"You can flip a coin to change its face, but it remains the same coin."

DaShanne Stokes

The battle is on. In the bulls’ camp, enthusiasm is rising. Global economic growth is accelerating; yet inflation is modest – in many countries almost non-existing. Inflation-less economic growth, they call it. On the other side of the table you’ll find a sizeable camp of bears. It is all going to end in tears, they argue. No wonder the average investor is slightly puzzled. What on earth is going on?

One side of the coin – the bull case

The return on US equities since 2009, when the current bull run was first established, has been quite extraordinary – almost 300% to be more precise (Exhibit 1), and the current equity bull run shows few signs of coming to an end.
Exhibit 1: Total return of great equity bull runs since WW II (%)

Source: Goldman Sachs Research, August 2017.

Note: S&P 500.

In defence of the bull case, one has to admit that the current level of investor optimism is more than just wishful thinking. Consumer confidence is growing, and so is business confidence, both of which are powerful drivers of equity returns. The global consumer is now more confident than he has been at any point since the 2007-08 upheaval (Exhibit 2).
The bulls take great comfort from the fact that the global economic recovery appears to be intact, even if the outlook for the second half of the year is modestly softer than the solid growth most countries enjoyed in the first half. Uncertainties surrounding US economic policy under Trump’s stewardship combined with slowing economic growth in China are the two main reasons why global GDP growth is likely to modestly slow in H2.

Meanwhile, the Eurozone continues to confound expectations as confidence reaches its highest point for years (Exhibit 3). The Eurozone crisis of 2011-12 has now been all but forgotten, it seems - whether rightly or wrongly.
Little inflation – or so it seems

Behind the inflation-less growth mantra lies a belief that there is absolutely no reason to worry about inflationary pressures coming from anywhere. Even if economic growth were to gain further momentum, inflation won’t come back to life anytime soon, the bulls say (and I would agree with that).

Consumer prices were most certainly impacted by the near-doubling in oil prices from early 2016 to early 2017, but that is now firmly behind us. Going forward, assuming oil prices stay at current levels, the impact on inflation from oil prices is likely to be neutral to modestly negative in the months to come (Exhibit 4).
Exhibit 4: Year-on-year effect on headline CPI from oil
Source: Barclays Research, IMF, Haver Analytics, June 2017.
Meanwhile, core CPI continues to be rather soft, particularly in the context of a comparatively robust global economy (Exhibit 5), and this is a major part of the bulls’ case. It is indeed quite a bullish scenario, should the economy continue to grow with little or no impact on inflation.
Exhibit 5: Core consumer price inflation in key areas
Source: Barclays Research, Haver Analytics, June 2017.
The main driver of very soft core CPI almost everywhere is muted wage inflation. Even in the UK, the recent pick-up in consumer price inflation (peaked at 2.9% in May) is entirely down to the weak British currency, following the Brexit referendum in June 2016. Away from FX, the UK story is no different from elsewhere, implying that relatively high consumer price inflation in the UK is very much a temporary phenomenon.

The other side of the coin - the bear case

A wise man once said: Economic expansions don’t die of old age. They are murdered! In other words, policy mistakes lead to recessions. Whether an economic expansion is two, six or ten years old matters little in the bigger scheme of things.

Despite that fact, I often come across the argument that the current economic recovery is rather long in the tooth. The global economy came out of a painful recession in early 2009, meaning that we are now more than eight years into the current recovery. With the average economic recovery lasting no more than 5-6 years (Exhibit 6), how much longer before we hit the wall?
Although I am somewhat sympathetic to that view, it fails on one critical point. Given the significant spread between the shortest and the longest recovery (2 and 10 years respectively), and given the modest number of observations (10 recoveries in total since WW II), the fact that the average economic recovery has lasted 5.7 years contains little information of value. The numbers are not statistically significant. Hence the bears have to come up with a better argument than that, and they have.

The valuation argument first. Although it is very much a US-based argument, equity valuations are not outright cheap anywhere in the developed world (Exhibit 7), and we all know that, should US equities run into the proverbial wall, it will definitely have some negative impact on equity markets elsewhere.
Let’s tune into the supposedly most overvalued market for a moment – the US equity market. I have come across bulls making the argument that the Shiller P/E ratio is only one of many valuation indicators, and that other indicators don’t paint the same bleak picture.

Sorry if I am about to ruin your day, but don’t believe what those tossers tell you. Regardless of which valuation indicator you zoom in on, the story is the same – the US equity market is grotesquely overvalued (Note: In exhibit 8, the CAPE ratio equals the Shiller ratio. so-pa) (Exhibit 8).
Switching to another favourite bear argument – excessive indebtedness – it is indeed correct that US non-financial corporates continue to load up on debt, almost as if 2008 never happened. As you can see below, total non-financial debt-to-GDP is now higher than it has been at any point in the past half century (Exhibit 9).
This implies that there is likely to be plenty of blood in the streets, should one of the following two scenarios unfold:

1. if interest rates were to rise meaningfully; or
2. if US GDP growth were to turn negative.

Whereas I wouldn’t assign a high probability to the former, the latter could easily happen, and will most likely happen in the not so distant future as policy makers are indeed making a policy mistake right now – more on this later.

The short term vs. the long term

Now to why I think the bulls could be reading the market correctly in the short term, but also why the bears are most likely to win the tug-of-war eventually.

The short term first. In an environment where interest rates are historically low, where commodity returns continue to disappoint, and where the apathy towards hedge funds is growing by the day, equities are increasingly becoming the only game in town for many investors.

When that happens, past valuation levels become less relevant. You simply have no choice if you run billions of dollars for a large pension fund (see for example here). Seeking protection in cash is not an option for more than a modest percentage of your capital-at-risk.

You must invest somewhere. If you think that (a) interest rates are going to rise over time, (b) relatively slow economic growth will continue to hold back commodity returns, and © most hedge fund managers do a pitiful job, what other option do you have but to invest a significant percentage of your capital-at-risk in equities?

It is exceedingly difficult to prove that this is indeed what is happening, but numerous conversations with industry insiders all point in the same direction. (Note: Not that they only invest in equities but that a very significant, and rising, percentage of capital-at-risk is allocated to equities.) It may also at least partly explain why US equities are valued more expensively than European equities are. As US interest rates are widely expected to ‘normalise’ long before European rates, short- to medium-term return expectations on bonds are more negative in the US than they are in Europe.

This would imply that US institutional investors probably have an even lower appetite for bonds than Europeans have. (Note: In this context, I only refer to the return portfolio. As you may be aware, pension funds run an LDI portfolio in addition to the return portfolio, and the LDI portfolio is unaffected by considerations like these.) In other words, the only-game-left-in-town theory that I offered above, which would drive equity valuations higher, could quite possibly be an even bigger issue in the US than it is in Europe.
The edge of the coin

So far, when talking about the bull and bear case respectively, I have only touched on cyclical and behavioural factors. However, there is also a structural factor in play here, which will eventually cause the bears to win the tug-of-war; at least I believe so.

My story begins with structurally low inflation, caused by an array of factors that I have discussed over the years, so I shall not repeat myself. Suffice to say that inflation is likely to stay comparatively low for many years to come, even if it will continue to be affected by all the usual suspects – FX, oil prices, etc.

In an environment of structurally low inflation, is it appropriate for central banks all over the developed world continue to pursue a monetary policy that is built around inflation targeting of 2%? I don’t think so.

The obvious implication of targeting 2% in a low inflation environment is that you end up with overheated conditions – maybe not in conventional terms but most definitely as far as asset price inflation is concerned.

We all know that Europe, and particularly Latin Europe, has been in need of some extra stimulus in recent years, so one could argue that easy monetary conditions there have been necessary, but that is not at all the case everywhere.

The theory of Knut Wicksell

Let me give you one simple example but, before I do so, allow me to spend a minute or two on the 19th century Swedish economist Knut Wicksell, whose ideas and theories are still widely followed.

Wicksell argued (rather convincingly) that there is not one but two interest rates, and that low interest rates may actually lead to deflation. The first one he called the bank rate of interest, which is nowadays interpreted as the cost of capital for the average entrepreneur. The Baa corporate bond yield is often used as a proxy.

The second one he called the real rate of interest, which is the marginal productivity of capital or the rate of return businesses get on their capital. The year-on-year nominal GDP growth rate is typically used as a proxy for that.

Wicksell’s philosophy was that it is not the absolute level of interest rates but the interaction between the two interest rates that determine price movements. If the bank rate is much lower than the real rate of interest, businesses are encouraged to borrow as much as they can, as they will (most likely) earn a positive return on the added capital.

Likewise, if the bank rate is much higher than the real rate of interest, nobody wants to borrow. Let’s assume that the real rate of interest (i.e. nominal GDP growth) is structurally low (as it is), and that
monetary authorities respond by lowering the bank rate of interest, as they have done in recent years.

If the spread between the two interest rates is lowered, but the cost of capital is still too high (relative to GDP growth) to warrant more risk taking, the balance between supply and demand for money is still out of whack. Wicksell argued (and he has been proven right several times over the last 130 years) that an oversupply of money relative to demand ultimately leads to deflation.

In practical terms, history has shown that the economy is in near perfect balance when the difference between the Baa corporate bond yield and nominal GDP growth (the proxy for the Wicksell spread) is about 2%. When the spread is much higher than that, bank lending grinds to a halt, and when it is lower, banks are increasingly eager to lend, and that eagerness increases, the lower the spread is.

The ‘bad’ boys

Eager banks obviously lead to more economic activity short term, but it also leads to more misallocated capital (more on this topic below). Take Australia, where the Wicksell spread is currently dramatically below 2% (Exhibit 10). I will challenge you to find a Wicksell spread anywhere that is lower than Australia’s is at present. And, as a consequence of years of a low Wicksell spread, Australia has enjoyed a phenomenal boom in property prices. Capital is widely misallocated!

| Exhibit 10: Australian Wicksell spread |

However, because Australia targets 2% inflation, like almost all developed countries do, the alarm bells don’t ring (yet) at the Reserve Bank of Australia. Now, before you think this is a vendetta against Australia, I should point out that many other countries currently have Wicksell spreads that are almost as low. In Europe, the two most out-of-synch spreads currently are those of Norway and the UK. No wonder property prices have done very well in those two countries.
Before you rush out and sell everything you own in countries with a low Wicksell spread, you should be aware that a negative Wicksell spread is actually short-term reflatonary. The party can go on for quite a long time, but the ultimate hangover only gets bigger.

**Misallocation of capital**

What do I actually mean when I say that capital is misallocated? Why is more capital misallocated when the Wicksell spread is below equilibrium (2%)? And why does more misallocated capital make me into a short-term bull but a long-term bear? All these are important questions that I shall now address, before I wrap up this month’s Absolute Return Letter.

First things first. As I have repeatedly pointed out over the years, what drives economic growth, other than workforce growth, is rising productivity. Capital allocated to productivity-enhancing investments is therefore critical – particularly when workforce growth is low or non-existing (as it is these days).

Having said that, a rising percentage of the capital at our disposal is allocated unproductively, i.e. it is misallocated.

Much of the capital provided by governments is misallocated – at least in economic terms, although my father would probably disagree that his pension allowance is misallocated. Unemployment benefits, and building bridges to nowhere, as they did in China for years, are just a couple of examples of how capital is misallocated every day of the year.

Now, if you compare the property index to the Wicksell spread, it is no coincidence that the two are highly negatively correlated – the lower the Wicksell spread is, the higher the property index is. It is indeed no fluke that countries with low Wicksell spreads in recent years (e.g. Australia, Canada, Norway and the UK) have all experienced a boom in property prices. When the Wicksell spread is low, banks are much more inclined to lend, and much of the capital they provide goes into property; i.e. it is misallocated.

But isn’t that good for asset prices - in this case property prices? It is indeed – at least in the short term – and that is why low Wicksell spreads not only lead to more misallocated capital; they also lead to reflationary conditions, i.e. the short-term impact on both asset prices and the wider economy is overwhelmingly positive.

Having said that, there are at least two medium to long-term negative implications of running a low Wicksell spread. The central bank typically falls behind the curve as the economy reflates. As it catches up, tightening monetary policy conditions more often than not kill even the strongest of bull markets.

The second negative is longer term in nature. The world has a finite pool of capital at its disposal. The more capital that is misallocated, the more productivity growth slows over time. In an environment of low (E.g. the US), no (E.g. the UK) or even negative (E.g. Japan, Korea and the Eurozone) workforce growth, a future of low productivity growth could quite possibly lead to persistent negative GDP growth in many countries, which *isn’t* good, considering how indebted most countries are.
Final remarks

It goes without saying that, in an ageing society, more and more capital will by definition be misallocated, as the cost of servicing the elderly can only go up. One therefore needs to distinguish between misallocation of capital that is avoidable and misallocation that is not.

At the same time, I would argue that inflation targeting is entirely the wrong approach in a low inflation environment. Monetary authorities should instead target misallocation of capital that is avoidable, and raise interest rates (i.e. impact the Wicksell spread) when too much capital is misallocated.

This raises the final question of the day. How much is too much? There is no simple answer to that question, but think about it the following way. Years ago, before the world fell in love with debt (back in the 1950s, 1960s and early 1970s), change in GDP roughly equalled change in debt; i.e. for every additional dollar of debt the world took on, GDP rose approximately a dollar. That is no longer the case. One of the worst offenders, China, raises its GDP by less than 20 cents for every dollar of debt it takes on, and the US is not far behind.

That is, to me, an unequivocal sign of too much capital being misallocated, and monetary authorities should zoom in on that. Whether they will do so, is an entirely different matter.

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