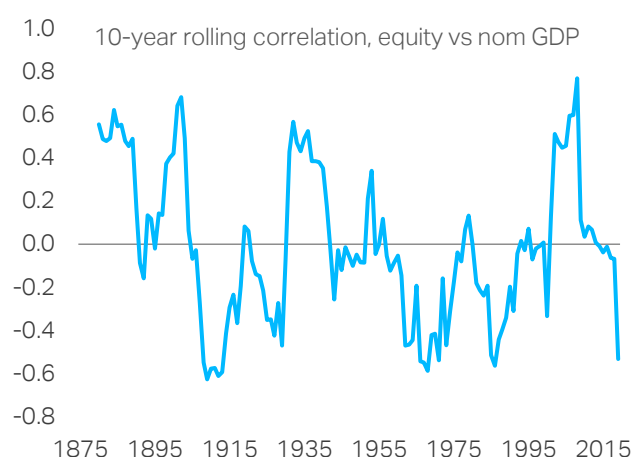
Source: Bank of England database, TS Lombard estimates

2. REALITY CHECK

The idea that financial markets have become ‘disconnected’ from the macroeconomic outlook has become particularly compelling in recent months, but it is not a new theme for investors. Equity bulls like to remind us that “*the stock market is not the economy*”, pointing out that the historical correlation between equity returns and macro variables – such as nominal GDP and corporate profits – is actually much weaker than many people assume. An influential study by Dimson, Marsh and Staunton made this point in the early 2000s, showing that stock-market performance rarely tracks national income, either through time or based on a cross-section of developed markets (the “DMS effect”). We have reproduced their findings in Charts 14 to 17, using the Bank of England’s long historical database plus the internationally comparable Macro History dataset. In all cases, the correlation between equities and macro aggregates is weak.

Chart 16: Cross-country correlation is low too


Source: MacroHistory database, TS Lombard estimates

Chart 17: US correlation is weak over time


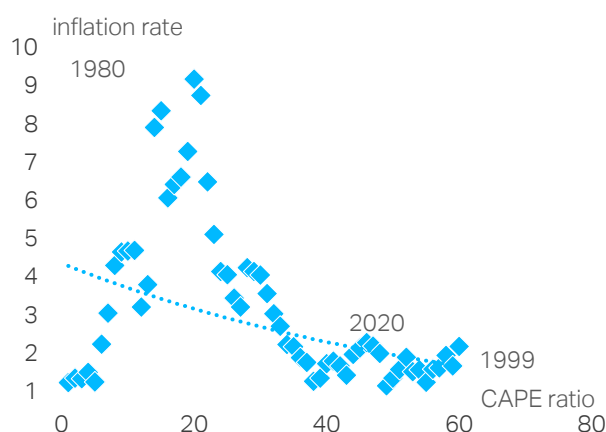
Source: MacroHistory database, TS Lombard estimates

GDP versus stock markets

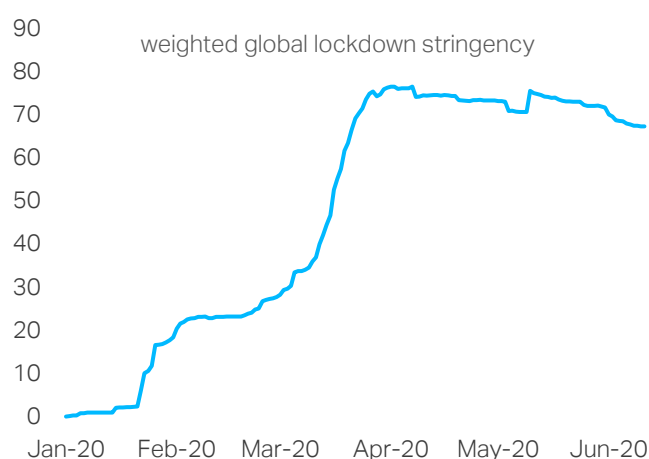
What explains these findings? Stock markets – in theory at least – are supposed to reflect the (discounted) value of future corporate earnings, so we might expect equity returns to track GDP over a long enough time horizon. But there are a variety of reasons why they might diverge:

- (I) **Expectations:** Stock markets are supposed to be forward-looking, reflecting analysts' expectations for future earnings. GDP captures the current macro state;
- (II) **The discount rate:** Lower interest rates raise the current value of future earnings, which will cause equilibrium PE ratios to increase – a market 'rerating';
- (III) **Shifting corporate profit share:** A rise in the corporate share of GDP will raise the return on equity, without necessarily altering the path of nominal GDP;
- (IV) **Globalization:** Large companies now generate earnings from all over the world, not just their domestic jurisdictions – so their performance will not follow GDP trends;
- (V) **Exclusion of other domestic sectors:** Stock markets only track the performance of listed companies. This excludes the public sector and the majority of SMEs;
- (VI) **Financial engineering:** The equity market is influenced by M&A activity, stock buybacks etc., which have no bearing on national output, capex or income;
- (VII) **Equity valuations are volatile.** The market determines the value of a company, which is clearly influenced by investor tastes, sentiment, media and politics.

The decline in the discount rate has probably been the most important force driving the perceived wedge between stock-market valuations and nominal GDP over the past decade. As theory dictates, Chart 18 shows a clear inverse relationship between inflation and cyclically-adjusted PE ratios (CAPE). When investors expect interest rates to stay low for long periods, they will pay more today for a given stream of dividends. Since we are talking about a decline in interest rates that has lasted more than a decade, it is unreasonable to blame this 'rerating' on overly loose monetary policy and central bank liquidity. The better explanation is that interest rates have declined for 'fundamental' reasons and that central banks had no choice but to reduce their policy rates if they wanted to have any chance of hitting their 2% inflation targets.

Chart 18: Lower inflation means market rerating


Source: Robert Shiller, TS Lombard

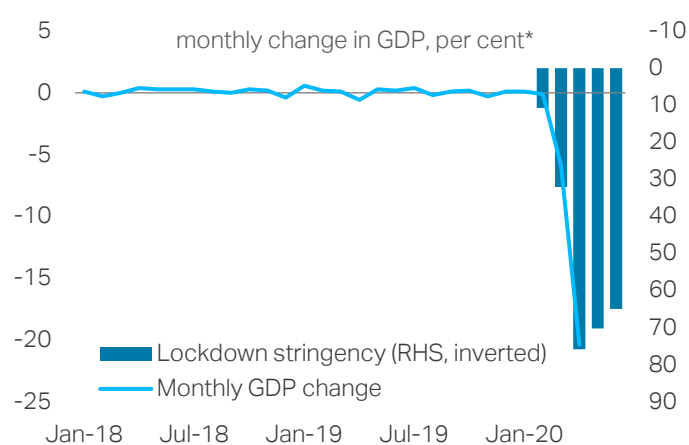
Chart 19: Global lockdown starts to ease


Source: Oxford University dataset, TS Lombard aggregate (IMF weights)

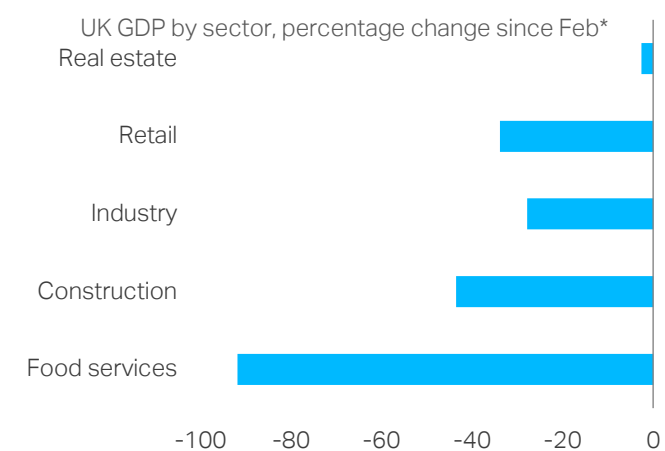
Is COVID-19 just more of the same?

The most bullish explanation for the recent rebound in the stock markets is that COVID-19 has reinforced the trends of the last decade, further lowering the discount rate. Certainly, bond

yields have declined and most investors expect inflation and interest rates to stay even lower than they were before the global pandemic. But this would reflect an alarming asymmetry – equity bulls would be assuming no lasting damage to earnings but persistently lower interest rates. This only makes sense in a scenario where earnings rebound quickly (the V-shaped recovery) but inflation remains extremely low. We think this is wrong. Our macroeconomic forecasts assume a much weaker post-pandemic recovery, in which investment rates stay low, consumers' save a greater proportion of their incomes and unemployment remains well above 2019 levels. Based on these forecasts, corporate earnings will miss expectations by a wide margin (not just in 2020) and the credit cycle will sour, leading to defaults and bankruptcies. In short, the world is facing a recession. There is no way a lower discount rate will compensate investors for lost earnings, which means they can't simply extrapolate from past "re-ratings".

Chart 20: UK data illustrate lockdown impact


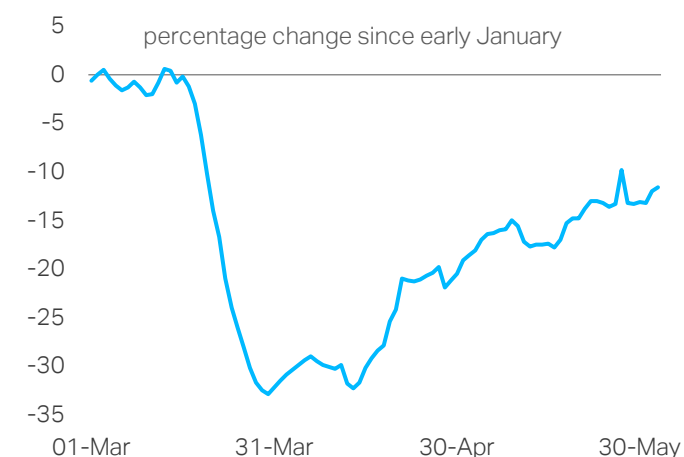
Source: ONS, Oxford University, TS Lombard, Data NOT annualized

Chart 21: Big sectoral differences too


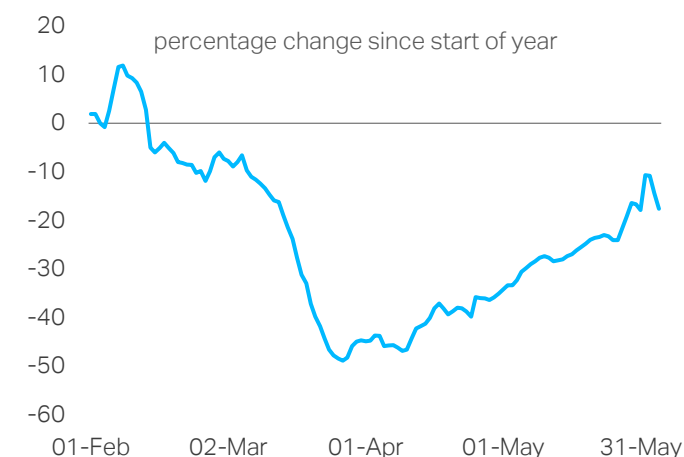
Source: ONS, TS Lombard, *Data are NOT annualized

When will the bear-market return?

A 'second wave' of COVID-19 is clearly the most immediate threat to global stock markets. Even if governments are reluctant to lockdown their economies again, it will be impossible for many businesses to return to anything resembling 'normal' activity if infection rates are picking up. Both the IMF and the OECD have shown that consensus forecasts for the next 12 months

Chart 22: US consumer recovery


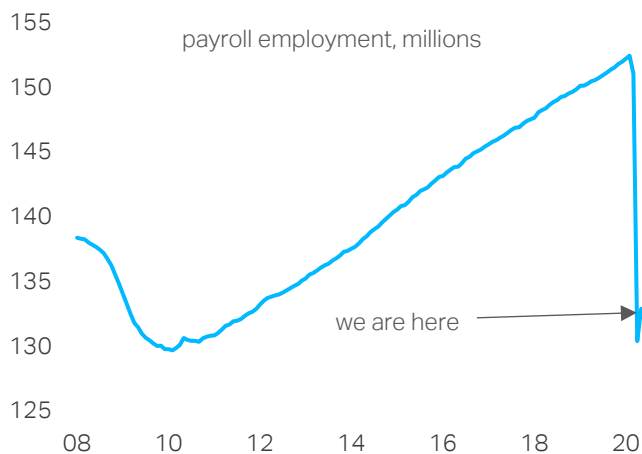
Source: Tracktherecovery.org

Chart 23: Business revenues improving too


Source: Tracktherecovery.org

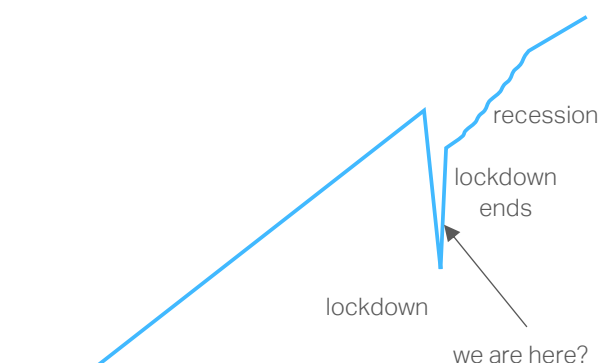
assume a steady improvement in the underlying health situation and any second-wave of COVID-19, either now or in the autumn, would have a powerful impact on the macro economy (see Charts 26-27 for the OECD's simulations, which it published at the start of the June).

Chart 24: The recovery in context



Source: BLS, TS Lombard

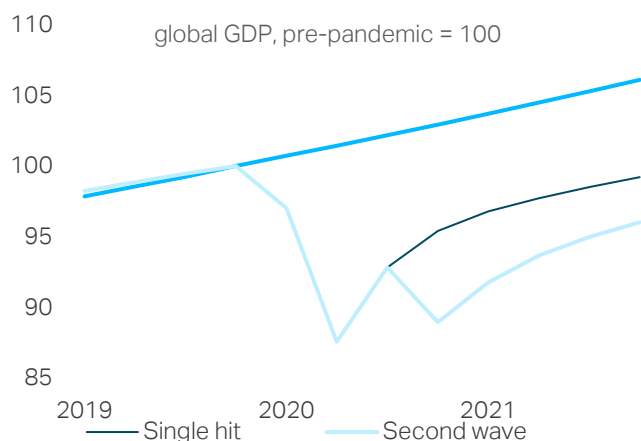
Chart 25: COVID-19 recession schematic



Source: TS Lombard

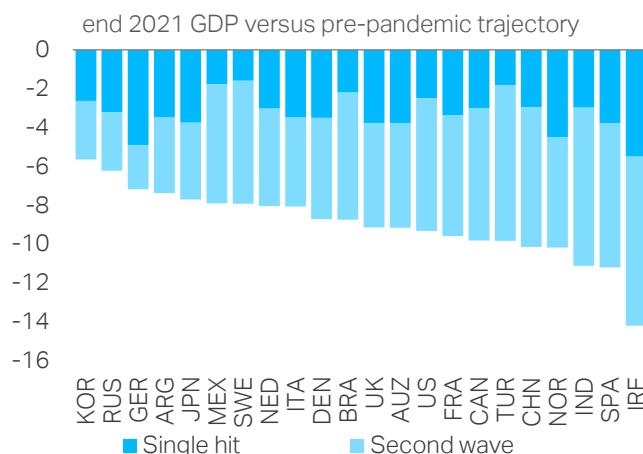
Recent mass protests provide an immediate test to the second-wave thesis. If there is no major reacceleration in COVID-19 over the next couple of weeks, especially in the US and UK – which saw some of the most widespread protests – investors will feel more relaxed about the short-term prognosis for the disease, postponing second-wave risks till the autumn. Meanwhile, the macro news flow is also moving in a direction that should support equity markets in the short term. Most countries have now ended the most stringent phase of their lockdowns, so a powerful rebound in economic activity is inevitable. The largest expansion in GDP in history is likely to follow the largest contraction in history. To see why, look at the UK's monthly GDP series – the only major country to publish GDP on such a timely basis. UK output plunged 20% (not annualized!) between February and April, the period of maximum lockdown. With the economy beginning to reopen in May and June, the data are likely to show an extremely large bounce.

Chart 26: The OECD's new forecasts



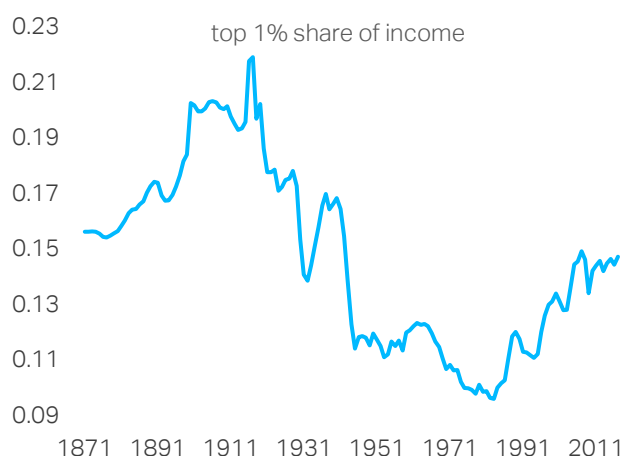
Source: OECD Economic Outlook, June 2020

Chart 27: Second-wave would hit hard

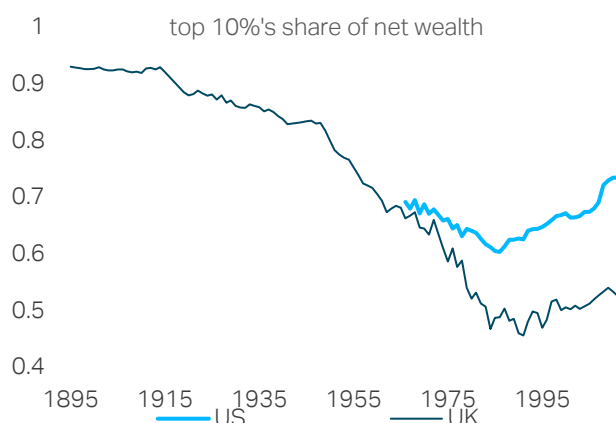


Source: OECD Economic Outlook, June 2020

We've already had a taste of the shifting macro news flow in the latest US data, which showed an expectedly large rise in employment and retail sales. Yet context matters. The economy gained a record 2.5 million jobs after losing 22 million in the previous two months. Chart 25 provides a simple schematic for the COVID-19 recession profile. While data must improve in the near term, the important issue is where we end up in 2-3 months. If activity remains far below pre-pandemic levels and is struggling to make up the ground, the macro environment will become more challenging for global markets. We expect to see a further plunge in global stock markets, which would make the rebound in stocks between March and June an exaggerated bear-market rally.

Chart 28: Rising income inequality


Source: Global Inequality Database

Chart 29: Rising wealth inequality


Source: Global Inequality Database

3. MIND THE GAP

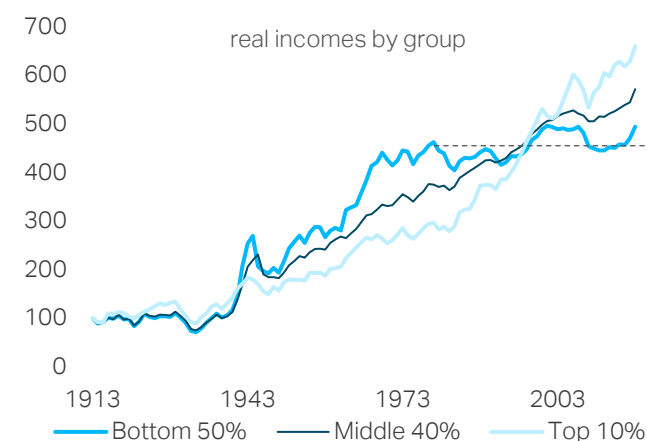
The disparity between stock markets and the real economy, or 'Wall Street versus Main Street', is unlikely to remain as stark as it was in the first half of 2020 – when equities rallied even as unemployment hit Depression levels. Yet it has highlighted deeper economic inequalities. Growing public discord, most visible in the form of mass protests all over the world, have further emphasized these problems. And this period has been a public-relations disaster for central banks, who are again accused of "bailing out" the financial sector while not doing enough to protect the most vulnerable. This is an exaggeration – central banks are not responsible for income and wealth inequalities – but it is clear monetary policy cannot provide a solution. Worse, a growing body of evidence suggests inequality is making secular stagnation worse, interacting with low growth to leave the world stuck in a bad macro equilibrium with unstable politics.

Mind the gap

Income and wealth inequality have been increasing for decades, particularly in the United States. Macroeconomists, including at central banks, have always downplayed these distributional issues, assuming they don't influence overall levels of output and inflation. In fact, back in the 1980s, when 'trickle down economics' was in vogue, some people believed inequality was good

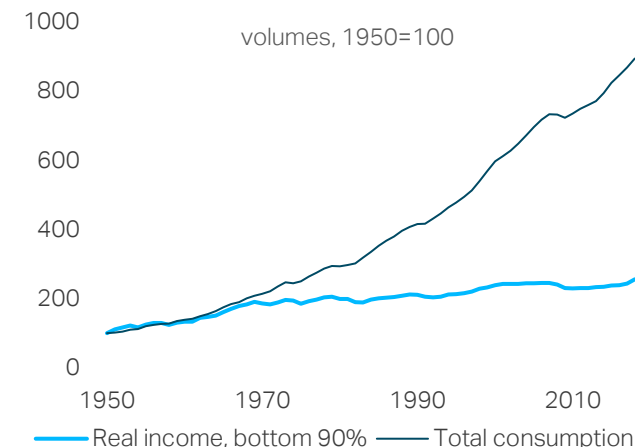
for growth, because it would motivate those at the bottom of the income distribution – seeing the success of others, people would work harder and entrepreneurs would take risks. Though they would deny it, central banks' stimulus programmes are not wildly different from trickle-down economics. Officials believe, if they can boost asset prices and keep financial conditions easy, this will indirectly support the living standards of the poor (by protecting their jobs). Yet the evidence that policies such as QE have supported employment and GDP isn't overwhelming.

Chart 30: Real income divergence



Source: Global Inequality Database, TS Lombard

Chart 31: Low-income earners had to borrow

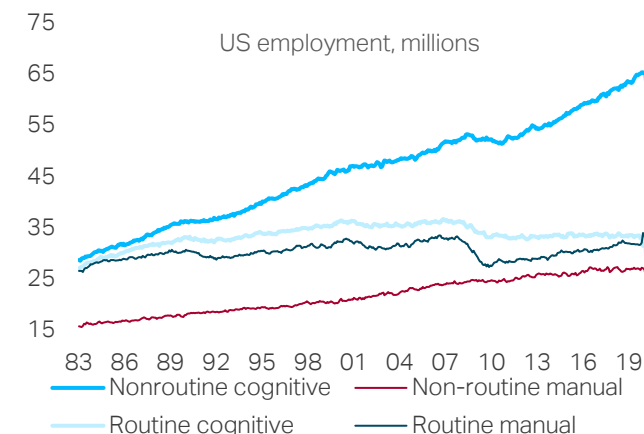


Source: Global Inequality Database, TS Lombard

Underlying causes

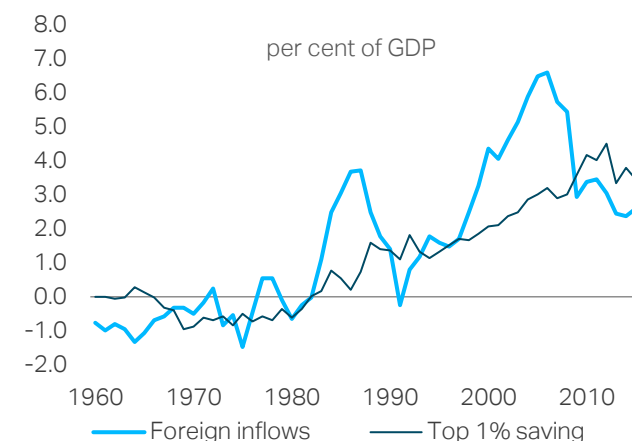
Even if central banks have contributed to rising inequality, they are not the most important cause. Secular forces such as globalization, technological change and the dilution of trade union power, have been more important. These shifts have eroded worker bargaining power, reduced the wage share and caused acute polarization in labour markets. Workers have either had to 'skill up', or accept lower-paid service sector jobs that were less vulnerable to automation and couldn't be outsourced to the emerging economies. In the short term, COVID-19 is making many of these disparities worse. Highly skilled workers in 'cognitive non-routine' tasks have been able to adapt to the pandemic by digitally working from home, while most of the job losses have been concentrated at bottom of the wage distribution (especially 'manual, routine tasks'). Fed

Chart 32: Technology and employment



Source: BLS, TS Lombard

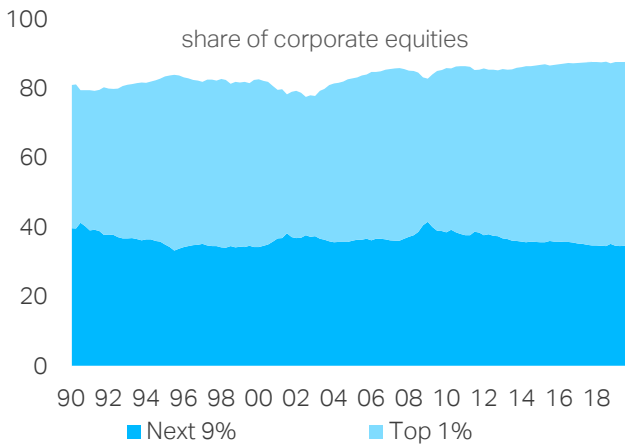
Chart 33: The wealthy's national saving glut



Source: Mian, Straub and Sufi (2020)

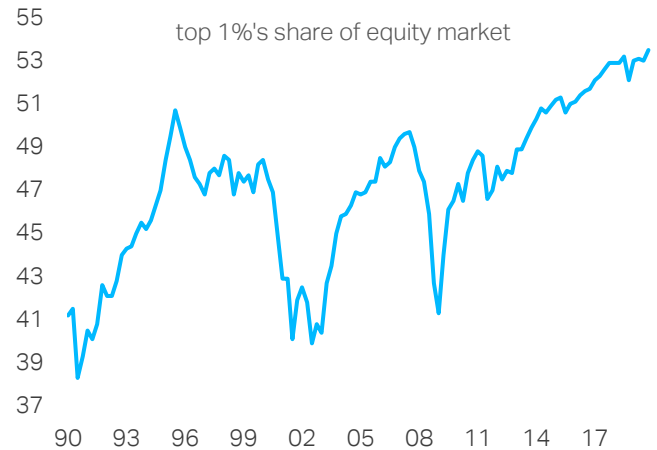
staff recently estimated that more than half of households making less than \$50,000 had experienced a loss in employment income because of COVID-19. Without a full recovery, many of these people will struggle to find new jobs. Some commentators are even talking about a 'K-shaped' COVID-19 recession, where only the wealthiest and most highly skilled people enjoy a quick rebound and lower-income, less wealthy households are stuck in a persistent depression.

Chart 34: The Top 1% dominate equity holdings



Source: FRED

Chart 35: Asset rerating helps the wealthy

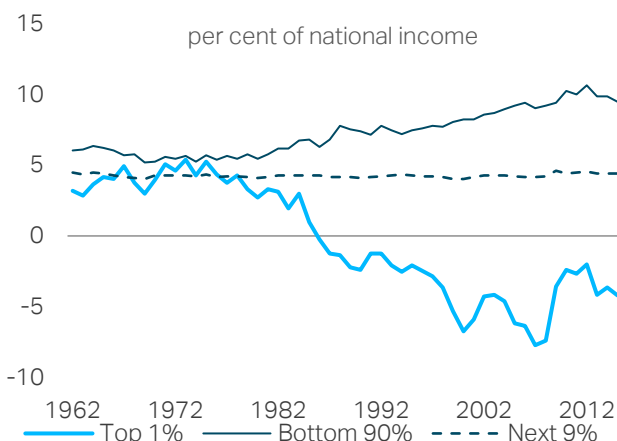


Source: FRED

Inequality and secular stagnation

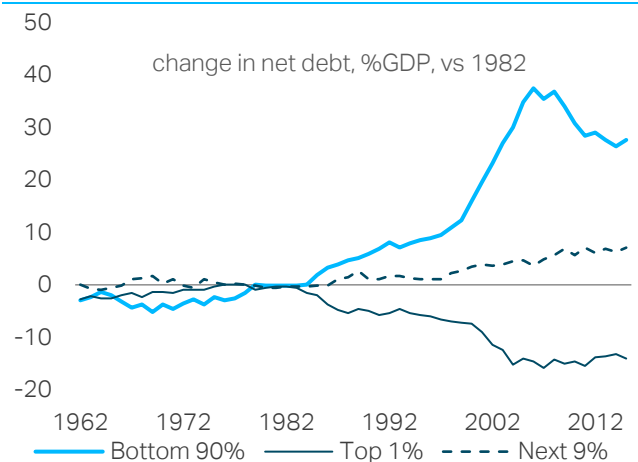
Whereas right-leaning politicians once claimed inequality might be 'good' for growth, there is a growing recognition that this is not the case. As inequality has increased over the past three decades, average growth rates have slumped. In fact, several recent studies suggest inequality is actually making secular stagnation worse, contributing to the persistent decline in equilibrium interest rates. And since lower equilibrium interest rates support a rerating in asset prices (which further boost wealth inequality) and encourage people to take on more debt (which make the financial system more vulnerable to higher borrowing costs), it is easy to understand how these dynamics might become self-reinforcing. Recent analysis by Larry Summers and Lukasz Rachel suggests that inequality has lowered equilibrium interest rates by around 1% point since the 1970s – not as important as demographics, but still a major driver of secular stagnation.

Chart 36: Top 1% are saving too much



Source: Mian, Straub and Sufi (2020)

Chart 37: Forcing everyone else to borrow



Source: Mian, Straub and Sufi (2020)

What is the mechanism linking inequality with lower interest rates? Summers and Rachel blamed precautionary savings. As inequality widens, the risks associated with an income shock – such as becoming unemployed – increase. And there is definitely plenty of evidence to show people with more wealth and higher incomes are more inclined to save, with marginal propensities to consume declining as we move up the distribution. So it makes sense that a growing concentration of income among the richest in society would naturally raise overall levels of saving and reduce aggregate spending. A [recent study by Mian, Straub and Sufi](#) highlights a 'glut' of saving among the wealthiest households, which has matched gross capital inflows. Everyone is familiar with the global saving glut, where foreign investors channelled their saving into US assets, but few people are aware of this other glut related to social inequality.

Monetary policy has no solutions

Even if we let central banks off the hook for inflating asset prices and making inequality worse – which a growing number of critics will never allow – it is clear the monetary authorities have no solutions to these problems. This is something officials implicitly acknowledge, by trying to [explain their actions to a more diverse group of stakeholders](#). But they lack the necessary tools to change this situation and break secular stagnation. The Fed's latest initiative, specifically designed to address the Wall Street vs Main Street chasm (the ["Main Street Lending Program"](#)), only provides cheap short-term loans to businesses. As [its own research shows](#), this is more effective than traditional QE, but it only adds debt to many businesses that are already over-leveraged. The real economy will ultimately need large income transfers, yet no central bank seems prepared to cross further into fiscal territory and move to full 'helicopter money'. The ECB has arguably come closest, but only by introducing transfers to the banking sector (!).

Our [previous Macro Picture](#) looked at big secular themes for the 2020s, including how demographics, globalization and technology could evolve. But the extent to which policymakers – especially on the fiscal side – decide to tackle inequality could also have profound medium term implications, both in terms of macro outcomes and financial markets. Obviously, there is a natural aversion to anything resembling 'state intervention' or 'redistribution' among investors – many of our clients were worrying about a "Marxist revolution" even before COVID-19! Yet, it is important to bear in mind what another decade of secular stagnation might mean for financial markets. Even if you believe stock markets have fundamentally 'rerated' to reflect the trend decline in interest rates, which would justify higher PE ratios, [this is a one-time move](#). We are unlikely to see any further rerating, especially with yields pinned to the lower bound. All else equal, this implies a decade of extremely low market returns. So what about an experiment in 'trickle-up economics', a multi-year fiscal expansion where policymakers also tackled inequality and broke the world out of its secular funk? This might even be good news for capital returns...

Bottom line

Everyone is talking about the big disconnect between financial markets and the real economy, which has widened as equities have rallied from the March lows. While analysts have come up with a variety of sophisticated explanations, we suspect the equity bulls are too optimistic about the post-COVID-19 recovery. This will become clear once the global economy has fully reopened, leaving a persistent shortfall in demand, weak earnings and a souring credit cycle. The recent divergence between financial markets and the real economy is not a simple continuation of the "rerating" in asset prices that has taken place over the past decade. But it has exposed important underlying social tensions and wealth/income disparities. The extent to which policymakers are prepared to tackle these problems – which requires fiscal action not monetary stimulus – could have an important impact on macro, politics and financial returns in the 2020s.