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Investing for a world of change

Skillful manoeuvring will be required to wean economies and markets off life support

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The fast view

- The current environment includes many 'unprecedented issues', from unprecedented sovereign debt levels, to unprecedented low and negative interest rates, to unprecedented budget deficits and money printing.
- It is useful to examine different types of recessions to understand our current experience. The 2020 recession was clearly not a standard recession, triggered by overheating or financial excesses, nor was it a financial or balance sheet recession such as the global financial crisis of 2008.
- Many of the new economic policies adopted post 2008 are however still in evidence, merely ramped up to 'unprecedented' levels.
- Recessions caused by shock generally don't last that long, but governments' efforts to contain Covid-19 saw economies around the world grind to a halt.
- Massive stimulus prevented the recession from becoming a depression, but the question now is whether major central banks can gently take the punch bowl away without upsetting everything.
- This requires investors to take a view on global growth, the thorny question of global supply shortages and the number one issue in financial markets – whether the rebound in global inflation will be transitory.
- Our view is that it is too soon to batten down the risk hatches and head for the hills. Ultimately, we are still only mid-cycle in terms of global economic growth, with few of the traditional excess leverage or inflation imbalances in evidence to act as cycle killers.

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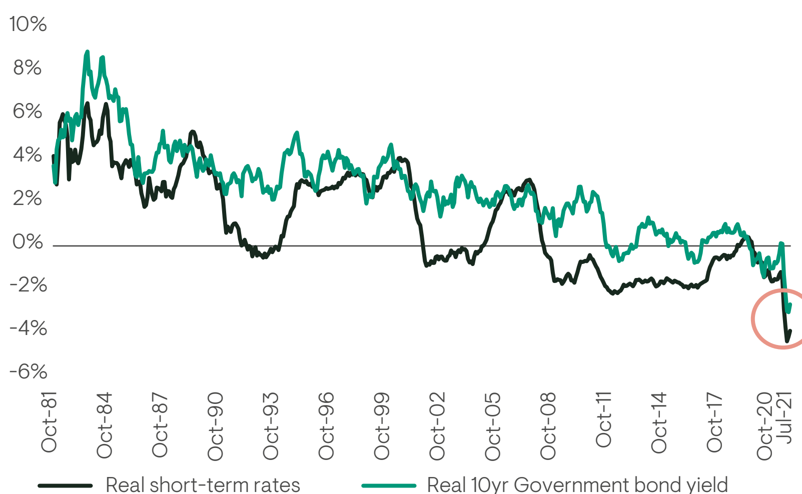
Doesn't it just irritate you when people tell you that 'the easy money' has already been made, before going on to give you their investment view? How come no one ever taps me on the shoulder before the event and whispers, 'Hey, there is easy money to be made. Just follow me!'

The truth is that there is never easy money to be made. At any given time, the world is always full of uncertainties and risk, instilling doubt in one's investment decisions. Were it not so, prices would already be sky high, reflecting this nirvana.

And so it is today. The current environment includes so many 'unprecedented issues', it is hard to know where to begin. From unprecedented sovereign debt levels, to unprecedented low and negative interest rates, to unprecedented budget deficits and money printing. The list goes on and on. How come global economies, including South Africa, have been trashed by Covid-19 and yet stock markets are doing so well? Making sense of it all is tricky.

Figure 1: Living in unprecedented times: Real US interest rates over the last 40 years



Source: Bloomberg, August 2021.

But let's first take a step back and remind ourselves how we got here and start by examining which of the various types of recessions we are currently trying to extricate ourselves from.

First, there is the common or garden vanilla overheating economy recession, where central bankers must take away the punch bowl as capacity – both manufacturing and labour – becomes overheated. The resultant generalised inflation beast needs to be tamed with some unpopular interest hiking medicine, economic slowdowns occur and the whole cycle repeats itself over time. Clearly, the 2020 recession was not that.

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Then there are what we call financial or balance sheet recessions. These generally involve way too much credit being issued by the banks, very often related to unsustainable property booms. And in the case of emerging markets, this sin is often compounded by doing much of the borrowing in hard currency, which they can't repay once the balloon goes up and their currency takes a huge hit. There have been several individual country instances of this (e.g. Thailand 1998 and Sweden 1992), but these were relatively easily contained in terms of global contagion.

However, the global financial crisis of 2008 was the first time this situation happened simultaneously across much of the developed world. Hence the chaos that followed, commencing many of these 'unprecedented' economic policies to prevent an economic depression. The recovery process from financial recessions is usually a long drawn-out affair, as the primary imbalance of too much debt can take a long time to fix. Consider, for example, Japan's two decade-long recession following the economic bubble of the 1980s. Thank heavens China made the 2008 recovery process a lot less painful when they opted for their massive infrastructural push in 2009.

Plainly this is not the current situation either, however many of these new economic policies adopted post 2008 are still in evidence, merely ramped up to 'unprecedented' levels.

The last common cause for recessions is the most difficult to see coming, as by definition they are shocks. These shocks can take the form of wars (9/11), oil spikes or health scares. This is clearly where we find ourselves now!

The good thing about these recessions is that because they are not usually caused by any underlying economic imbalance, they tend to be very short.

The problem this time however was that in their efforts to contain Covid-19 with lockdown strategies, governments around the world caused economies to grind almost to a dead halt with the most severe recessions ever recorded. Once they set out on this path, in order to prevent economic depression, they had to throw the proverbial kitchen sink at the problem to ease conditions. Bank policy rates went to zero or negative, many long bond yields followed suit, and central banks started creating money to buy bonds to fund massive government budget deficits and flood markets with liquidity. When monetary easing was exhausted, fiscal boosts took over the baton. Modern Monetary Theory (MMT) by stealth is tentatively becoming more acceptable – essentially a view that governments can issue as much money as they want to central banks to achieve their goals without there being a payback problem.

In order to prevent economic depression, they had to throw the proverbial kitchen sink at the problem.

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Economically their efforts worked. Policy makers stopped the recession turning into a depression. Covid-19 problems are still with us, but it does seem that a combination of herd immunity and vaccinations mean that this will largely be a rear-view issue for most of the world by the start of 2022. Economies have bounced back in a V-shaped pattern. And so paradoxically it does make sense for equity markets to have recovered like they have, given the extreme policy support and recovering growth.

> The question now is, if Covid-19 lockdowns do largely subside soon, can the major central banks gently take the punch bowl away without upsetting everything?

Firstly, you must take a view on economic growth. Broadly it is reasonable to assume that 2022 and 2023 are likely to witness at least trend-like growth, given the still depressed base and continued albeit reduced policy support. But this view is not without risk. Currently the Chinese economy is going through a property, economic priority restructuring, and COVID-led slowdown. Furthermore, more recently energy related turmoil is exerting further pressure on the Chinese economy. The markets are already expecting a slowdown in Chinese economic growth, but there is certainly a risk that it gets worse than expected. However, if history is our guide, Chinese authorities are likely to prevent a rout if push comes to shove, and further ease policy to stop any disorderly slowdown.

Then there is the thorny issue of global supply shortages. Whatever it is – whether it is the well-publicised computer chip shortage, the inability to get a ship, or dock hands to offload the ship, or too few truck drivers – not having enough stock of goods is a major issue. The relevance of this mismatch in supply and demand for goods extends beyond growth. This issue is causing price hikes in certain sectors, and it appears on balance that this problem will be with us until around mid-2022.

Which brings us to the number one issue in financial markets. Will the current rebound in global inflation be transitory as the US Federal Reserve expects, and soon subside? Or will it persist at higher levels for longer before ultimately subsiding, or will it morph into a significant inflation problem like the 1980s? That is the million-dollar market conundrum.

At present markets appear to be fairly comfortable with the idea of central banks buying fewer bonds soon and gently hiking interest rates in the second half of 2022 or 2023. But if central banks start to lose credibility, and are seen as being ‘behind the curve’ on tackling inflation, bond market pressure is likely to force interest rates to go up faster and higher than expected. Markets really will not like that!

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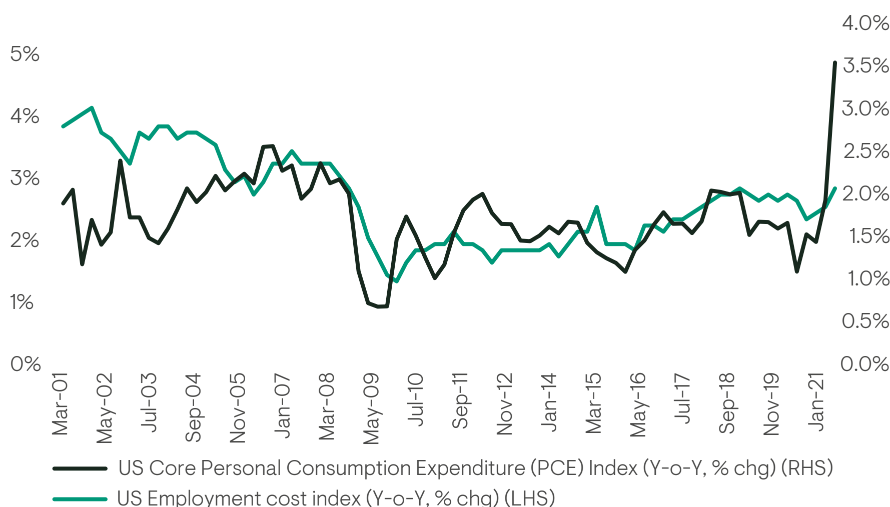
Our base case is that due to the supply issues above, this inflation problem is going to be uncomfortable for at least another few quarters, before ultimately subsiding back to lower historic levels. Current developed market bond yields are implying much the same outcome. Similar to the 1980s, wage pricing power is likely to be the key variable in deciding this issue. At present, despite a labour skills mismatch, workers do not appear to have too much leverage for more pay however it is certainly something to watch.

Figure 2: Wages still lagging the uptick in Personal Consumption Expenditure - will it catch-up?



Source: Bloomberg, August 2021.

Our conclusion is that it is too soon to batten down the risk hatches and head for the hills. There are very likely going to be periods when markets fall due to either a growth scare or central bank sabre rattling. The current China slowdown is worrying. But ultimately, we are still only mid-cycle in terms of global economic growth, with few of the traditional excess leverage or inflation imbalances in evidence to act as cycle killers.

This time around the imbalances are not in the private sector, but in the public sector. Weaning economies and markets off life support will take some skillful manoeuvring, but is doable if our view on growth is correct.

> It is too soon to batten down the risk hatches and head for the hills.

So no, there is no easy money to be made. Perhaps it is not the time to be all-in in terms of risk positioning, but if you can stomach the inevitable periodic market setbacks, hold the line, as General Maximus urges his troops in the great movie Gladiator. (And assume we don't meet the same fate as the General!)

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