Macro Picture

THE NEW MACRO SUPERCYCLE

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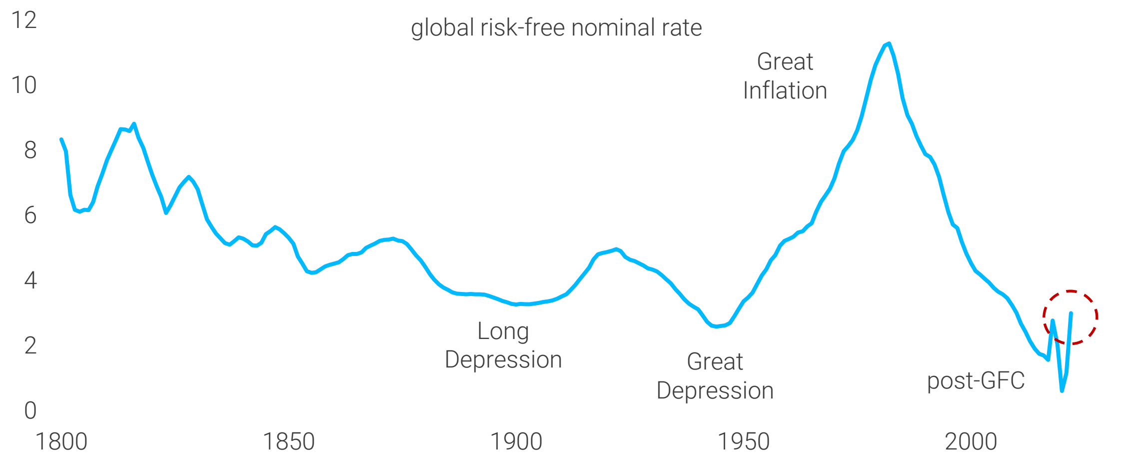
A new macro "supercycle" is emerging from the turmoil of the past three years. With neoliberalism losing its grip, the balance of power between labour and capital is shifting for the first time since the 1980s. Central banks will fight this transition, but they cannot stand in the way of deep structural changes (such as deglobalization). The implications look profound.

Chart 1: Secular turning points in interest rates



Sources: Bank of England, TS Lombard.

NEOLIBERALISM'S LAST STAND

The economy that emerges from COVID-19 and the war in Ukraine will look fundamentally different from the economy of the 2010s. Like other historic episodes, the period 2020-2022 could mark an inflection point in the long macro-financial "supercycle". The supercycle in inflation and interest rates is ultimately about "power", and the balance of power seems to be shifting.

SUPERCYCLE INFLECTION

Central banks are the guardians of post-1980s neoliberalism and will try to prevent this secular transition, even at the cost of a recession. But a mild recession is not going to eliminate current worker shortages or tilt the balance of power back to capital. Central banks cannot stand in the way of structural shifts, such as deglobalization, climate change and "wartime economics".

THE TANGIBLE TWENTIES

The new supercycle will have profound implications for financial markets. The prevailing bias in monetary policy must change, which means interest rates will be secularly higher in the 2020s. Rather than rely on the continuous rerating of all asset prices, investors will need exposure to the real economy, with "tangible" sectors – commodities and value stocks – set to outperform.

THE NEW MACRO SUPERCYCLE

The economy that emerges from the turmoil of the past three years will look fundamentally different from the one that preceded it. Like other historic events, including previous pandemics and military conflicts, the combination of COVID-19 and the war in Ukraine is set to mark an infliction point in the long macro-financial "supercycle". Ultimately, it is the balance of power between labour and capital that has driven the underlying path of inflation and interest rates over the past 150 years; and for the first time since the 1980s, we are seeing profound structural changes that will shift these power dynamics again, this time favouring labour (reversing post-1980s "neoliberalism"). Naturally, the transition to this new regime will not be smooth or linear. Recent distortions in the global economy must unwind, which at times will give the impression that the world is returning to pre-2020 norms. At the same time, central banks – the ultimate guardians of neoliberalism – will do their best to resist this secular transition, even at the cost of a recession. But we think the authorities will fail in the efforts to preserve the status quo. A mild monetary policy-induced recession is not going to eliminate current workers shortages, while central banks will not be able to stand in the way of the longer-term shifts that are going to enhance labour power in the post-COVID era.

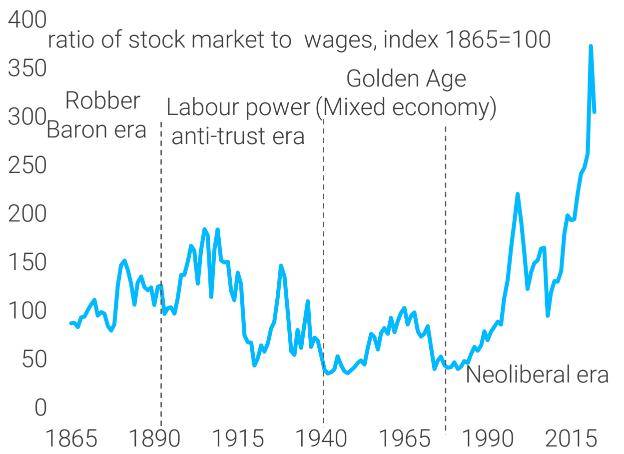
Neoliberalism gave us free trade, globalized supply chains, deregulation, smaller government, independent central banks and the death of trade unionism (especially in the US and the UK). The 2020s are set for a partial reversal. Deglobalization, which started even before COVID-19, is likely to gather pace. The pandemic underlined the vulnerabilities inherent in long, complex supply chains, while the conflict in Ukraine has caused political alliances to splinter more clearly into regional trading blocs. Since globalization reduced inflation, lowered interest rates and destroyed worker power, it is reasonable to think deglobalization will have the opposite effects. Meanwhile, governments everywhere are set to play a more activist role. A "wartime economy" (hopefully a cold war, not a hot war) demands greater public-sector involvement, as will the transition to new green technologies. Industrial policy is making a comeback, for the first time in decades. Naturally, many investors are worried about what this means for economic efficiency. Parts of the capital stock will be destroyed or duplicated, which will undermine returns for existing equity holders. Profits are likely to suffer, with the corporate share of GDP set to decline. But new investment opportunities will arise, and the outlook for most economies is reasonably bright. Pre-COVID "Goldilocks" is gone, but we are not headed for 1970s-style perma-stagflation.

What does the inflection point in the supercycle mean for markets? In the short term, we are likely to see further swings in the inflation/deflation pendulum. A volatile and uncertain environment will continue to frustrate both the bulls and the bears, bringing further gyrations in bonds and equities. Ultimately, however, we think the period 2020-22 will mark a secular turning point in long-term interest rates, which will shift the prevailing bias in monetary policy. After a long battle with disinflation – CPI rates that always threatened to dip too far below central banks' targets (i.e., <2%) – the authorities are facing a regime whereby inflation will mostly be threatening to break above those objectives (i.e., >3%). A difference of 100-150bps may not sound like a lot, but it will have profound implications for global markets. The era of perma-zero interest rates and QE is over. With secularly higher interest rates, investors will no longer be able rely on the continuous rerating of all other asset classes, especially long-duration equities such as US tech stocks. The 2020s will demand a more discerning approach to asset allocation. Investors will need to look for exposure to the real economy, especially those sectors that stand to benefit from deglobalization, the green transition and higher public investment. This is a world where "tangible" assets such as commodities, real estate and "value" stocks will do well, ending the dominance of the intangibles.

1. NEOLIBERALISM'S LAST STAND

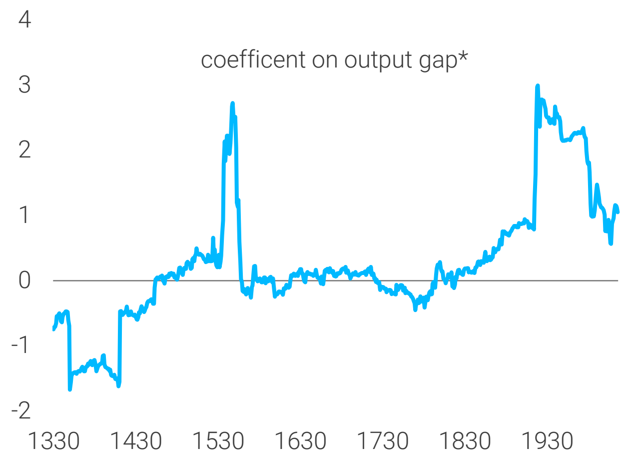
Since the very start of the COVID crisis, there has been a lot of talk about a "new macro regime". Intuitively, this idea is certainly appealing. Developments during the past three years have definitely felt "historic", and we know these sorts of events can change the long-term trajectory of financial markets and the real economy. An influential Bank of England study published before the pandemic identified all the big turning points in yields over the past 900 years, showing that history's greatest secular bear markets in bonds ("real rate reversals") all started with major mortality crises, such as pandemics, famines and military conflicts. And now, of course, we are not only dealing with the aftermath of COVID-19; we are also seeing important geopolitical shifts associated with the war in Ukraine and increasing tensions between the US and China. It makes sense that the macro-financial regime that emerges from these various crises could look different from the one that preceded it. Surely there is no going back to the world as it was in 2019?

Chart 2: Supercycles since the 1800s



Source: The Bichler & Nitzan Archives.

Chart 3: Labour power steepened the Phillips curve



Sources: Bank of England, TS Lombard estimates.

The market pendulum swings

From the perspective of popular narratives and market pricing, there has clearly been a lot of uncertainty about the long-term macro-financial trajectory. Bond yields, which are perhaps the cleanest distillation of these narratives, have experienced powerful oscillations over the past three years, as the market pendulum has swung between recession anxiety and "secular reflation". The combination of COVID-19 and the war in Ukraine has caused massive macroeconomic distortions, and there is still a great deal of ambiguity about the sort of economy that will emerge at the other side. The policy response has been confusing, too. Twelve months ago, all the talk was about "monetary financing", "fiscal dominance" and "the victory of MMT economics", ideas that have suffered a setback recently, as an unexpected surge in inflation has strengthened the hand of fiscal conservatives and forced central banks to tighten policy unexpectedly rapidly. These uncertainties are unlikely to be resolved in the three to six months, especially as the unwinding of previous distortions in the global economy has sparked fears about an imminent recession. The kaleidoscope has been shaken, and it will take time to see how the pieces settle.

Looking beyond the noise

In this Macro Picture, we want to look beyond the noise and likely volatility of the next six months and focus on "the other side". How will the economy of the 2020s differ from the economy of the 2010s? It makes sense to frame this discussion around the long "supercycles" we identified in previous analysis. These are deep underlying socio-political trends in the economy; though these do not necessarily influence investors or policymakers on a month-by-month basis (they will not, for example, tell us whether the FOMC should hike rates by 50 or 75 bps in September), they do dominate the macroeconomic and investment landscape over much longer horizons. Over the past 150 years, there have been three main "supercycles", all inherently socio-political, which ultimately saw the balance of power swing between labour and capital:

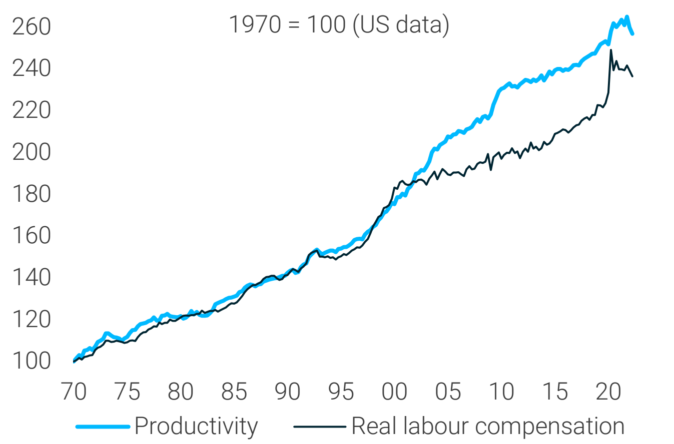
(i) The pre-WWI era, which combined the Gold Standard with "corporatism";

(ii) The "mixed economy" that followed WWII (aka the "Golden Age"); and

(iii) Post-1980s "Neoliberalism", which gained traction with Reagan, Thatcher, etc.

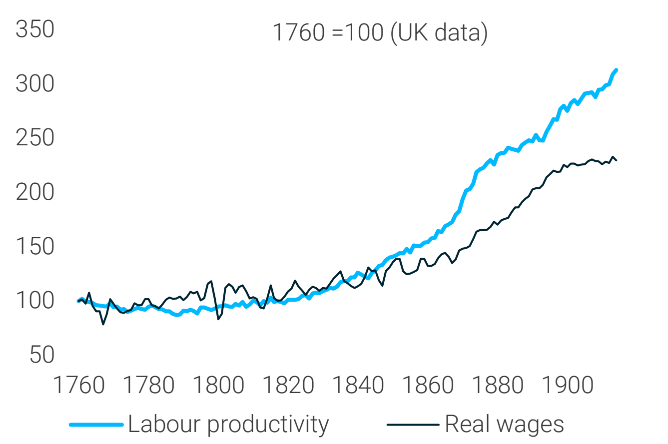
Traditionally, political-economy analysis assumed exogenous events – such as the oil shocks in the 1970s – caused the switch between these three regimes. But excellent analysis by Dafermos, Gabor and Michell (2020) shows that something deeper has been going on. Channelling Hyman Minsky, the authors argue that the capitalist system is fundamentally unstable, which forces the authorities to design institutions and "thwarting mechanisms" to try to manage and ultimately reduce this instability. In line with other recent work – such as Blyth and Matthijs (2017) – they go on to argue that the configuration of these institutions ultimately depends on the balance of power between different economic "interests", especially labour versus capital. When labour is dominant, we end up with institutions (such as trade unions) designed to ensure full employment. When capital is in charge, the focus is on keeping inflation low and supporting asset values (so we appoint "conservative" central bankers, for example). And the whole system is highly reflexive: institutions affect macro outcomes; and macro conditions, in turn, alter the balance of power.

Chart 4: Neo-liberalism crushed worked power



Sources: BEA, BLS, TS Lombard.

Chart 5: Similar trends in the late 1800s

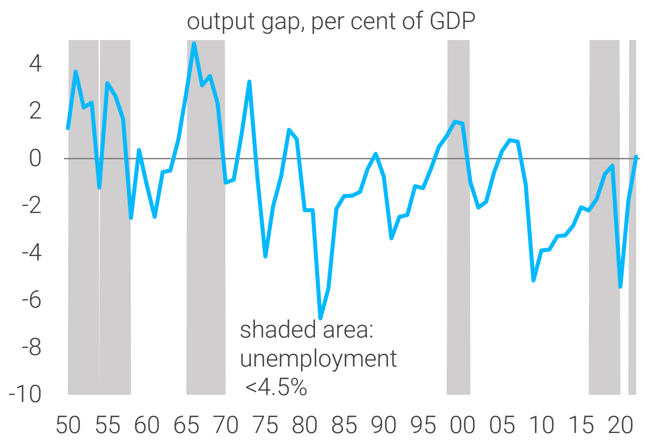


Sources: Bank of England, TS Lombard.

The next supercycle

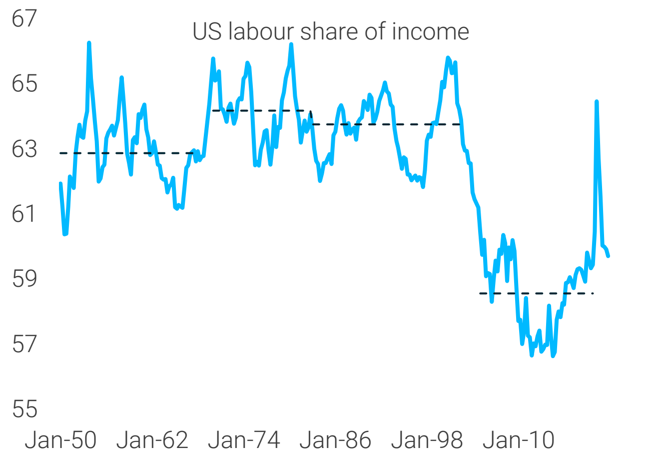
We think COVID-19 and the war in Ukraine are historically significant, marking a new secular turning point. They will further undermine neoliberalism – the prevailing supercycle of the last 40 years – which will gradually shift the balance of power away from capital and back towards labour. Neoliberalism was a political response to the stagflation of the 1970s. It brought free trade, deregulation, smaller governments, large-scale immigration, international supply chains, independent central banks and the death of trade unionism. These policies crushed the position of workers and tilted the balance of power back towards capital. But by in effect recreating the economic environment of the late 19th century, neoliberalism (like every supercycle) ultimately contained the seeds of its own destruction. After the global financial crisis, a long "balance-sheet recession" and an unfortunate experiment with austerity, it seemed that stagnant median wages, polarization and historic levels of wealth inequality would trigger a political reaction. Brexit, Trump and growing popular extremism were the first signs that neoliberalism was doomed.

Chart 6: The perma-lukewarm economy



Sources: CBO, TS Lombard.

Chart 7: Wage share plunged during 2000s



Sources: BLS, BEA, TS Lombard.

'Enemies of the people'

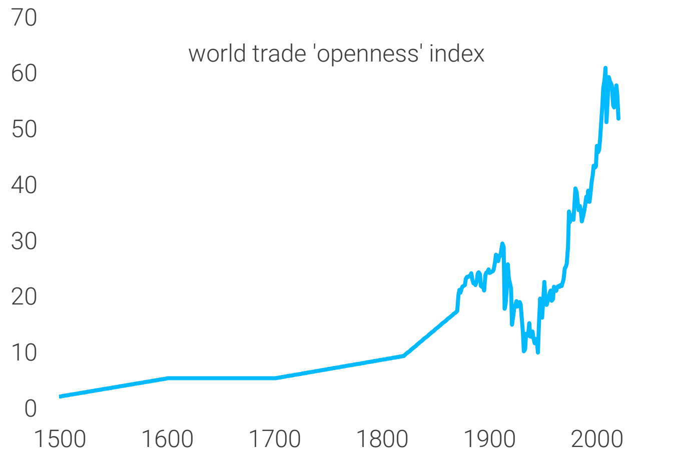
As the ultimate guardians of neoliberalism, central banks obviously want to avoid the transition to a new supercycle. That is why they are committed to "restoring price stability", even at the cost of a recession. And the monetary authorities can certainly influence the balance of power in the economy, at least temporarily, if they are prepared to inflict enough pain. Putting people out of work – which is, in effect, what officials are threatening – tends to dampen economy-wide wage demands. Paul Volcker, who famously "broke the back" of inflation in the early 1980s, helped to usher in the era of neoliberalism by giving Ronald Reagan (and, in the UK, Margaret Thatcher) the opportunity to permanently neutralize the trade unions. There is even an argument that central banks have continued to preserve the interests of capital over the past 40 years by running their economies deliberately "too cold". This ensured that there was always a pool of unemployed workers, which helped to keep wages down. But neoliberalism also came with profound structural changes – particularly globalization – which ensured that central banks had a relatively easy task. We doubt today's monetary authorities will be able to prevent the transition to a new supercycle. The broader political situation is shifting, and labour shortages are already so severe it would take a huge recession to restore "balance". No central bank has a mandate for mass unemployment.

2. SUPERCYCLE INFLECTION

At best, central banks might be able to postpone the next supercycle. But they cannot stand in its way. The basic tenets of neoliberalism – free trade, deregulation, smaller governments, easy migration, international supply chains and the death of trade unionism – are all now moving into reverse. This is a process that began before COVID-19 and the war in Ukraine, which these events are likely to accelerate. And now, we also have increasing and potentially "structural" tensions between the US and China, which could provide a further accelerant. There are obvious parallels with what happened after WWII, which was always our favourite historical precedent for today.

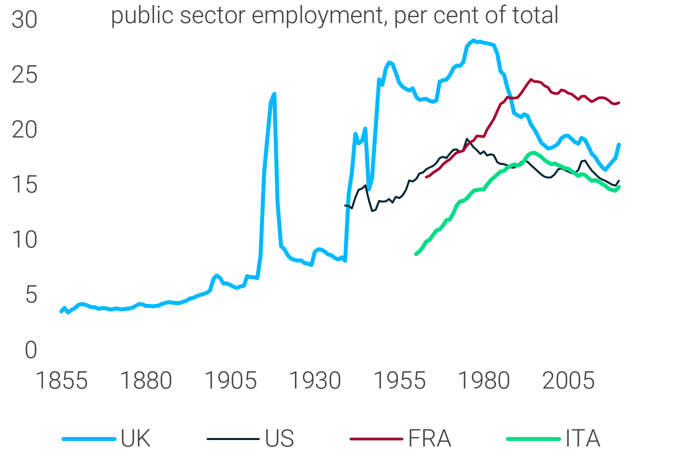
The economy of the 1940s looked very different from the economy that had existed before the war, even if there were clear signs that the political landscape was shifting before the conflict.

Chart 8: Neoliberalism brought globalization



Sources: OurWorldInData, TS Lombard.

Chart 9: The mixed economy after WWII

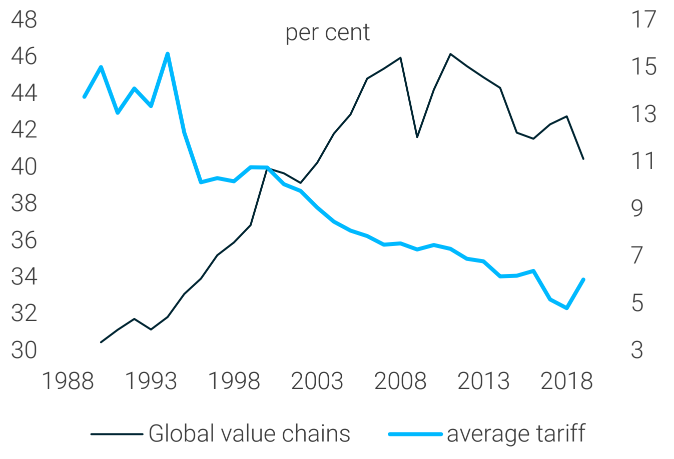


Sources: OECD, TS Lombard.

Today, the attack on neoliberalism is happening across several (mutually reinforcing) fronts:

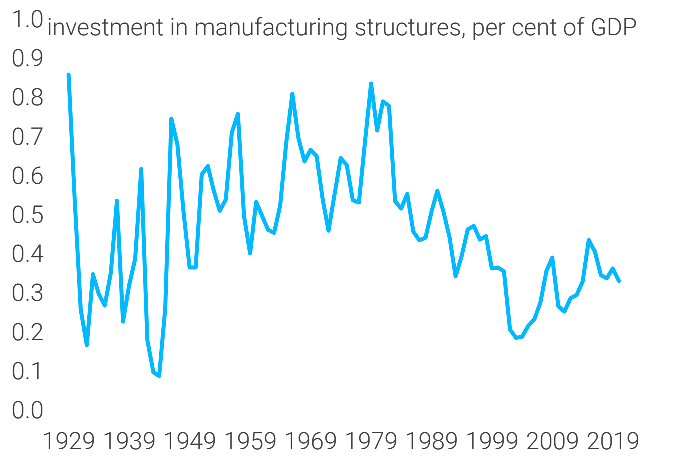
(i) The deglobalization of supply chains: Companies made massive improvements in their efficiency from the 1980s onwards, as new technologies and a rapid reduction in trade barriers encouraged the creation of complex international supply chains. It is now clear that business leaders had prioritized cost efficiencies over resilience, with COVID-19 exposing the inherent vulnerabilities in this system. The best example of this is what happened in the auto industry, where a large number of manufacturers had to halt production because they could not secure key components such as semiconductors. This experience is forcing many larger manufactures to rethink the way they source their inputs, by reducing the complexity of their supply chains and/or securing multiple suppliers. We are also seeing more "reshoring", not least as decades of rapid wage gains have eroded the EM cost advantage (see Chart 19). Incentives have shifted.

Chart 10: Free trade gave us global supply chains



Sources: United Nations, IMF, TS Lombard.

Chart 11: Companies stopped investing at home



Sources: BEA, TS Lombard.

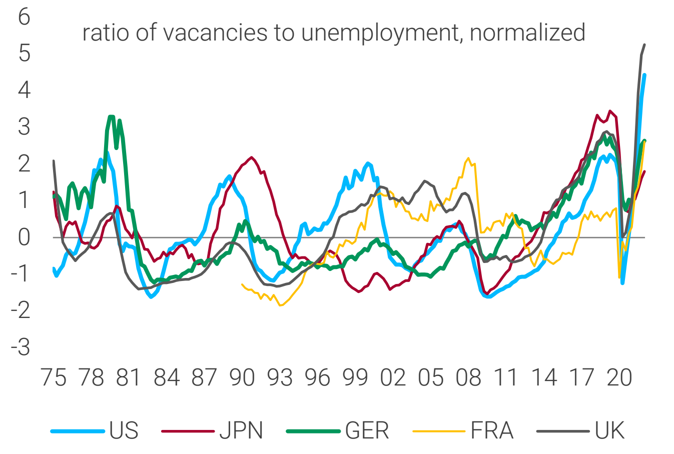
(ii) A reconfiguration of international allegiances: Even before COVID-19 and the war in Ukraine, we thought the world would "deglobalize" and splinter into two main trading blocs, one oriented around China and the other around the US (with Europe mostly aligned with the latter). The events of the past three years have accelerated this trend, particularly as manufacturers are also looking to shorten their supply chains. We know from the Cold War that hard-power political divisions amplify economic divisions, encouraging countries to align their trade and financial systems with their primary military protector. And we saw similar economic and political rotations around the two world wars. The recent "weaponization" of the US dollar pushes the world further in this direction, especially among countries that were already nervous about US dominance.

(iii) Bretton Woods III: The influential Zoltan Poszar has written about the new supercycle from a "monetary" angle, arguing that the dilution of the dollar's "reserve status" will alter the plumbing and functioning of the international monetary system. He calls the new system Bretton Woods III. Poszar sees a regime whereby, instead of hoarding dollar assets, countries that are hostile to the United States will in effect adopt gold and commodity-backed currencies. This will cause resource nationalism, structural commodity shortages, massive increases in investment (global trade must now be re-routed) and reduced international demand for dollar-denominated securities. Unlike in Bretton Woods II, China and the OPEC countries will no longer want to "recycle" their Eurodollars into the US Treasury market, which will push up long-term interest rates.

(iv) Increasing state intervention: The challenges the world faces in the 2020s – especially climate change and what is, in effect, a new Cold War – are going to encourage governments to play a greater role in the economy. Defence spending is a classic "public good" and climate change is the textbook "externality". Of course, there is still a debate about how far governments will, in fact, go to tackle climate change. The appetite is clearly greater in Europe than in the US, not least because of the urgency with which the EU must transition away from Russian natural gas. But there is no question "industrial policy" is now making a comeback. Noah Smith has recently written a number of excellent blog posts on the return of "the wartime economy", examining how shifting geopolitics will force strategic government interventions and investment in areas such as semiconductor production and the securing of critical resources (e.g., pharmaceuticals and rare earths). Evidence from the past suggests greater public-sector involvement is not necessarily a bad thing, especially if it boosts aggregate R&D.

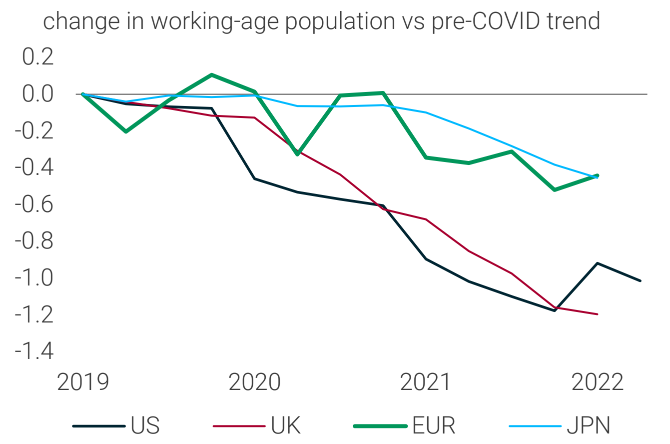
(v) No return to fiscal austerity: While inflation at 40-year highs has undermined the case for MMT-style economics, there is clearly no appetite for returning to the fiscal austerity of the 2010s. In fact, governments are under pressure to inject even more money into their economies in an effort to protect the public from the "cost of living" crisis. Not only has the Biden administration just secured another fiscal expansion (by cunningly rebranding its plans as the Inflation Reduction Act); politicians in other jurisdictions are also under pressure to support their economies. Further fiscal stimulus now seems inevitable in the UK, regardless of who becomes prime minister. We also expect more flexible fiscal rules in the EU, which will ensure policy remains relatively loose. Tight fiscal policy undermined worker power in the 2010s because, without a sufficient monetary offset (which QE could not provide) it ensured persistent lukewarm demand.

Chart 12: Labour markets are tight



Sources: national sources, OECD, TS Lombard.

Chart 13: Labour force has declined

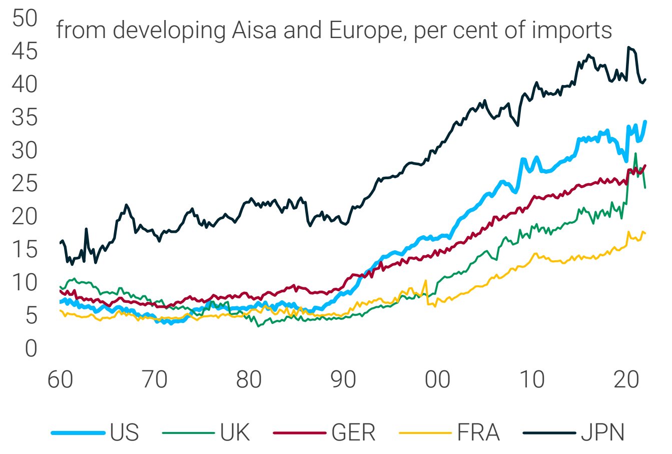


Source: OECD, TS Lombard.

Globalization and secular disinflation

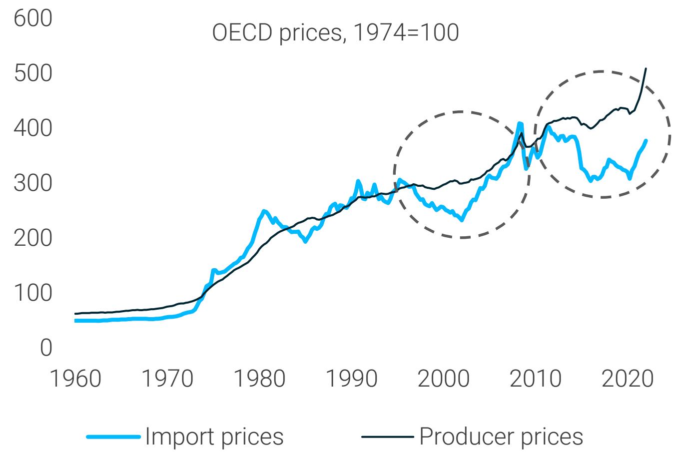
Understandably, investors are keen to see precise forecasts about what this new supercycle means for the macro economy. They regularly ask, for example, how much deglobalization is likely to boost inflation in the 2020s. Naturally, it is difficult to provide specific estimates, particularly as the absolute scale and timing of this transition is hugely uncertain. The best we can do is to look at the previous era of globalization and reverse some of the trends. Naturally, there has been a huge research effort over the past 30 years to try to understand these trends. And the consensus answer, rather surprisingly, is that the impact of globalization has not been huge. Most estimates suggest that opening up the global economy to increased international competition reduced annual OECD inflation rates only by around 0.3-0.5%. Yet there are two reasons why the true effect is likely to have been much larger. First, traditional studies focus only on the "direct" impact of globalization, namely falling imported goods prices and lower PPI; they ignore the "indirect" effects, particularly via lower wages. Second, these academic findings – popular among central bankers – contradict what most businesses have been saying[1].

Chart 14: Globalization brought competition



Sources: IMF, TS Lombard.

Chart 15: Import prices reduced goods inflation



Sources: OECD, TS Lombard.

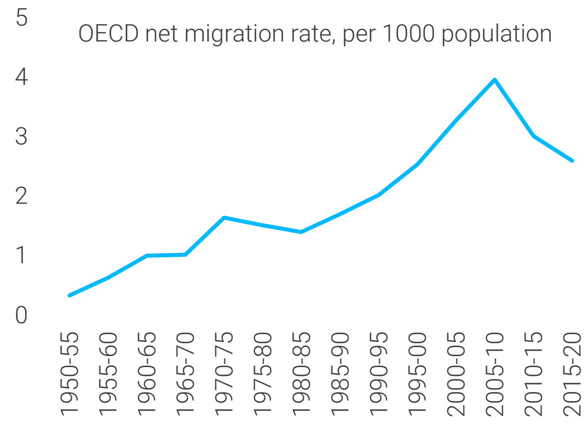
[1] A quote from 2007 illustrates the point. Charlie Bean, noted: "If you ask the average businessman or woman why [inflation has been low], he or she is almost certain to reply that it is down to cheap imports from the Far East and Eastern Europe. Monetary policy won't get a mention. Yet you will all know from your first-year macro course that this can't be right, as inflation must ultimately be a monetary phenomenon." Obviously, non-economists simply cannot be right.

There was a bigger story with globalization, too – namely, what was in effect the doubling of the global labour force that resulted from the entry of China, India and Eastern Europe into international markets. Most of these extra workers were unskilled and brought little capital with them, so the effect was to lower the ratios of skilled labour and physical capital to unskilled labour. This, in turn, drove down the wages of unskilled labour relative to skilled labour and increased the rate of profit on capital. Naturally, the production of goods and services that were intensive in the use of unskilled workers shifted to the emerging economies. But the effects did not stop there. New technologies allowed businesses to push the division of labour even further. Products that were designed in the US, for example, could now be assembled in China, for example, using parts from surrounding countries, perhaps with a call centre in India or elsewhere providing after-sales services and assistance. This unbundling of the production process into its constituent tasks allowed businesses to maximize efficiency gains and profits and destroyed the bargaining power of low- and mid-skilled workers.

Deglobalization and secular reflation

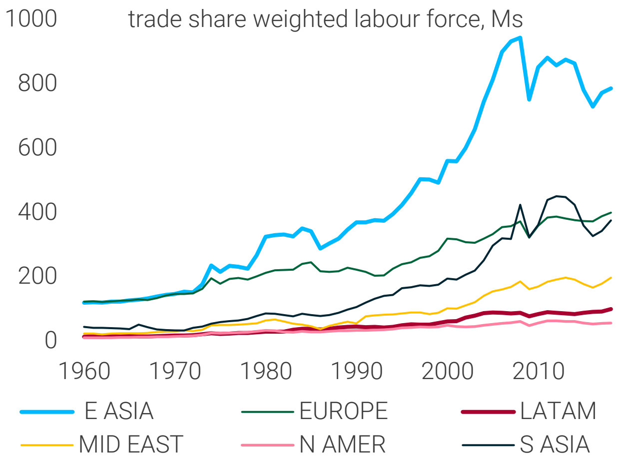
Central banks denied the impact of globalization because they liked to take credit for the Great Moderation. It was their magical "credibility" that kept inflation low. And according to textbook economic theory, globalization was mainly a "relative price shock". By keeping interest rates low and raising real incomes, monetary policymakers should (in theory) have been able to reflate the domestic services sector, which would have neutralized the aggregate disinflationary impact of globalization. But this is not how the process worked in practice. The countries that were able to defend their export markets after the 1980s (Germany, Japan, China, etc.) did so only by suppressing wages. And the deflationary effect from the expansion of the global labour force extended well beyond the traded goods sectors. The classic Phillips curve became "flatter". Even when domestic unemployment was low, workers could not secure higher wages. Global factors took over from domestic forces as the main driver of CPI. We suspect deglobalization will have equally powerful effects, even if the precise impact on inflation is impossible to quantify. Wages and prices will rise at a faster average pace, and the Philips curves will become steeper.

Chart 16: Rapid immigration after mid-1990s



Sources: United Nations, TS Lombard.

Chart 17: Labour force expanded rapidly



Sources: World Bank, IMF, TS Lombard.

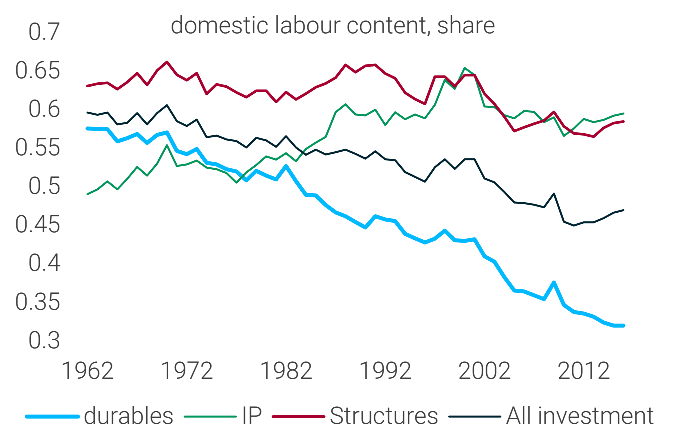
What about demographics?

It is impossible to discuss the next supercycle without mentioning demographics. For the "structural deflationists", population aging is the main reason why there can be no return to the post-WWII supercycle. "Look at Japan", they say. Yet, the impact of demographics is more complicated than many pundits realize. And Japan's experience may not be a useful guide to how this will play out in the rest of the world. Population aging reduces both savings and investment in the economy, which means the overall impact on interest rates is ambiguous. Older people have lower incomes, which cuts total spending, but at the same time they save less. (And governments typically support the elderly's spending during retirement via state pensions and free healthcare). That said, thanks to the pandemic, we now have a case study that shows how demographics can boost inflation, especially if it causes severe labour shortages. COVID-19 encouraged many older workers to leave the job market, which boosted the wages of younger workers. So, it is easy to see how demographics and deglobalization might work together to produce persistently stronger wage gains in the 2020s. This did not happen in Japan because companies were able to outsource production even as their domestic workforce shrunk. A situation where all countries face demographic challenges and trade barriers are increasing could be radically different.

So, to sum up the causes of the new supercycle:

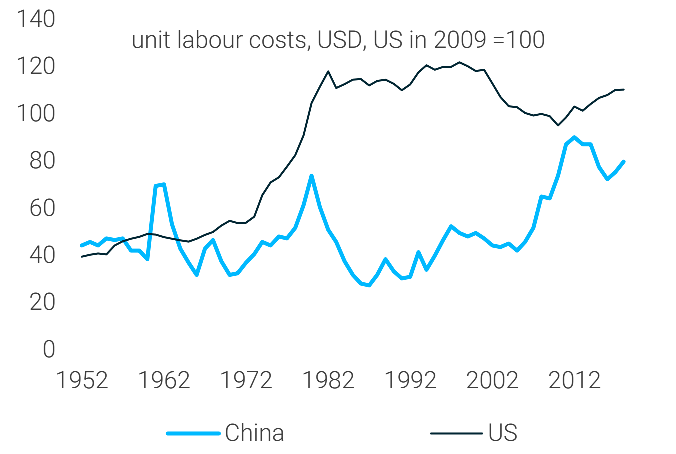
Existing worker shortages + deglobalization + structurally easier fiscal policies (especially on defence spending and climate change) + population aging = structural labour shortage, which will start to shift the balance of power away from capital for the first time since the early 1980s.

Chart 18: Outsourcing of domestic employment



Source: EmployAmerica.org.

Chart 19: Reduced incentive to outsource

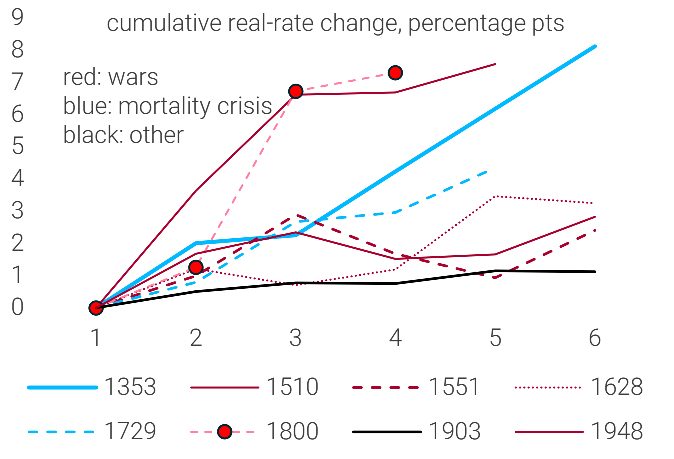


Sources: TS Lombard, Conference Bopard, Ceglowski and Golib (2007).

3. THE TANGIBLE TWENTIES

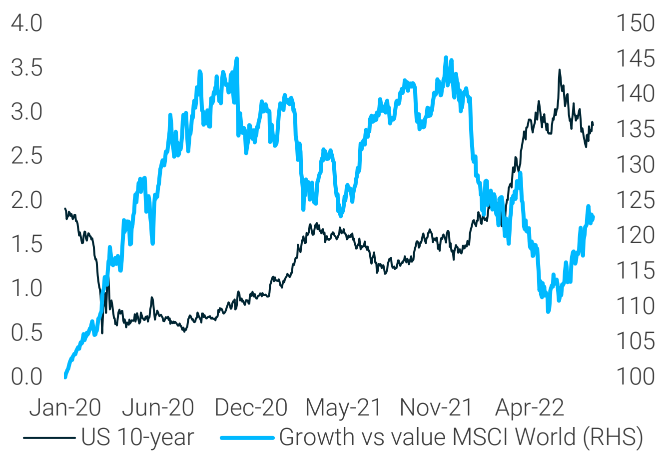
The neoliberal supercycle gave us subdued inflation, low interest rates, supernormal profits and a collapse in the wage share. If we are correct about the 2020s, the next supercycle will start to reverse these trends. Inflation will be higher, interest rates will go up, profits will be lower and the wage share will recover. Obviously progress towards this new supercycle is not going to be linear or continuous – particularly if central banks raise interest rates too aggressively over the next 12 months. But this still means we are looking at a very different environment for policymakers and investors over the longer term. In the 2010s, "perma-zero" interest rates caused all financial assets to "rerate", so investors could make outsized returns just by holding "long-duration" equities such as US tech stocks. At times, financial markets seemed detached from what was happening in the real economy. We suspect the 2020s will provide a more challenging backdrop for financial markets. But the decade will also bring new opportunities.

Chart 20: History's big real-rate reversals



Sources: Bank of England, TS Lombard.

Chart 21: Rates have driven equity themes

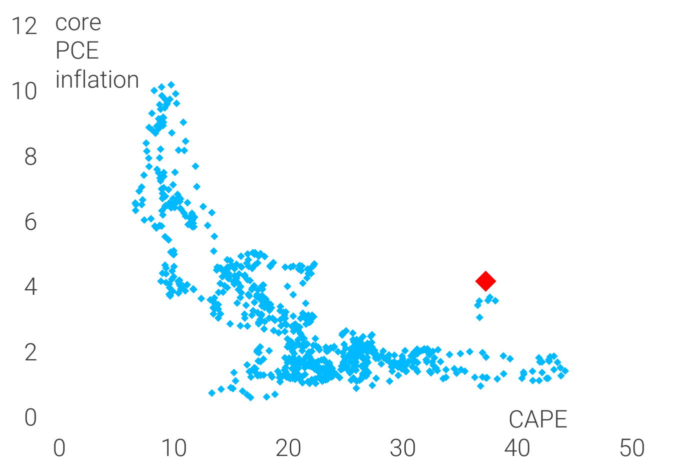


Sources: Bloomberg, TS Lombard.

Secular bear market in bonds

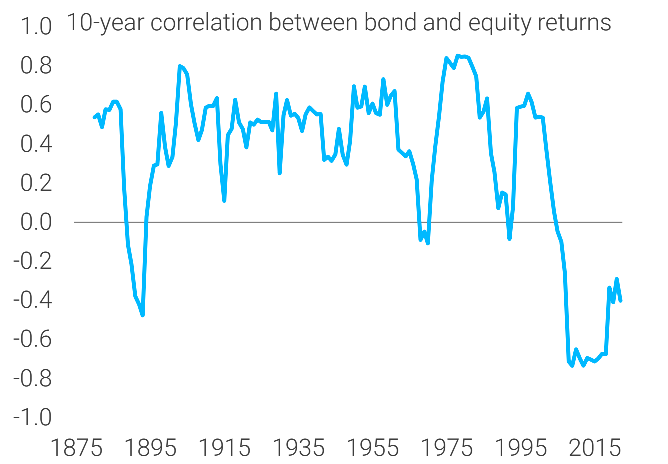
Talk of a "new supercycle" tends to spook investors, especially when it entails interventionist governments. People inevitably imagine a 1970s-style endgame, not least in the wake of the stagflationary environment of the past six months. But 2022 is not necessarily a sign of what is to come, and there is no reason to expect persistent 1970s-style stagflation. Many of the current distortions in the economy will unwind, which means inflation will come down and growth will recover. The main point is that we are not going back to a world where inflation is persistently below 2%.This, in turn, will change the basic task of monetary policy and shift the relationship between central banks and financial markets. From now on, central banks will be battling mainly to keep inflation below 3% rather than fighting to stop it falling below 2%. NIRP, ZIRP and QE are gone, and the authorities will naturally be less sensitive to any problems in the financial sector. Of course, there will still be volatility in yields – the inflation/recession pendulum will keep swinging – but long-term rates are likely to trend higher (which means "higher lows" and "higher highs").

Chart 22: Low inflation encouraged mkt rerating



Sources: Shiller database, TS Lombard.

Chart 23: Bond-equity correlation to weaken?



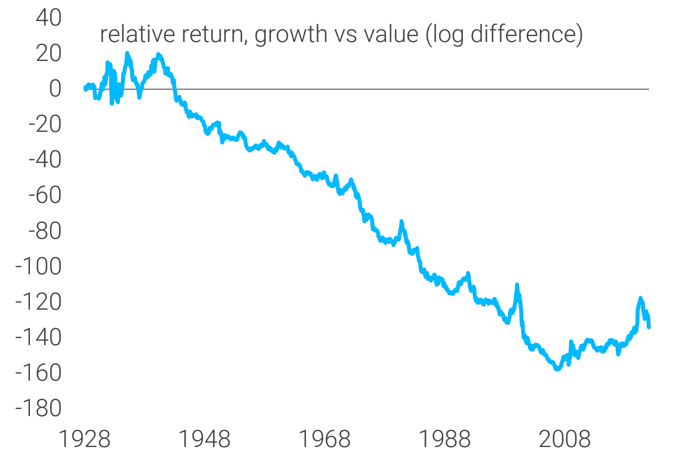
Sources: MacroHistory database, TS Lombard.

The secular bear market in bonds does not mean government securities will completely lose their hedging properties. Bonds can still provide some "insurance" for portfolios, especially during recessions and times of extreme risk aversion. The bond-equity correlation, which ultimately depends on the cyclicality of inflation, is likely to remain in negative territory, at least most of the time. But this relationship – which has been the bedrock of modern portfolio constructive – is set to become weaker than it was during the perfect Goldilocks era of the early 2000s. And there will be times, like the first half of 2022, when the correlation breaks down altogether. Climate change and the transition to new intermittent energy sources will produce more frequent bouts of stagflation, even if it is not the prevailing macro characteristic. This suggests investors will need to find ways to hedge these episodes –by e.g. holding more commodities in their portfolios.

A new equity-market regime

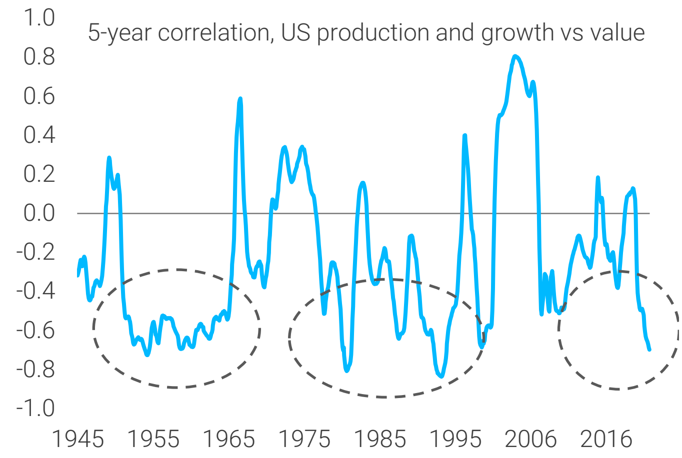
While the repercussions for bond markets and global commodity prices seem clear, there is less clarity about what this new macro regime means for equity markets. Secular stagnation had a profound impact on the relative performance of different stocks, and an era of "secular reflation" could produce a very different type of stock market. We see this most clearly in the decade-long outperformance of "growth" vs "value" stocks. 'Growth" stocks are those that have relatively high market-to-book values, priced this way presumably to account for their superior long-term growth prospects. They include companies like Tesla, which have relatively low earnings today but (supposedly) fantastic future prospects. "Value" stocks are the opposite: they have a low market-to-book value, presumably because their future revenue performance looks weaker. Yet it is important to stress how unusual the last decade has been, much to the frustration of traditional "bottom-up" stock-pickers. The growth sector's continuous outperformance has bucked the "megatrend" of the past 50 years at least, if not even longer.

Chart 24: The 2010s were a little weird



Sources: Fama/French database, TS Lombard.

Chart 25: High-pressure economy suits value

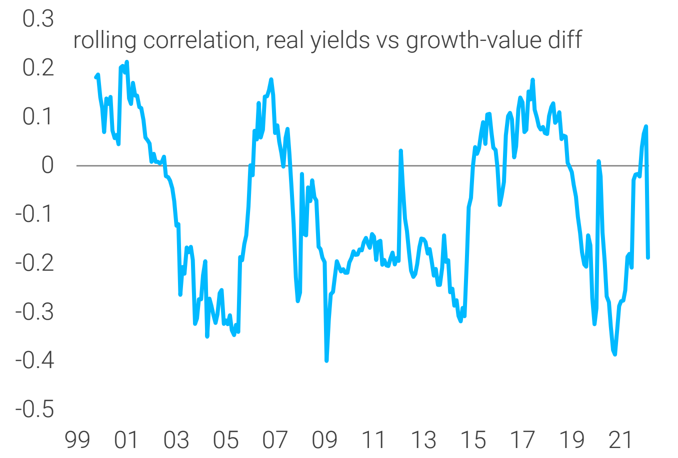


Sources: Fama/French database, TS Lombard.

Secular stagnation: 'growth' outperformed

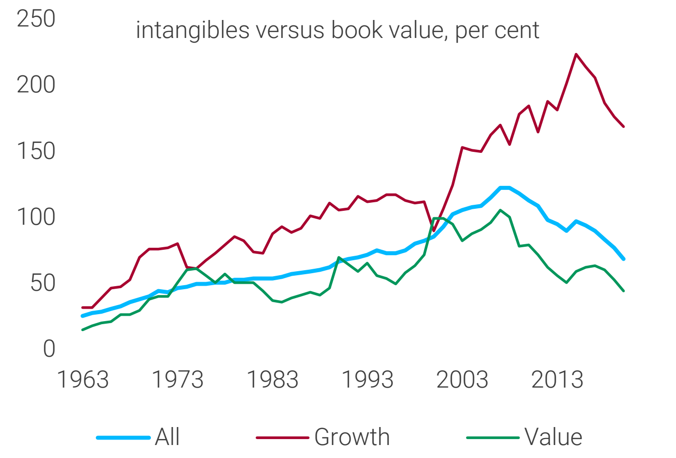
The secular stagnation regime favoured "growth" stocks for two main reasons. First, it delivered lower nominal GDP growth: it seems obvious that if economic growth is secularly scarce, investors will pay a premium for those companies that promise to perform better. Chart 25 plots the long-term historical pattern, which shows there has generally been a negative correlation between secular periods of industrial strength and "growth" performance. The "high-pressure" economies of the 1950s, 1960s and 1990s provided the ideal macro backdrop for "value" outperformance. The second reason why secular stagnation favoured "growth" stocks has to do with interest rates. When investors expect rates to stay chronically low, they will place a higher value on companies (and investment projects) that promise strong returns in the future, even if those returns are a long way off. This is just arithmetic. Growth stocks are "longer duration", which means valuations rise more for a given decline in bond yields (see this example of how the maths works). Chart 26 shows a negative correlation between interest rates and "value".

Chart 26: Higher rates also suit value



Sources: Fama/French database, TS Lombard.

Chart 27: Intangibles dominated in 2010s



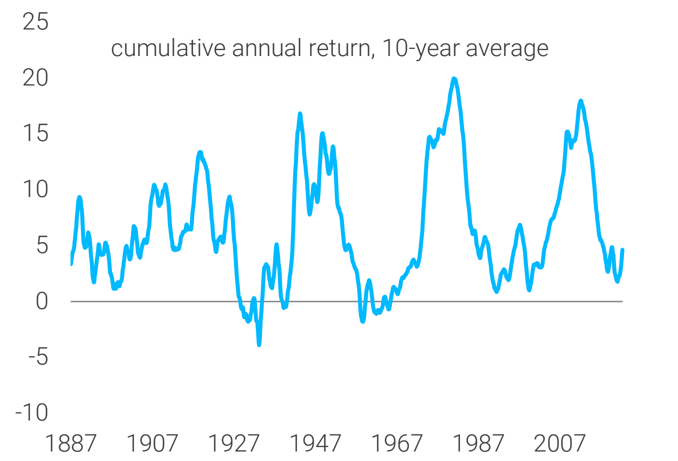
Sources: Robert Arnott, Campbell R. Harvey, Vitali Kalesnik & Juhani.

Secular reflation: 'Value' and 'tangibles'

Just as secular stagnation and zero interest rates favoured growth stocks, so an era of secular reflation and rising yields should favour value stocks. This means the recent "rotation trade", which has been mainly about the reopening of the economy and the bursting of the US tech bubble, is just the first instalment of a broader theme. And we can also think about this issue another way, in terms of "tangibles" and "intangibles". The growth stocks that were dominant over the past decade were big investors in intangible assets. As Vincent Deluard points out in a recent podcast, the S&P 500 index can be broken down into two: the 15 largest intangible companies (the FAANGs, big pharma, VISA and MasterCard) have a capitalization of US$15 trillion despite reporting just US$2.5 trillion in assets, while the remaining 485 companies control US$40.4 trillion in assets but are worth just US$26 trillion. Tangible companies are businesses that "make stuff with other stuff". The value of intangibles is not derived from their balance sheet; rather, it comes from their intellectual property, branding, market power, goodwill" and distribution networks.

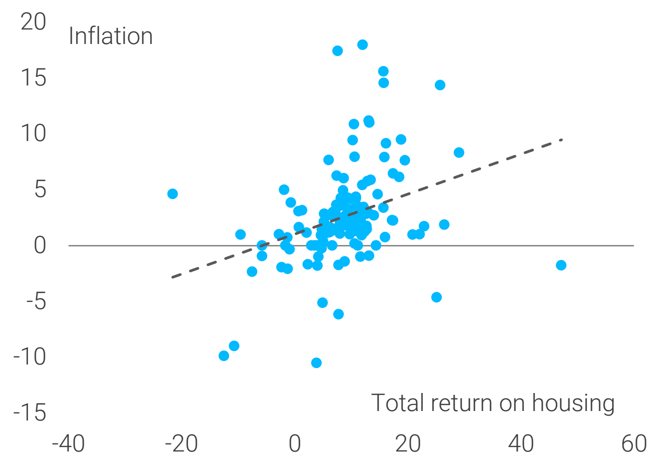
Intangible assets have four main characteristics: (i) large sunk costs (they have limited resale value); (ii) strong scalability at zero/low marginal costs; (iii) powerful synergies (intangible assets feed on one another); and (iv) strong spillovers (intangible assets can have various different applications). Subdued inflation and low interest rates favoured intangible assets, but this advantage disappears in a reflationary environment. That is not just because intangible assets have a longer duration; it is also because a higher-pressure economy would raise the scarcity premium on physical assets, increase the uncertainty about future returns, erode the nominal value of debt (tangible businesses have more collateral and higher debt ratios) and discourage the various forms of "financial engineering" that boosted intangible valuations during the 2010s. The scalability of intangible businesses meant that they also benefitted disproportionately from globalization, which is an advantage they will lose in the era of deglobalization.

Chart 28: The commodity supercycles



Sources: AQR.com "commodities for the long run", TS Lombard.

Chart 29: Housing reflated with inflation



Sources: MacroHistory, TS Lombard.

The return of the real economy

In short, tangible assets have a closer link to the "real economy". And when we think through the secular growth themes that are emerging out of the chaos of the past three years, it is clear that there are important sectoral "winners" that will experience a revival in the 2020s, namely:

(i) Higher interest rates – banks, financials, healthcare

(ii) Infrastructure spending – industrials, materials, commodities

(iii) Structural energy shortages – energy, commodities

(iv) Defence spending – defence, aerospace, materials

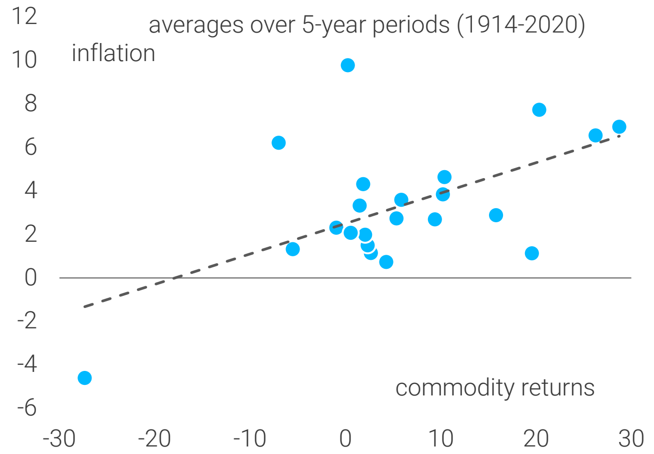
(v) Global housing revival – banks, materials, commodities

(vi) Deglobalization and reshoring – industrials, capital goods

(vii) Climate change – commodities, metals, energy (new "green" investments)

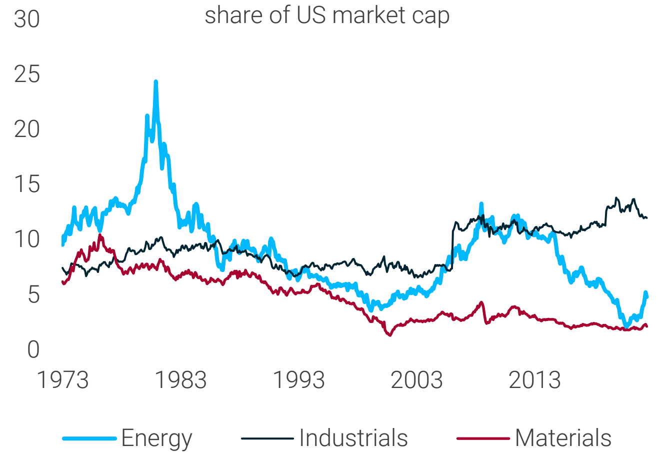
In the 2010s – the decade of secular stagnation – investors could earn outsized returns simply by investing in "growth" stocks, especially US tech. We are not particularly pessimistic about these companies and think they could continue to enjoy decent earnings. But their post-COVID valuations more than fully reflected those future growth prospects (they even became over-valued). Now the big investment opportunity is shifting back to the "real economy", areas that could enjoy a secular revival. Investors should seek exposure to "tangibles", such as commodities, real estate and many traditional "value" parts of the equity market, which are likely to gain from this transition. And the realignment of financial markets with the real economy, after a decade in which they have seem "detached", could even bring certain advantages. Beyond the artificial stability of the Great Moderation, the perma-low interest rates environment encouraged the regular build-up of serious underlying financial imbalances and a series of asset-price bubbles. The new supercycle might bring more frequent episodes of inflation and recession, but at the same time it could contribute to a more stable financial system, with fewer of the extreme imbalances that came to define the neoliberal era.

Chart 30: Commodities are an inflation hedge



Sources: AQR, MacroHistory, TS Lombard.

Chart 31: Share of energy and materials to rise?



Sources: Datastream, TS Lombard.

Bottom line

The economy has been a confusing mess for investors in 2022, with the war in Ukraine compounding lingering distortions from COVID-19. The next three to six months is unlikely to provide a moment of clarity. More likely, the pendulum will continue to swing between recession risk and inflation anxiety. A soft landing is possible but will require better inflation data and a more gradualist approach from central banks. Beyond the current noise and macro distortions, however, a new supercycle is emerging. The post-COVID, post-Ukraine economy will not return to the norms of 2019. The balance of power between labour and capital has started to shift; and with persistent worker shortages, deglobalization, more activist fiscal policy, greater government intervention and "wartime economics", the neoliberalism era of the past 40 years is now in retreat. Naturally, the emergence of a new supercycle will have profound implications. Although inflation is likely to ease from current levels, the persistent "low-flation" era is over. This means the basic task of monetary policy is changing, from keeping inflation above 2% to preventing it from rising above 3%. There will be a secular bear market in bonds, with higher lows and higher highs. This new supercycle calls for a different approach to asset allocation, too: investors will no longer be able to rely on the continuous rerating of asset prices, especially long-duration equities. The best returns will come from exposure to the real economy, especially the sectors most exposed to the new supercycle (commodities, infrastructure, value stocks and even real estate).

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