Confluence Investment Management

Bi-Weekly Geopolitical Report

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The Pandemic's Impact on Inequality

During the global coronavirus pandemic that exploded globally in 2020, perhaps the most notable economic development was the effort by governments around the world to stop the spread of infections through lockdowns, while simultaneously trying to support incomes and economic activity via loose fiscal, monetary, and regulatory policies. Importantly, the pandemic struck just as concern about income and wealth inequality was increasing among economists and policymakers. This report discusses how the pandemic crisis and the government response to it might affect inequality going forward. As always, we conclude the report with a discussion of the implications for investors.

Economic Implications

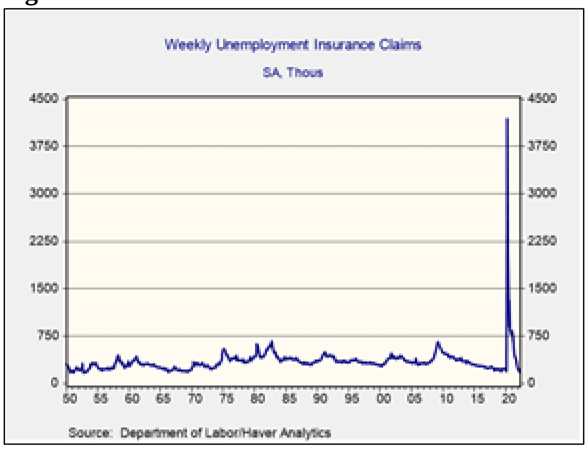
Among consumers globally, mass unemployment and fears of contracting COVID-19 sharply reduced the demand for services such as hospitality and dining. The fear of contracting COVID-19 also pushed down the labor force participation rate, setting the stage for today's worker shortage and pushing up hourly wages, especially for blue collar and service industry employees (see Figure 1).

Among government officials, the economic damage from the lockdowns and disease prompted a range of relief programs. As unemployment insurance applications soared, exceeding their record high in 2008 by more than 500%, lawmakers dramatically increased and extended federal unemployment benefits (see Figure 2 on the following page). Transfer payments in the form of increased unemployment insurance, enhanced child tax credits, stimulus checks, student loan payment suspensions, and rent assistance were complemented with eviction moratoriums to avoid a wave of mass homelessness. Landlords dropped rents, reducing their income streams but leaving renters with extra cash. Some of this additional income also found its way into the financial markets, boosting asset values.

Figure 1

By mid-2021, mass vaccinations and other pandemic control successes had allowed governments to ease their lockdowns. Coupled with the immense fiscal and monetary stimulus still in place, the reduced restrictions sparked booming demand, strong hiring, and rapid economic growth. The economy was exponentially driven by the rebounding demand for goods. The strong influx of liquidity, rising wage rates, supply disruptions, and initially low prices all contributed to soaring inflation. As inflation surprised policymakers in both level and duration, central banks, led by the Federal Reserve, began to aggressively tighten policy.

Figure 2



Socioeconomic Implications

To understand how the pandemic might impact inequality in the longer term, we focus on the impact of wealth disparities and reduced labor supply on three socioeconomic classes. Our key theses are as follows:

1. Based on Federal Reserve data, the top 1% of households by income and assets hold enough long-term financial investments (the highest of all asset groups) that they benefited from the stimulus-driven rise in asset values and will be relatively more insulated from the post-pandemic surge in inflation as less of the income and wealth from this group is used for necessary goods and services. Rising interest rates may weigh on their asset values in the short term, but only temporarily until rates come down again.

2. We assume middle-income households, defined as those in the top 50% to 99% by income and assets, would be more vulnerable to the acceleration in inflation, the increase in interest rates, and the inevitable normalization in economic growth rates. For this group, it could become especially difficult to keep up with debt service obligations, while inflation will likely drive many to hike borrowing to maintain their lifestyle.

3. The less affluent class, defined as the bottom 50% of households, benefited from increased transfer payments and discounted rents during the pandemic, which inflated their purchasing power. However, in the post-pandemic world of moderating growth rates, slowing labor demand, higher inflation, and increased interest rates, they will likely find it harder to access funds or to maintain their recent consumption levels.

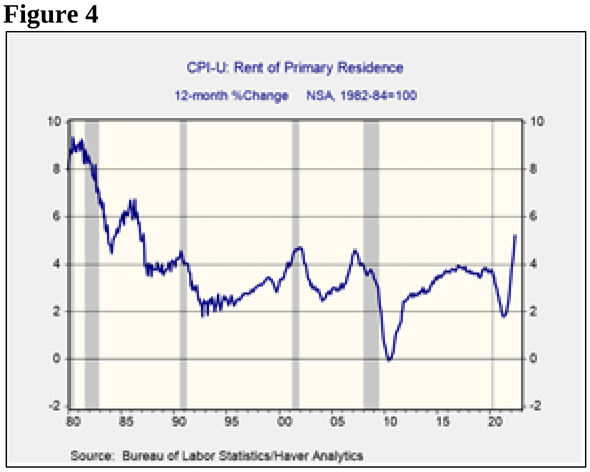
The Problem of Inflation

In the near term, we think the post-pandemic surge in consumer price inflation will be more damaging for working-class families than for the wealthy. For example, food and rent inflation rates are at their highest in decades (see Figures 3 and 4). Since it's hard to find substitutes for staples like housing, food, and energy, these cost increases will consume more of the income of middle- and working-class households than higher-income households for whom consumption of such goods and services is typically a much lower share of income. That seems to be the case especially as inflation-adjusted average hourly earnings are already trending downward below pre-pandemic rates (see Figure 5).

As long as post-pandemic supply shortages continue and high liquidity and savings lead to excess demand, consumer price inflation could remain high and erode working-class purchasing power. In addition, as the Fed and other major central banks hike interest rates to fight inflation, more Americans will be susceptible to defaulting on debt, affecting their credit and long-term financial success. Finally, the resulting economic scarring will be a challenge to overcome in the proceeding years, causing generational disadvantages for the socioeconomic groups most affected. In other words, today's inequality is also a signal for future inequality.

Figure 3

Figure 4



Longer-Term Inequality

To measure a nation's overall equality or inequality, economists often compute a "Gini coefficient." The Gini coefficient, based on either income or wealth distributions, is designed so that 0 represents complete equality and 1 represents complete inequality. As shown in Figure 6, the Gini coefficient for the U.S. has been trending upward for decades, reflecting a steady increase in inequality.

Figure 5

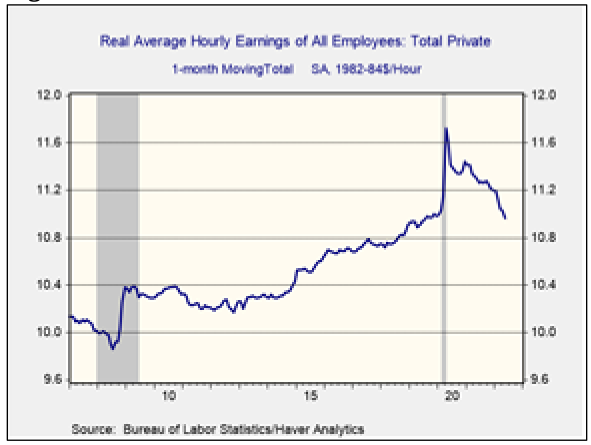


Figure 6

Of course, complete equality is not likely to be achieved in any economy and arguably may not even be desirable. Some level of inequality between people and groups is natural and often the result of differences in skill and accomplishment. The more advanced and complex a modern economy, the higher potential for inequality. A society's inequality can also be a consequence of how social classes earn their income. Working- and middle-class citizens typically exchange their physical or mental labor for hourly pay or a salary. The wealthy derive much more of their income from interest, dividends, and other capital investments.

In his tome *Capital in the Twenty-First Century*, French economist Thomas Piketty argues that inequality tends to increase under capitalism because the return on capital investment grows faster than wage and salary income, giving capital owners an advantage. In other words, Piketty argues that the difference in wealth and income is not due to skill or accomplishment, but rather pre-existing wealth. To the extent that this is true, the pandemic-driven boost in liquidity, corporate profitability, and asset prices suggests that wealthy, higher income earning citizens have probably enjoyed disproportionate increases in their wealth and purchasing power.

Ramifications

Piketty's argument implies that whenever capital gains grow more slowly than the economy, inequality should lessen. More to the point, the economist Walter Scheidel theorizes that reversing inequality requires a nation to undergo big, violent changes. For example, Scheidel argues that such changes can include a mass mobilization war or societal collapse that weigh on derivative asset returns the rich were previously profiting from and increase the power of the working class.

Equality can be attempted in civil forms aside from violence. Political power can structure an economy toward efficiency or equality. Policies can promote equality between socioeconomic levels to combat the drive for higher corporate profits and efficiency. However, we assess that the political initiative for equality policies currently remains weaker than the drive for policies favoring efficiency and higher corporate profits. Until there is a catalyst to diminish the returns from financial assets at a rate exceeding the adverse effects of inflation on the average American, inequality will remain.

Our assessment is that the pandemic itself probably was not traumatic enough to produce such a change. Current tax law and other policies favor efficiency and the wealthy over protecting workers to achieve the goal of contained inflation. Under current policies, the future trajectory of the U.S. economy will remain geared toward efficiency rather than equality.

Therefore, even though factors like deglobalization will tend to raise production costs and hurt corporate profitability going forward, companies, for now, will probably not face the double-whammy of income equalization policies or dramatically higher labor power, despite today's labor shortages, strikes, and union-organizing efforts. Equities should therefore remain an attractive long-term investment option, even if they suffer to some extent from today's tight monetary policies and the coming costs of deglobalization. Without the inflationary impact of equality policies and increased labor power, bonds are also likely to perform better than they otherwise would, with the caveat that as equality policies become more attractive, the most at-risk asset is long-duration fixed income. Finally, relative policy stability should keep the dollar more stable than it would be if the U.S. adopted strong equality policies.

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Confluence Investment Management LLC

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