

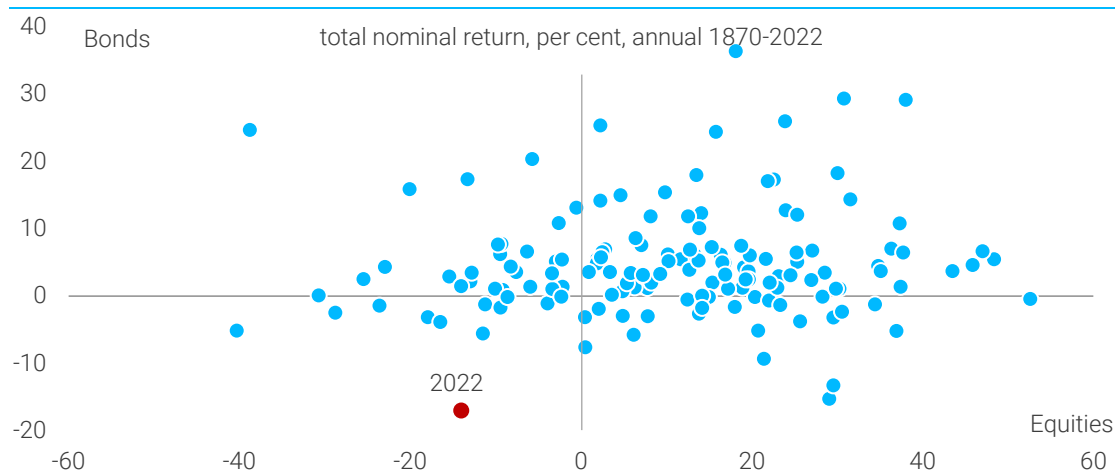
Macro Picture

THE NEW NORMAL FOR MARKETS

Dario Perkins

High inflation, deteriorating growth and hawkish central banks – 2022 created a horrible environment for global markets. But we should be careful not to over-extrapolate from these trends. While the 2020s promise to be very different from the 2010s, it will not be an era of perma-stagflation. There will still be investment opportunities in the new macro supercycle.

Chart 1: 2022 has been exceptionally bad for investors – a sign of things to come?



Source: MacroHistory database, TS Lombard

GOLDILOCKS IS DEAD

High inflation has damaged economic growth and encouraged central banks to tighten policy at an extremely rapid pace, creating a particularly toxic (stagflationary) environment for global markets. Investment strategies drawn up during the Great Moderation broke down. Now various high-profile pundits are forecasting a new regime of disastrous market returns for the 2020s.

SECULAR SHIFTS

There is no doubt that 2022 can provide clues about a secular shift in markets. Supply disruption is likely to become a regular problem in the 2020s, which means more frequent periods of stagflation. On average, inflation and interest rates will be higher. But we are not expecting a repeat of the 1970s. Real economic growth will improve and there could be fewer financial crises.

TANGIBLE TWENTIES

The next decade will provide a more challenging environment for investors. Without the secular bull market in bonds – which caused all long duration assets to “rerate” – investors will need to identify the specific macro themes of the 2020s. We see opportunities in commodities, “value” stocks and real (tangible) assets. Intangibles will be the big losers, especially “growth” stocks.

THE NEW NORMAL FOR MARKETS

2022 has been radically different from the “Goldilocks” environment investors anticipated at the start of the year. In part owing to the war in Ukraine, inflation has hit levels that were unimaginable 12 months ago, killing economic growth and forcing central banks to raise interest rates extremely rapidly. Policy moves that once seemed impossible, such as 75bps rate hikes from the ECB, are now standard. Naturally, the combination of stagflation and hawkish central banks has been disastrous for global markets. The value of most financial assets has declined, while investment strategies that were drawn up during the Great Moderation – such as the “60-40 portfolio” – have broken down. Bonds and equities have both lost around 15% of their value in 2022, the worst performance in 150 years, and a drawdown of truly historical proportions. Unfortunately, there have been few safe havens in this generally toxic environment. With TIPS and gold prices failing to live up to their reputation as an inflation hedge, only commodities (and specific parts of the stock market) have provided adequate protection. Looking forward, the question is whether the market turmoil of 2022 will be a historical outlier or – as some pundits warn – the start of a “new regime” in which investors will experience secularly abysmal returns.

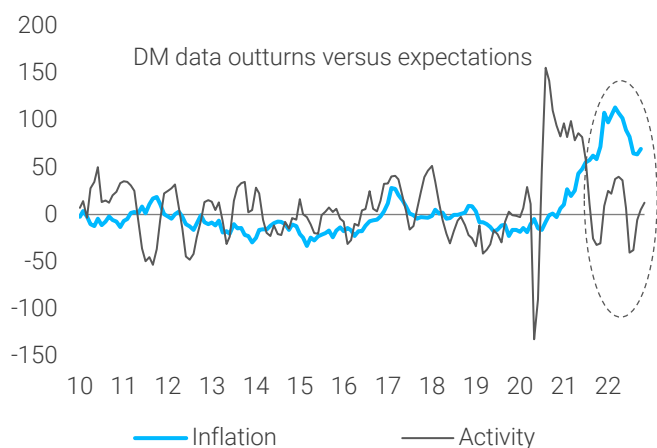
Market behaviour in 2022 can doubtless tell us something important about the future. Investors have had to deal with several nasty supply shocks, which are set to become a more regular feature of global economy in the 2020s. The Great Moderation of hyper-efficient supply chains and persistently low and stable inflation is surely over, giving way to more frequent episodes of high inflation and macro instability. On average, we expect inflation and interest rates to remain significantly higher in the 2020s than in the pre-COVID era. With the balance of power in the global economy shifting from capital to labour for the first time since the 1980s, the macro supercycle seems to have passed a crucial inflection point – something that post-pandemic worker shortages, deglobalization, aging demographics, shifting geopolitical allegiances, climate change and more activist fiscal policy will only reinforce over the next decade. Yet it is important to recognize that this new supercycle is not necessarily an era of persistent stagflation, and this means recent market performance provides an excessively bearish guide to its significance for investors. This is not going to be a repeat of the 1970s; in fact, the 1940s and 1950s probably provide the better historical template, especially if higher levels of investment, a superior policy mix and a revival in productivity can drag the global economy out of its long secular slump.

What should investors do? With central banks tightening policy, economies adjusting to rapid increases in the cost of borrowing, and recession risks building, there is an obvious disconnect between how investors should position for the next six months and our longer-term thesis. The important point, however, is that we do not believe the current period of cyclical weakness in the global economy will derail the new supercycle. The inflation-recession pendulum will continue to swing, but the prevailing tendency of inflation has shifted, from a world where inflation was always threatening to drop too low, to a world where it will mostly be threatening to break too high. This not only alters the inherent bias in monetary policy; it also upends a decade of institutional investing. Whereas the era of lowflation and permazero rates naturally favoured fixed-income markets and long-duration equities (which continuously “rerated”), investors are going to have to work harder to secure decent returns in the 2020s. Rather than looking for exposure to intangible assets such as US tech, the FAANGs, cryptocurrencies and all the speculative investments that outperformed in the era of zero interest rates, investors should now seek exposure to the real economy, especially sectors that are likely to become secular growth catalysts in the next supercycle. Commodities, energy, value stocks and real assets (including housing) should all perform well – at least, once the immediate recession scare has passed.

1. GOLDBLOCKS IS DEAD

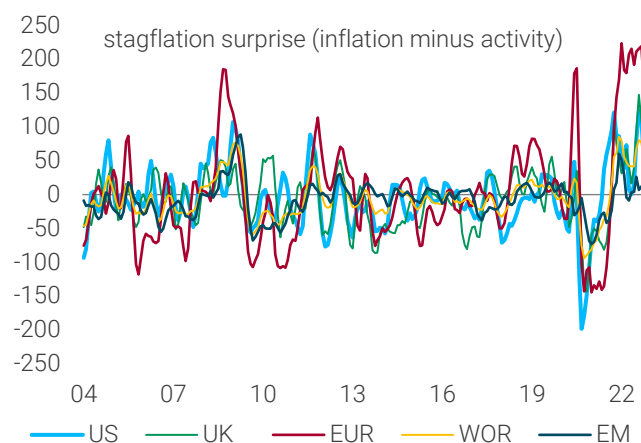
It seems almost laughable now that, at the start of the year, most sellside economists thought the Goldilocks economy would return in 2022. Inflation would plunge, global growth would stay “above trend” and central banks’ “policy normalization” would do nothing to destabilize otherwise buoyant financial markets. Every part of this consensus thesis has proved wildly optimistic, and today we have something closer to the exact antithesis of Goldilocks – stagflation. Inflation has reached new highs, growth has deteriorated sharply – much of the world seems to be on the brink of a recession – and monetary tightening has had a devastating impact on asset returns, with central banks deliberately squeezing financial conditions in an effort to destroy wealth and reduce aggregate demand. The fastest and broadest episode of monetary tightening in decades has produced asset-market returns which – unless there is an epic turnaround in the final weeks of the year – will go down as some of the worst in history. Goldilocks, it seems, is dead.

Chart 2: A year of stagflation surprises



Source: Datastream, TS Lombard

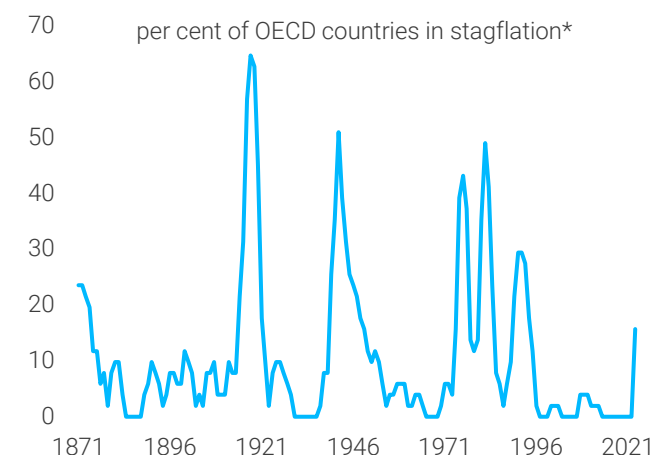
Chart 3: Europe suffered stagflation most



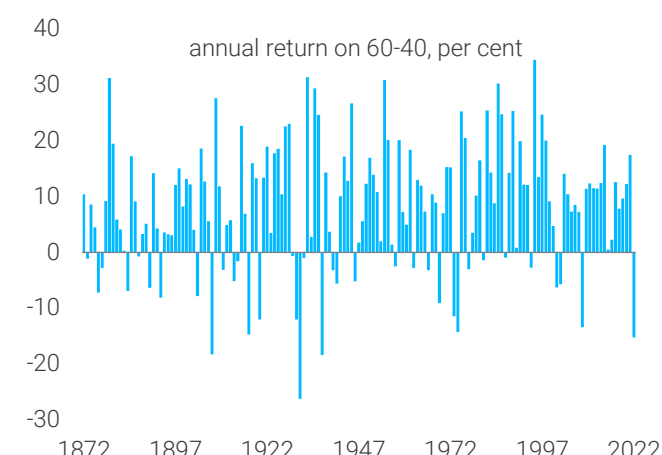
Source: Datastream, TS Lombard

Toxic 2022

Investment strategies such as the “60-40 portfolio”, which appeared during the Great Moderation, were poorly equipped to deal with a stagflationary environment. As Chart 1 (front page) shows, total returns in bonds and equities have fallen simultaneously – their worst performance in a century. The underlying problem is, of course, that the correlation between bonds and equities has flipped from negative to positive in 2022, which means the bedrock of modern portfolios crumbled. This was something we warned about in the years before COVID-19. While many investors took the negative bond-equity correlation as a basic rule of nature, we pointed out that it was a recent phenomenon, rooted in the procyclicality of inflation and the type of shock that dominated the economy. When demand shocks are more frequent/larger than supply shocks – which was true through the late 1990s and early 2000s – the CPI is procyclical and the correlation between bonds and equities is negative. But in a regime where supply disturbances take over, inflation is countercyclical and the bond-equity correlation flips. In this sense, 2022 has been a throwback to an earlier period in history, something few investors were prepared for.

Chart 4: History of stagflation


Source: MacroHistory, TS Lombard, *GDP growth <1%, inflation >4%

Chart 5: 2022 was bad for the '60-40 portfolio'


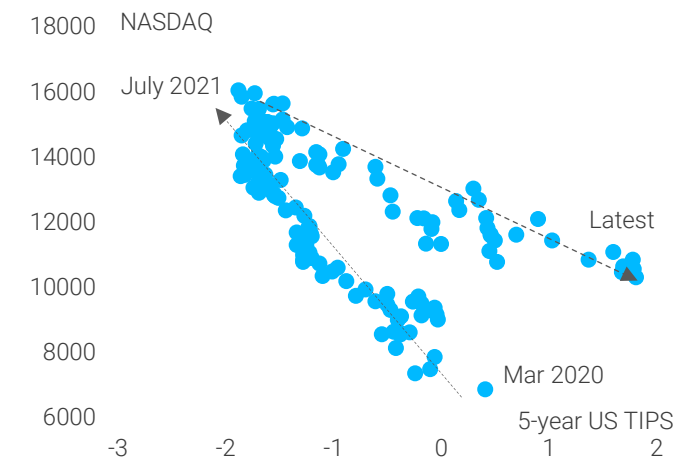
Source: MacroHistory, TS Lombard

Nasty supply shocks

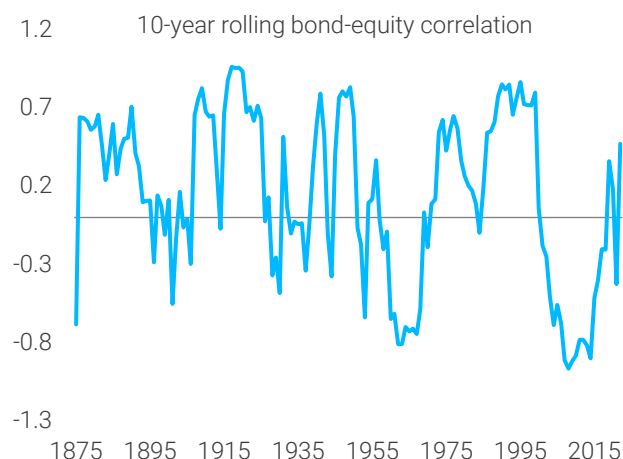
Unlike the global financial crisis, which was a persistent demand shock, COVID-19 has had a powerful supply component. The combination of lockdowns and income support was highly inflationary, which the chaos in global supply chains amplified. For a while, there were good reasons to think this inflation episode would be “transitory” – prices would not fall but inflation would come down. But the supply problems have continued throughout 2022, first in labour markets and then with the war in Ukraine. Naturally, as inflation has approached “double-digit” levels, it has squeezed private-sector spending. Real incomes have plunged, reducing the purchasing power of households and businesses, which has led to broad economic weakness (especially in Europe, which was most exposed to the energy crisis). Even without a monetary response, the global economy would have struggled in this environment, providing a more challenging environment for international investors. Yet the aggressive response from central banks has intensified the pain. Haunted by the ghosts of the 1970s, the authorities have been desperate to dampen inflation expectations and avoid dreaded “second-round effects”. Their aggressive monetary tightening has caused further demand destruction, especially in the most interest-rate sensitive sectors of the economy such as housing and durable goods production.

Chart 6: Yields drive equity rotations

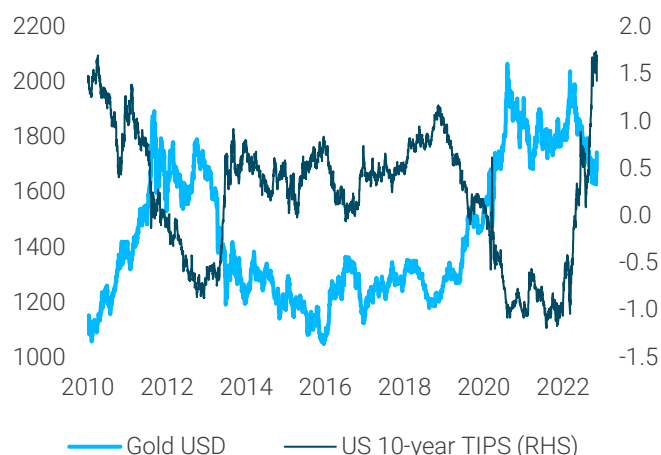

Source: Datastream, TS Lombard

Chart 7: Rates drive long-duration stocks


Source: Bloomberg, TS Lombard

Chart 8: Bond-equity correlation has flipped


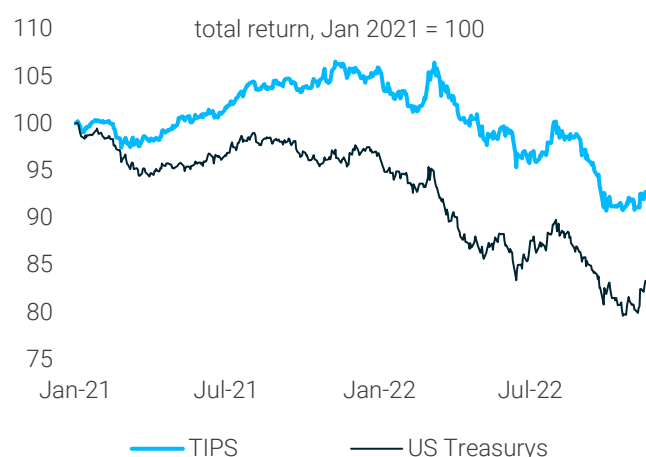
Source: MacroHistory, Bloomberg, TS Lombard

Chart 9: Real yields, not CPI, drove gold prices


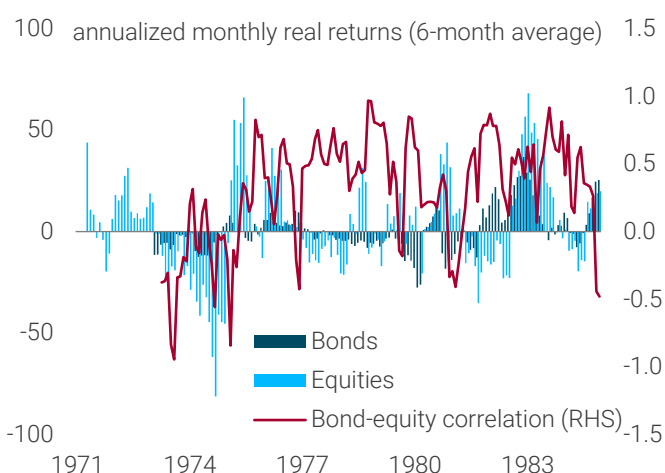
Source: Datastream, TS Lombard

Zero parachutes

Inflation and monetary tightening caused bond prices to plunge, while weaker growth simultaneously undermined equity markets. Even worse, there has been clear reflexivity between markets, as rapidly rising bond yields reduced the discounted value of future earnings. This was a severe problem for a global equity market that had become disproportionately weighted towards “long-duration” stocks such as the FAANGs and US tech. As interest rates rose, the COVID-19 asset bubble burst; and, unfortunately for investors, there were few places to hide. It is true that value stocks, defensives and commodity markets have provided a degree of protection, but most other asset prices have plunged. Even traditional “inflation hedges” such as gold and TIPS have performed poorly – mainly because real yields have risen significantly. Gold and TIPS perform better when inflation is persistent and investors think the monetary policy response will be inadequate. TIPS protect against the inflation component in yields, not the real component.

Chart 10: Not much inflation “protection” here


Source: Bloomberg, TS Lombard

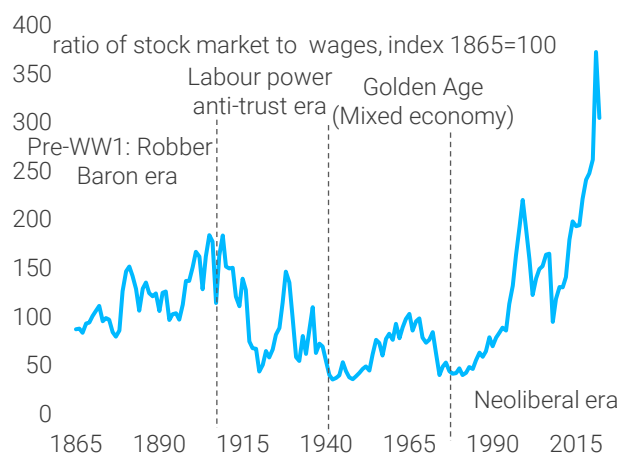
Chart 11: The ‘70s were a dark period for markets


Source: Bloomberg, TS Lombard

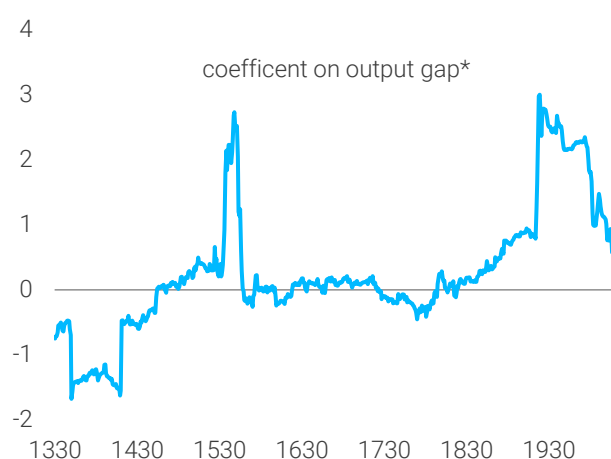
The mother of all crises

Unsurprisingly, the toxic market environment we have today has encouraged some extremely bearish views about long-term market returns. With a global energy crisis and inflation at multi-

decade highs, it is hard to avoid the comparison with the 1970s – which, thanks to persistent stagflation, was a horrible time for investors. Some commentators, [such as Russell Napier](#), are forecasting a period of “financial repression”, in which governments force substantial losses (in real terms) on unsuspecting markets as a way to fund their borrowing. Radical, perhaps, but as we explained in a recent Macro Picture, history provides plenty of examples of governments “inflating away their debts” in a similar way. Perhaps the most pessimistic take of all, however, is from Dr Doom himself – Nouriel Roubini. In his new book, Roubini predicts [a scenario that in effect combines the worst features of the 1970s and the most dangerous elements of 2008](#) – the mother of all debt crises with a stagflationary bust. But unlike in 2008, central banks will not be able to resolve the crisis with rate cuts and QE. While we agree with some of Roubini’s analysis – since he is essentially describing our “[new macro supercycle](#)” – the good news for investors is that we do not share his apocalyptic assessment of what this means for global financial markets. Things will certainly be very “different”, but not necessarily disastrous.

Chart 12: The macro supercycle


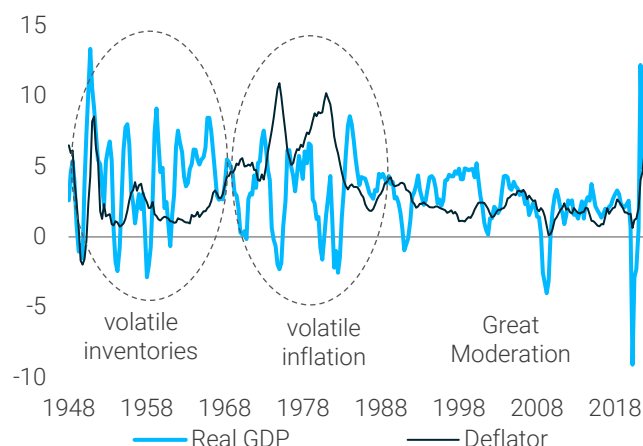
Source: The Bichler & Nitzan Archives.

Chart 13: Inflation is about ‘power’


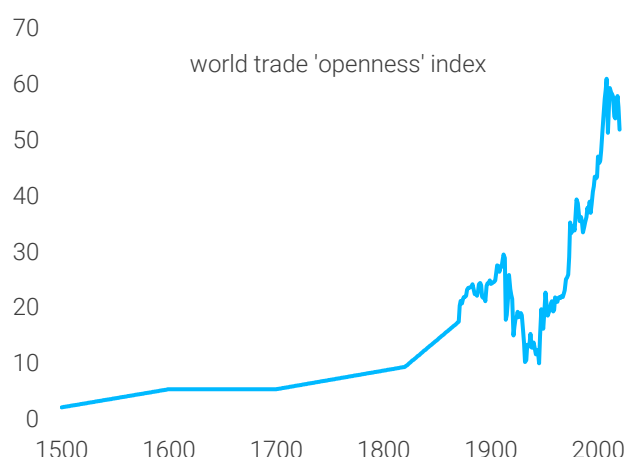
Source: Bank of England, TS Lombard, *rolling 25-year coefficient

2. SECULAR SHIFTS

Investors should always be careful not to read too much into the way financial markets perform in any single year. 2022, which has been particularly awful, is not the “new normal”. Inflation is not going to remain stuck in double digits indefinitely, and when it eventually comes down, economic growth will bounce back. We are not entering an era of relentless stagflation. Similarly, the threat from aggressive monetary tightening will fade once central bankers realize that their worst fears about inflation have not been materialized. This is not a rerun of the 1970s. But while there is no doubt developments in 2022 have cast the outlook for the global economy in an excessively gloomy light, it is certainly true that something is fundamentally changing in the macro environment. We are not going back to the pre-COVID regime. And this will have profound implications for longer-term asset allocation. As with all the other big events in history – including past military conflicts and various mortality crises – the combination of the pandemic and the war in Ukraine will mark an inflection point in the global macro supercycle. While the consequences are not unambiguously bad, despite what Roubini and Co claim, they will certainly present major challenges for investors who honed their skills during the Great Moderation.

Chart 14: The end of the Great Moderation


Source: BEA, TS Lombard

Chart 15: The two waves of globalization


Source: OurWorldInData.com, TS Lombard

Volatility returns

The macroeconomic volatility of the past three years represents a clear break from the Great Moderation. Ironically, the two things that contributed most to the long period of macro stability – stable prices and efficient supply chains – have also been responsible for its recent unravelling. Inflation surged to multi-decade highs and supply chains buckled. While we do not think macro volatility will persist at current levels, there is every reason to think that it will remain higher in the future and that there will be more frequent periods – like 2022 – when the macro environment turns unambiguously toxic. The Great Moderation is over. [Climate change is becoming one particularly important source of macro instability](#). As weather patterns become more extreme, we are likely to see more frequent supply disruption and much larger swings in commodity prices, especially for food and energy. At the same time, the world is trying to make the transition to new energy sources, which are inherently intermittent. Combined, this will lead to greater volatility in inflation, which, in turn, will produce more regular episodes of macro instability. Even if there is no 1970s-style wage-price spiral, we should expect further episodes of high “transitory” inflation.

The new supercycle

Until recently, investors rarely had to worry about nasty supply shocks. Our view is that this will change in the 2020s. Even without perma-stagflation, we should expect more years like 2022, when growth and inflation move in opposite directions and the bond-equity correlation flips from negative to positive. Investors will need to adjust their portfolios to allow for this, perhaps by including commodities as a stagflation hedge. But periodic supply shocks are not the only challenge financial markets face over the next decade. As we explained [in previous research](#), we also see deeper political shifts that will change the balance of power in the global economy, causing a broader inflection point in the long macroeconomic “supercycle”. For the first time since the 1980s, “labour” is set to gain power at the expense of “capital”, which will shift the prevailing tendency of inflation and long-term interest rates. Again, we do not want to overstate the amplitude of these changes – there is no doubt 2022 has exaggerated the inflationary consequences of this new regime – but we are looking at a subtly different macro environment that will ultimately shift the bias in monetary policy and create a new regime for global investors.

What is driving this secular turning point? There have been several big changes since 2019:

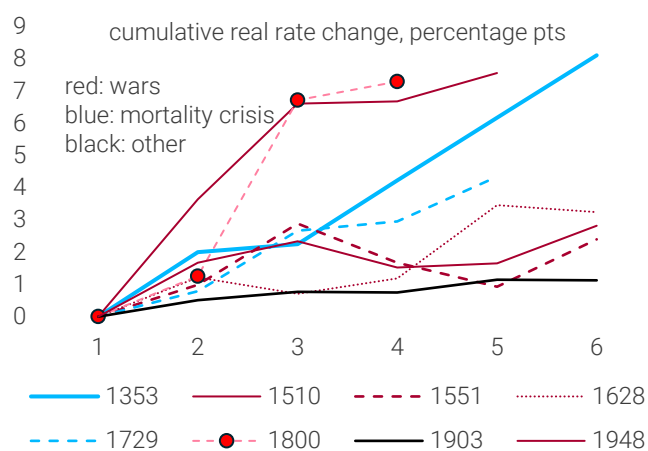
- (i) **The global economy has emerged from the pandemic with serious labour shortages:** Many parts of the world have seen the supply of workers decline over the past three years, which has created a serious imbalance in labour markets. It would take a huge recession to reverse these trends and – despite what central bankers say – there is no political appetite for mass unemployment. More significant, the pandemic has shown that population aging strengthens the bargaining power of younger workers, putting significant upward pressure on wages. These trends will continue.
- (ii) **Deglobalization:** Globalization peaked long before COVID-19; and even before the upheaval of the last three years, it was clear that the neoliberal order was facing a severe political backlash. In this respect, there were very similarities with the late 1800s (when the word “populism” originated). The pandemic and the war in Ukraine will surely accelerate deglobalization. COVID-19 exposed the inherent vulnerabilities in long, complex supply chains, while the war in Ukraine has triggered irreversible geopolitical shifts. Since globalization crushed worker power and lowered inflation, it is reasonable to think deglobalization will have the opposite effect during the 2020s.
- (iii) **Shifting geopolitical allegiances:** The world economy is splintering more clearly into regional trading blocks, with a new Cold War between China, Russia and their allies, on one side, and the US, Europe and their allies, on the other. The implications are profound – not just owing to “friendshoring” and the shortening of supply chains but also because of what it means for the role of governments. A wartime economy will encourage greater state intervention, particularly in terms of strategic investments, public R&D and securing resources (such as semiconductors). Countries are more likely to deploy food and energy protectionism, as we have seen in 2022. And the weaponization of the US dollar could undermine the prevailing International Monetary System, ending the informal Bretton Woods II regime of the last 50 years.
- (iv) **Structural energy shortages:** While the recent focus has been on whether Europe can get through the winter without blackouts and power cuts, the current energy crisis could become part of a wider multi-year problem. With the loss of Russian natural gas, the international supply of energy has gone down. Europe, which was most exposed to this problem, has managed to address the shortage by attracting LNG imports but by doing so, it has only shifted the pain to elsewhere – particularly those parts of the world that cannot afford higher prices. The energy situation could deteriorate again in 2023, especially once China reopens from its COVID lockdowns and the US stops running down its strategic oil reserves. After nearly a decade of underinvestment, the era of abundant cheap energy seems to be over – at least until technology can provide reliable (green) alternatives.
- (v) **Decarbonomics:** The transition to new energy sources will require massive public and private investment over the next decade. At the same time, it will put enormous pressure on a range of commodities, including metals (copper, aluminium, nickel, zinc) and rare earths. If the 2010s were all about “secular stagnation” and a continuous shortfall of investment relative to saving, the 2020s are likely to look very different. Decarbonomics will also increase the demand for labour since the “employment multipliers” on green public investment are generally large.
- (vi) **A new global policy mix:** The combination of public-sector austerity and easy monetary policy was extremely disinflationary in the 2010s. Fiscal multipliers were large and low interest rates and QE could not provide the necessary offset. We doubt the political climate will tolerate a return to that policy mix, especially as median

incomes have been stagnant for a decade, public infrastructure has plunged and inequality has hit historical levels. On the contrary, we see significant pressure on the public finances over the next decade, including from the current “cost of living crisis”, the demands of [the wartime economy](#), climate change and any future recessions.

The impact on the macro economy

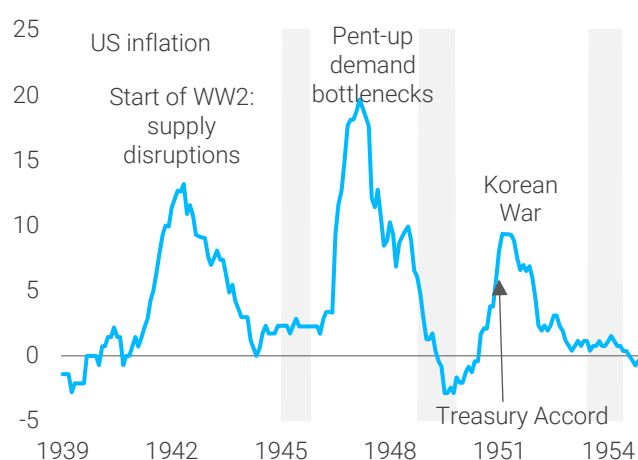
What does this new supercycle mean for the economy? Understandably, most investors are fixated on the implications for inflation. But while there could certainly be periods of extremely high inflation in the 2020s, we suspect the “regime change” we are facing is more subtle than most commentators realize, especially those pundits who are prone to making doom-laden predictions. Inflation is likely to be higher – perhaps 100-150 basis points on average – but the more important point is that [the prevailing tendency of the CPI will shift](#), from an environment where inflation was always threatening to fall too low to an environment where it is always threatening to rise too high. Whereas 2% inflation was a sort of ceiling in the 2010s, we are facing a regime where 3% is likely to be the floor. This might not sound like a huge deal; but from a central bank and investor point of view, it is very significant because it means the whole bias in monetary policy will shift. Rather than central banks using every monetary tool at their disposal (QE, NIRP, ZIRP etc.) to try to prevent Japanese-style deflation, the authorities will be constantly battling to keep inflation down. In turn, this probably [means a secular rise in interest rates](#) – an increase in r^* over time. Obviously, the pendulum between inflation and recession risks will continue to swing, but we suspect the “lows” and “highs” in interest rates will increase.

Chart 16: Historic events mark big rate reversals



Source: Bank of England, TS Lombard

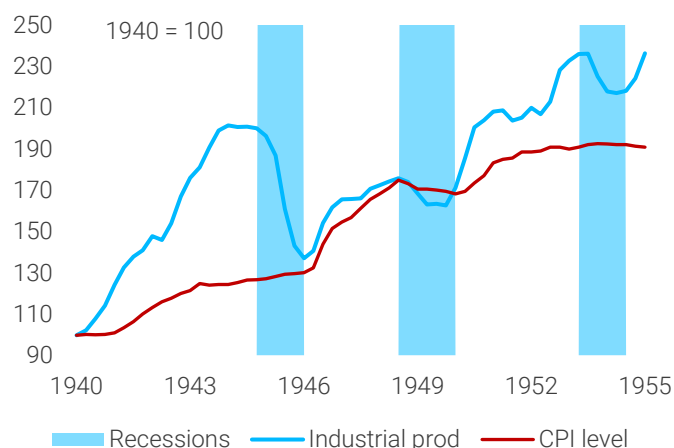
Chart 17: Volatile inflation in the 1940s and 1950s



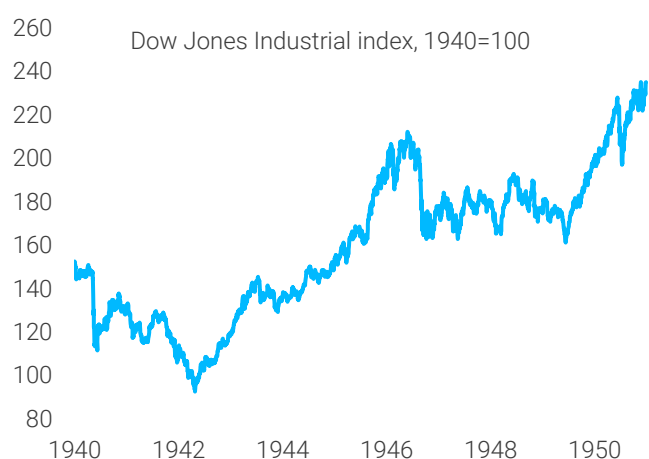
Source: BLS, TS Lombard

Another important point about this new supercycle is that although there will be more frequent periods of stagflation – perhaps more regular recessions, too – we think real economic growth will be higher on average. There are three reasons for this. First, we expect much higher investment. Reshoring, decarbonomics, and [the wartime economy](#) all require massive capital spending. Admittedly, a significant part of this will come at the expense of equity holders – since much of the existing capital stock will be redundant – but this is still a large net addition to GDP, which will lead to higher levels of employment and output. Second, the global policy mix is becoming decidedly more reflationary. Since the combination of tight fiscal policy and easy monetary policy was disastrous for the real economy, the reversal of this policy mix is likely to have the opposite effect. Finally, we think [there is a good chance productivity will improve](#). The perma-lukewarm economy of the last decade was disastrous for economic efficiency because it

allowed zombie companies to grow via cheap credit and low wages. Technological diffusion slowed, with corporate “superstars” catching all the benefits of digital investment. We suspect a higher-pressure environment will reverse these dynamics, forcing the economy to “work harder”.

Chart 18: Post-WW2 macro instability


Source: BEA, BLS, TS Lombard

Chart 19: Stocks range-traded post-WW2


Source: Dow Jones, TS Lombard

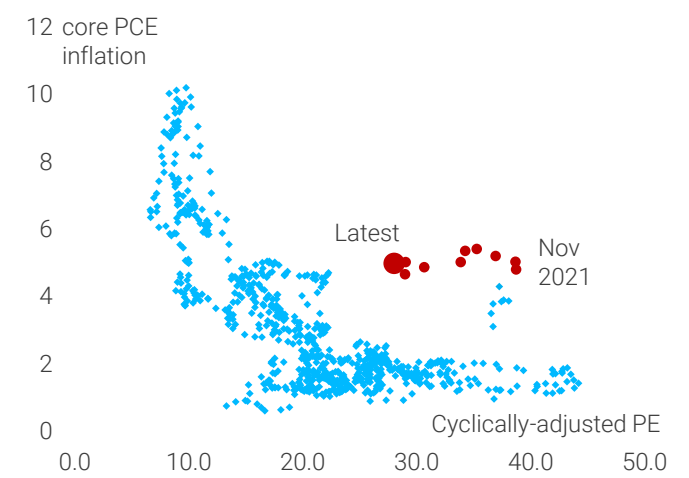
Echoes from the 1940s

While everyone – especially central banks – are obsessed with the “1970s redux” scenario, we think the 1940s remains the closer historical analogy for the new supercycle. There are certainly transitional problems emerging from the pandemic, just as there were after WW2. In both episodes, the combination of commodity shortages, supply disruptions, pent-up demand and “mismatch” in labour markets has proved highly inflationary. The US CPI jumped 20% after WW2. But while inflation was volatile in the 1940s and early 1950s – which caused episodes of macro instability – there was no “spiralling” of wages and prices, or persistent stagflation. In fact, over time, more expansionary government policy and an increase in worker power delivered a high-pressure economy, which lifted nominal incomes, boosted productivity and reduced the burden of post-WW2 public debts. While we would not want to push the analogy too far – not least because demographics look very different today – there are good reasons to think that, like in the post-WW2 period, a stronger economy will emerge after a lengthy period of secular stagnation.

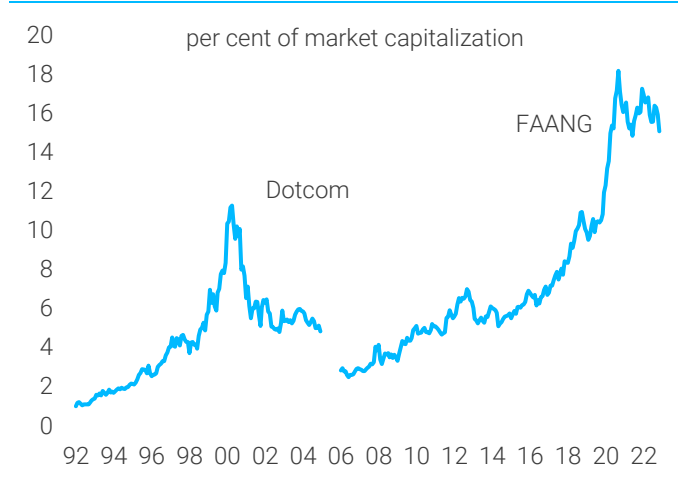
3. TANGIBLE TWENTIES

A regime of secularly higher inflation and rising interest rates would have profound implications for financial markets. There will be plenty of investment opportunities, but they will be radically different from those of the last decade, where the expectation of permazero interest rates forced investors to search for yield or invest everything in long-duration equities (the FAANGS, US tech, etc.) that benefitted from a continuous “rerating” of their valuations. Average returns are likely to be lower, especially among those assets that outperformed in the 2010s. The key point, however, is that while “intangibles” dominated the post-GFC era, the 2020s is likely to be a good decade for the “tangibles” – including energy, commodities, value stocks and anything exposed to the new secular catalysts of decarbonomics, defence spending, reshoring and public infrastructure. Government bonds, meanwhile, are likely to perform poorly – especially in real terms. But most of

the time they will still provide a useful portfolio hedge for equity exposure. The correlation between bonds and equities will weaken, but it will not turn persistently positive.

Chart 20: A gradual realignment in 2022


Source: Robert Shiller website, Datastream, TS Lombard

Chart 21: The intangible 2010s


Source: Datastream, TS Lombard

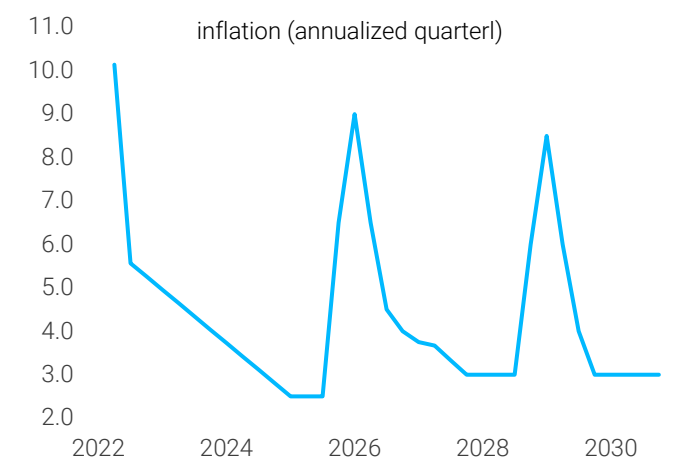
The pendulum swings

Before we outline the market implications of the new supercycle, it is important to point out that this is not investment advice for the next 6-12 months. Right now, with central banks still raising interest rates and recession risks increasing, the inflation-recession pendulum is swinging firmly in the opposite direction to our longer-term macro thesis. Terminal interest rates have moved sharply higher in 2022, but if either inflation eases (as it should) or central banks slow their policy tightening (as they should), rate expectations could revert lower, which would ease the pressure on bond markets and perhaps even revive those parts of the equity market that have suffered most in 2022. As Chart 28 below shows, there is a strong inverse correlation between bond yields and “growth” stocks. But we want to focus here on the longer-term outlook – the picture that will emerge from all the distortions and volatility of the past three years. Remember, the supercycle is not something that should drive investment decisions month by month; rather, it provides the prevailing direction of inflation and interest rates for extended periods. Understanding these dynamics could help investors make outsized returns over time, while avoiding serial errors.

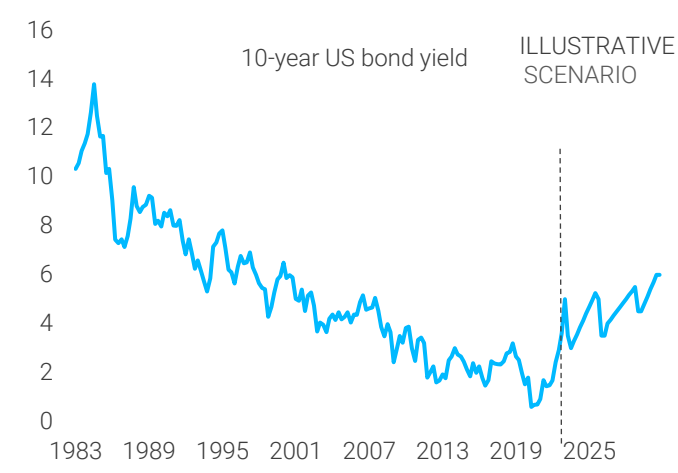
Secular bear market

The impact of the new supercycle on fixed income seems obvious since we are talking about a secular bear market in bonds. Yields will not rise linearly from here, but – over time – it is reasonable to expect “higher lows” and “higher highs”. To clarify, we can produce a simple projection based on an illustrative macro scenario that is consistent with the stylized features we identified in Section 2 above. This is not a forecast. Using US data, we assume the economy grows at a faster pace (with higher average inflation) in the 2020s but is vulnerable to more frequent supply shocks. Somewhat arbitrarily, we assume three large spikes in commodity prices, which cause sudden (transitory) increases in inflation and mild recessions. Not surprisingly, our simulations imply dismal real returns in bond markets, even when we allow for “carry”. The bond-equity correlation weakens, too, which means government securities are a less effective portfolio hedge. But it is important to point out that we are not expecting a large increase in yields from current levels: indeed, the worst period for bond markets has already passed. Instead, it is the volatility of inflation that is likely to be the killer for real returns in bond markets. Because central banks do not raise interest rates in line with every spike in the CPI, they in effect impose a form of

financial repression on the holders of these securities. Outside of these acute stagflationary episodes, bonds provide better average returns and a more effective equity hedge.

Chart 22: Illustrative scenario for inflation volatility


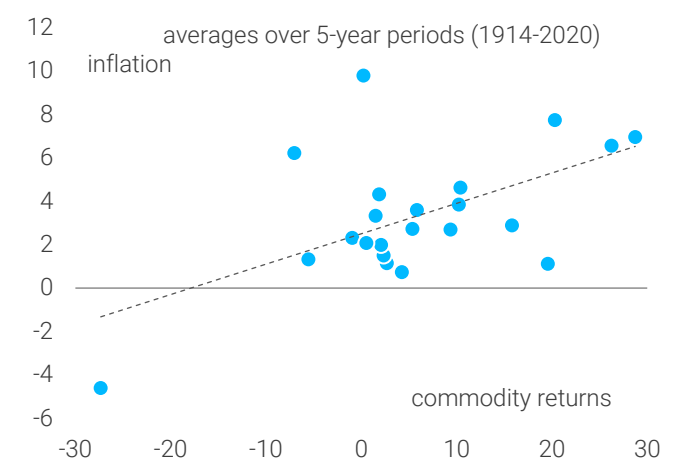
Source: Datastream, TS Lombard

Chart 23: The end of the secular bull market


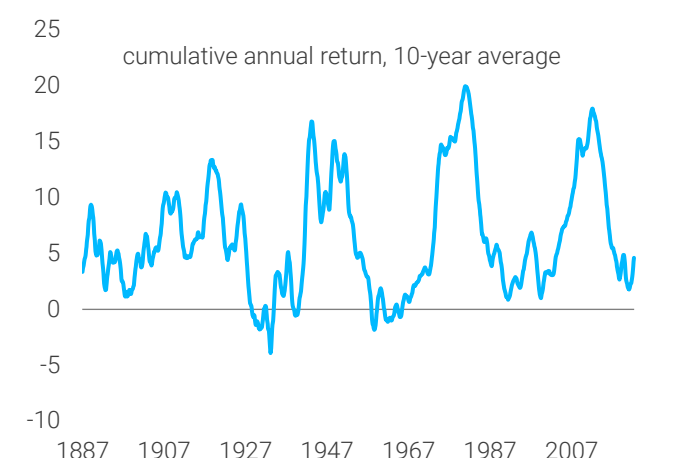
Source: Datastream, TS Lombard

Commodities and alternative hedges

If inflation is set to become more volatile, investors will need a better hedge for those periods in which supply shocks produce a positive bond-equity correlation. The obvious choice is commodities, not least as they provide protection against the risk that inflation turns out much higher than we expect, or becomes “reflexive” above certain thresholds ([the nightmare scenario for central banks](#)). More generally, however, everything we have identified as the main drivers of the new macro supercycle – decarbonomics, resource nationalism, energy shortages (which will also affect food prices), the reconfiguration of supply chains, and the desire to rebuild domestic manufacturing/infrastructure – points to a secular bull market in commodities. In terms of other portfolio hedges, we also see a role for more traditional sources of inflation protection such as gold and TIPS, since there is now more upside to inflation than real interest rates. TIPS and gold perform better when inflation is high and real interest rates are relatively unresponsive.

Chart 24: Commodities are the inflation hedge


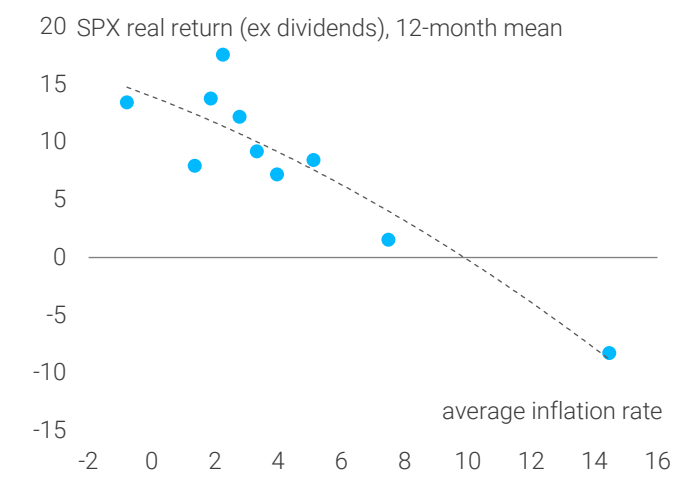
Source: AQR.com [“commodities for the long run”](#), TS Lombard

Chart 25: Another commodity supercycle?


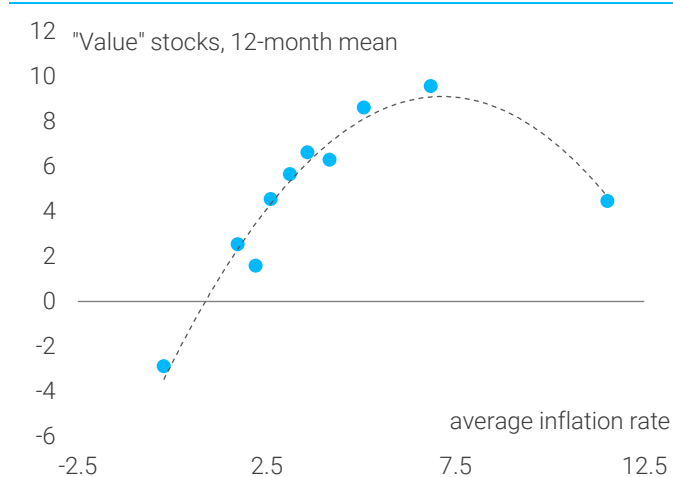
Source: AQR.com [“commodities for the long run”](#), TS Lombard

Equity returns in the new supercycle

While the impact of higher inflation and interest rates on bond markets is clear, the effect on equity markets is more controversial. Again, 2022 has been particularly toxic, mainly because inflation was countercyclical and central banks hiked interest rates despite the deteriorating economy. Yet the recent performance of global stock markets does not necessarily imply a gloomy longer-term outlook. Equities are a “real” asset, which deflates nominal earnings by an expected discount rate. In principle, inflation affects both their numerator and their denominator. And in the new supercycle, both the discount rate and nominal earnings are likely to be higher. To analyse the implications for equity markets in more detail we can draw on [the excellent work of Steve Hou at Bloomberg](#), who recently published a detailed investigation of asset returns at different levels of inflation. Hou’s findings suggest stock markets are generally resilient to rising inflation, at least up to a certain threshold. Once inflation rises beyond that threshold – typically around 5% YoY – equity returns deteriorate. This all makes sense because, as we have seen in 2022, high inflation damages economic growth and force an aggressive central-bank response.

Chart 26: Inflation hurts equities only at high levels


Source: [Steve Hou \(Bloomberg\)](#)

Chart 27: Value stocks like higher inflation


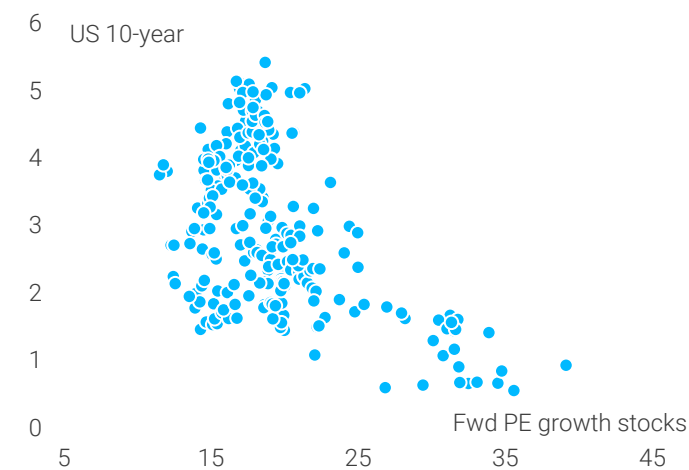
Source: [Steve Hou \(Bloomberg\)](#)

At the start of the year, we published a controversial scatter plot of the cyclically adjusted PE ratio and US core inflation (Chart 20). We showed that the equity valuations we had at the time were not consistent with the sharp rise in US inflation, at least based on the historical evidence. Either inflation had to be “transitory” – as central bankers claimed – or stock markets were vulnerable to a major correction. The plunge in market valuations since then confirmed our view, with the adjustment playing out via lower equity prices rather than falling inflation. Looking again at the chart, we see there is still some evidence of a misalignment, which suggests – if inflation does not come down soon – the bear market in equities could have further to run. More generally, however, we do not believe the new supercycle is fundamentally bearish for global stock markets. But it could have profound consequences for the composition of equity returns going forward.

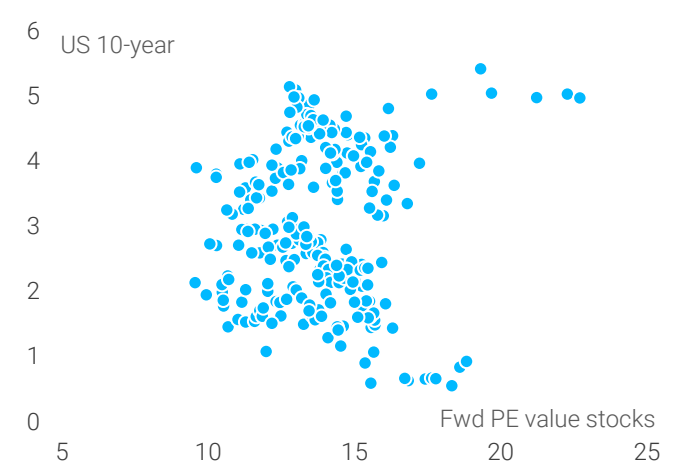
Secular rotations

The stocks that suffered most in 2022 were those that were particularly sensitive to higher interest rates. Long-duration “growth” equities derated on the basis that their revenues would not rise (post-lockdown they would probably decline) while the discount rate on that earnings stream would now be significantly higher. There is a good chance this pattern becomes one of the most important themes of new supercycle, especially since “growth” stocks were by far the biggest winners of the zero-rate environment. We can see this clearly in Charts 28 and 29, which provide a more granular version of Chart 20, breaking down the MSCI index in growth and value sectors.

The inverse relationship between inflation and valuations is much more evident in growth stocks than in value stocks. In fact, at high levels of inflation, the latter should comfortably outperform. But the experience of 2022 is not needed to confirm this. When we look at historical data on equity returns, we can see that the continuous outperformance of growth stocks in the 2010s was an extreme historical outlier, the result of a structurally disinflationary environment and zero interest rates. With structurally higher yields, we should see a persistent rotation back the other way, meaning a revival for those stocks that fared badly during the era of secular stagnation. Steve Hou's analysis confirms this point, showing which sectors of the market will benefit most.

Chart 28: Yields hurt 'growth' stocks most


Source: Bloomberg, TS Lombard

Chart 29: Value stocks less reliant on low rates


Source: Bloomberg, TS Lombard

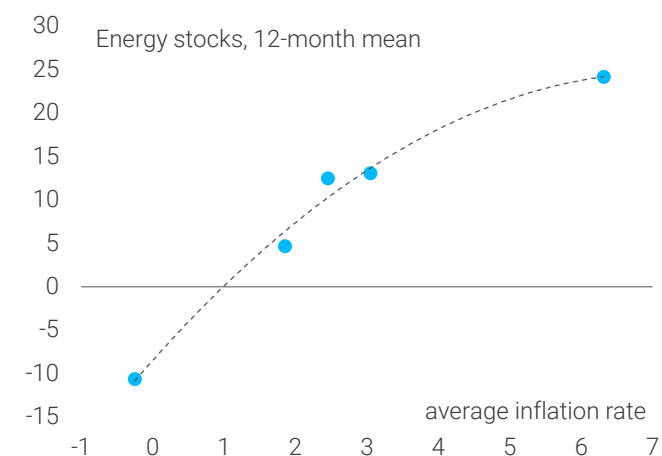
The end of the intangible era

The 2010s saw financial markets in effect decouple from the real economy. Weak economic growth and stagnant wages were a disaster for median incomes, but persistently low inflation and the prospect of permazero interest rates created a Goldilocks environment for risk assets. Long-duration intangible assets such as US tech and other speculative investments (including cryptocurrencies, NFTs, etc.) performed particularly well. But the new macro supercycle – which is fundamentally a shift in the balance of power between labour and capital – is likely to benefit Main Street rather than Wall Street. Financial returns will generally be lower, there will be no big “rerating” in asset prices, and the wage share is likely to increase at the expense of a lower corporate profit share. Naturally, the old rules of investing in the permazero regime will no longer apply. Rather than put all their funds into intangible assets, investors are going to need greater exposure to the real economy, especially those sectors – like energy and commodities – that stand to benefit from deglobalization, decarbonomics and more expansionary fiscal policy. “Real” assets like property should perform well, too, once the current recession scare has passed. After a long period in which intangible assets were totally dominant, the tangibles are due a comeback.

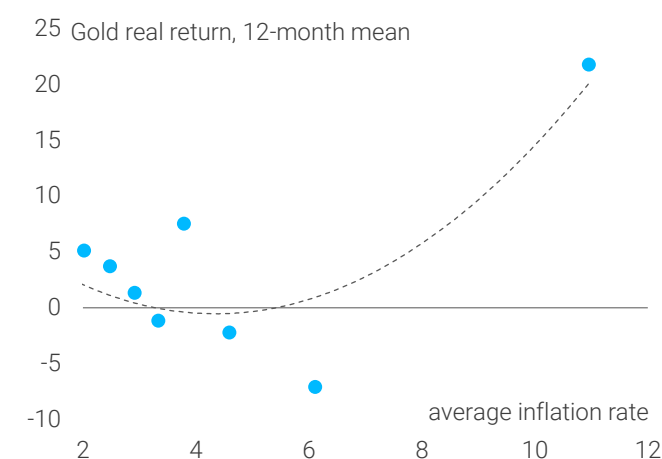
Bottom line

2022 has been an abysmal year for financial markets, especially for those investment strategies which – like the classic 60/40 portfolio – were designed for the Great Moderation. Inflation has hit multi-decade highs, growth has deteriorated to the brink of a global recession, and central banks have tightened monetary policy at a rate nobody imagined at the start of the year. Since financial markets have a completely different “feel” after a decade of Goldilocks, the only remaining bull market is in pundits making apocalyptic predictions about where the world is headed. Yet the toxic environment of 2022 is unlikely to be a reliable guide to the longer-term

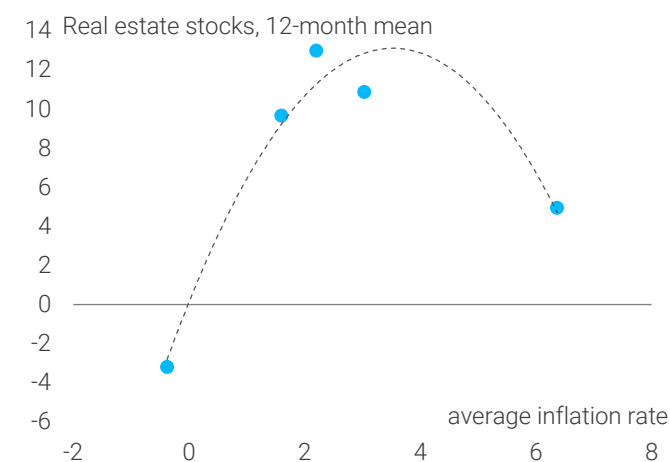
outlook or the likely performance of financial markets. We are not facing persistent 1970s-style stagflation. Inflation will eventually come down – perhaps sharply – and the global economy will reaccelerate. That said, it seems unlikely that we will return to the era of structurally low inflation and permazero interest rates that preceded COVID-19 and the war in Ukraine. With severe labour shortages, deglobalization, decarbonomics, a new Cold War and a more reflationary policy mix, we see a fundamental realignment in the balance of power between labour and capital that will allow a new supercycle to emerge from the chaos of the past three years. Inflation and interest rates will trend higher, albeit gradually, shifting the bias in monetary policy and creating an entirely new regime for institutional investors. Rather than invest in long-duration equities and speculative intangible assets, investors will need exposure to the real economy and new secular catalysts of the 2020s. Welcome to the Tangible 20s, where commodities, energy and value stocks rule.

Chart 30: Energy stocks like inflation


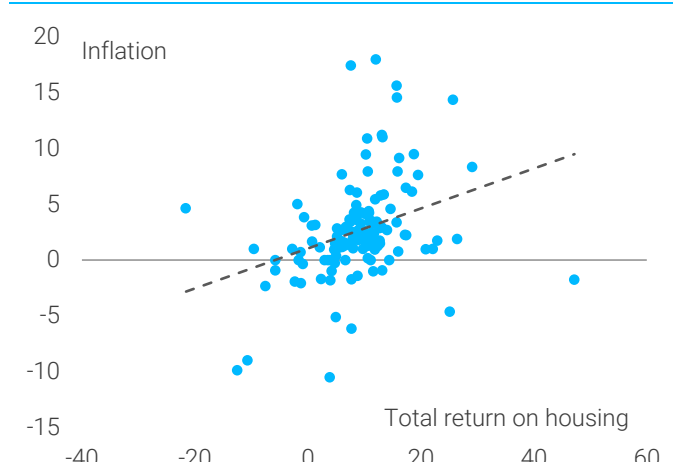
Source: [Steve Hou \(Bloomberg\)](#)

Chart 31: Gold performs well at high inflation


Source: [Steve Hou \(Bloomberg\)](#)

Chart 32: Inflation good for housing, up to a point


Source: [Steve Hou \(Bloomberg\)](#)

Chart 33: Housing benefits from hotter economy


Source: MacroHistory, TS Lombard