Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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Reflections on Inflections: Part II

(N.B. Due to Martin Luther King Jr. Day, the next issue of this report will be published on January 28.)

In Part I of this report, we discussed the issues surrounding predicting inflection points, which are defined as reversals of long-term trends. In this week's issue, we will examine two long-term trends that we believe are approaching inflection points and offer guideposts that we think will signal further progress toward inflection. For regular readers, these two trends should sound familiar as they are topics of frequent discussion. Some often consider them the same issue, while, in reality, they are separate but affect each other. By discussing them separately, this confusion should be laid to rest. As is our normal practice, we will offer market ramifications. Since an inflection of these two points is significant, this section will be larger than usual.

Inflection Point #1: The End of U.S. Hegemony

The world has seen the rise and decline of a parade of superpowers. Since the Age of Discovery, when Europeans came across the Western Hemisphere, we have seen Portugal, Spain, the Netherlands, France and Britain precede the U.S. in this role. On average, each hegemon has ruled for around a century. The U.S. took this role officially in 1945, although it was the de facto hegemon after WWI. So, given the normal lifetime of a hegemon, the U.S. is probably about due to leave the role.

The hegemon provides two primary global public goods, world security and the reserve currency. In return for providing these goods, the hegemon gets to enjoy a relatively stable world and the benefits of being the center of global trade. Throughout history, hegemons have tended to hold tightly to the role even as costs escalated; they usually lose the role because it is wrested from them by the incoming superpower. There is no recent history suggesting a superpower willingly abandons the role. However, it appears the U.S. may be doing exactly that.

A primary reason for abandonment is that, unlike the European nations, the U.S. didn't really want the role. The U.S. economy was far larger than the British economy by the turn of the last century but was more than willing to "punch below its weight" and let the British rule the world.

After WWII, U.S. policymakers realized that the likelihood of a third world war was elevated if they refrained from fulfilling the hegemonic role. However, these same policymakers had to sell a skeptical American public on the wisdom of accepting this role. To build acceptance for this grave responsibility the Truman administration developed the policy of communist containment. Essentially, the American people were told that communism was a dangerous concept and had to be stopped, and they generally accepted that idea.

However, unspoken in this pitch was that the U.S. was also freezing three conflict zones. The first zone was in Europe. The European continent was unable to peacefully deal with the formation and rise of Germany. The country was in the center of Europe on the Great Northern European Plain. Because of this geography, Germany was destined to be a major economic power as it faced few internal obstacles to transportation. However, that same geography made it vulnerable to invasion because it had no natural land barriers. Thus, Germany became a massive and paranoid industrial power. The inability to manage the German Problem led to two world wars. To solve this persistent difficulty, the U.S. effectively disarmed Germany, allowing it to focus solely on economic recovery and development. The rest of Europe, protected by NATO, also disarmed, knowing they no longer had to fear Germany.

A similar process developed in the Far East. Japan had also become an industrial powerhouse that had few natural resources. It was vulnerable to a naval blockade and thus became aggressive in protecting its naval supply lines. The U.S. also disarmed Japan after WWII; this led to the island nation no longer needing to project power to secure resources. As a consequence, it reduced tensions between Japan and its neighbors, who no longer had to fear Japanese power.

The third conflict zone was the Middle East where the U.S. had two goals, secure the region's massive oil supply for the Free World and maintain local stability. The U.S. committed military resources on numerous occasions to maintain the flow of oil out of the Persian Gulf and regularly intervened in the region to ensure the territorial integrity in the area. The latter task was complicated by the fact that the nation states that emerged from the colonial period were not "naturally" developed. European powers created these colonies with little regard for religious, ethnic and social differences. The local governments were thus dependent on the colonial power to remain in control. After independence, they nearly all became authoritarian regimes run by strongmen. Although these governments were often allies, the states were governed in a fashion that was in opposition to American ideals. But, to maintain order, the U.S. was forced to accept their shortcomings.

The American public was mostly on board with shouldering the costs of hegemony as long as communism was a threat. Stabilizing Europe, Asia and the Middle East were framed as being part of containment but, in reality, the U.S. was still required to allocate resources to these regions even after the Cold War ended. Unfortunately, most Americans felt their deep involvement in the world should have ended with the fall of the Berlin Wall and resented the long wars in Iraq and Afghanistan, along with the burden of protecting rich nations in Europe, Asia and the Middle East. Complicating matters further was the development of fracking, which opened up oil fields in the U.S. that were previously cost prohibitive to develop. America found itself spending assets to stabilize the Middle East to secure oil flows for nations other than the United States. The desire to step back from these burdens is understandable.

Of course, there was a reason the Truman administration and its successors accepted these extra geopolitical responsibilities beyond the mere containment of communism. Left to their own devices, the potential for conflict in the aforementioned zones increases significantly. However, the world has been at peace for so long that the fear of a third world war has lessened. As a result, both Presidents Obama and Trump campaigned and have governed with an eye on reducing America's global footprint. After nearly a century of being the de facto hegemon and nearly 75 years of actively managing that role, Americans have tired of the costs and become oblivious to the benefits.

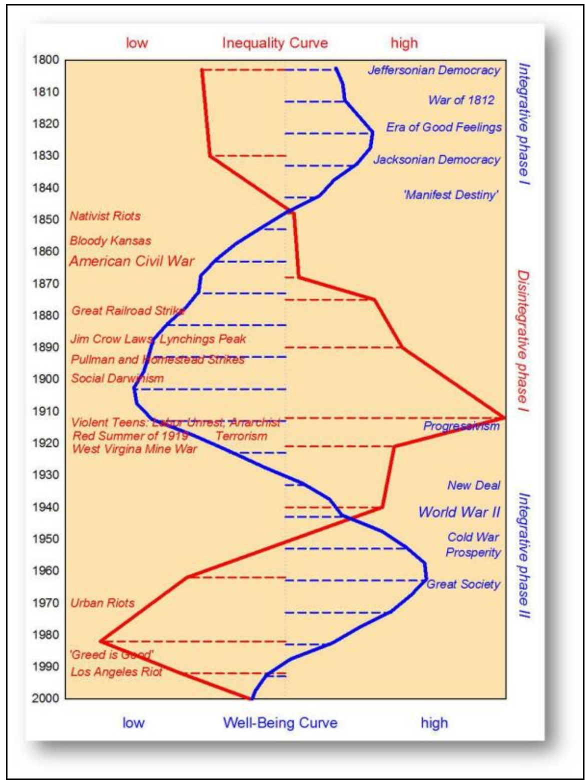
President Obama began this process; he was elected, in part, due to his opposition to the Iraq War. He was reluctant to increase troop levels in Afghanistan and only agreed to the action by establishing a deadline for withdrawal. In the Libya conflict, he indicated he wanted to "lead from behind." And, he refused to enforce his own redline in Syria after the Assad regime deployed chemical weapons.

President Trump has moved further down this path. He has sharply criticized NATO and has called on Japan and South Korea to pay more for their own defense. Recently, he seemed to call for a quick withdrawal of U.S. troops from Syria, although officials within his government appear to have pulled back from this position. Still, Trump's campaign slogan of "America First" is a clear indication that the benevolent hegemony practiced by the U.S. is coming to a close.

However, the retreat is far from complete. A new administration may try to reverse the positions of the past two presidencies. Although possible, a complete reversal appears unlikely. The trend in place seems to be moving in the direction of the end of U.S. hegemony.

Inflection Point #2: The Efficiency Cycle Ends and Equality Cycle Commences

Arthur Okun wrote a small book[1] in the mid-1970s where he discussed the idea that economies have to choose degrees of equality and efficiency. In other words, if you want more equality, you sacrifice some efficiency and vice versa. Peter Turchin, a quantitative historian, attempted to chart these shifts.



(Source: http://peterturchin.com/)

Turchin further develops these themes in his book *Ages of Discord*.[2] Although Turchin has a number of indicators he uses to explain why the inequality and well-being lines behave as the above chart shows, our own take on the work of Okun and Turchin is that societies move through equality and efficiency cycles. Although there are numerous factors involved, we think the inflation cycle is critical. In general, rising price levels signal that the economy needs to increase productive capacity. The quickest way to increase capacity is to favor policies that support capital formation. These include deregulation, globalization and reducing tax rates. As aggregate supply

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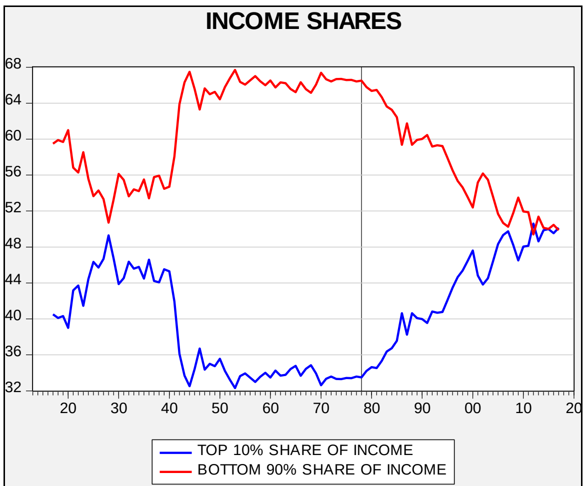
[1] Okun, A. (1975). *Equality and Efficiency: The Big Tradeoff*. Washington, D.C.: The Brookings Institute.

[2] Turchin, P. (2016). *Ages of Discord: A Structural-Demographic Analysis of American History*. Chaplin, CT: Beresta Books LLC.

rises, price levels tend to decline at all levels of aggregate demand. The cost to society is that inequality rises. Although some degree of inequality is probably necessary for the economy to function, at extreme levels, it can lead to political instability. At these extremes, the wealthy become politically powerful and take measures to defend their position which may come at the expense of society as a whole.

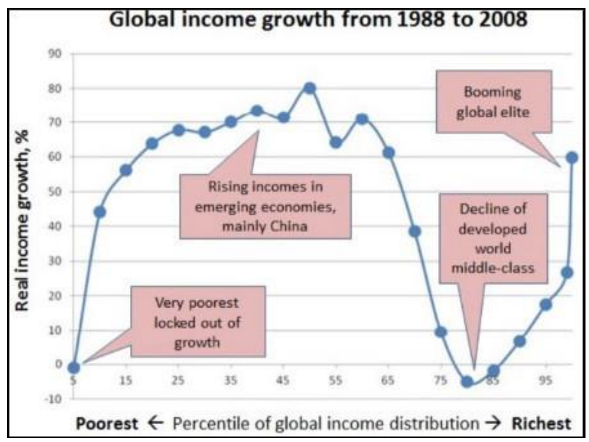


Sources: Emmanual Saez, CIM

This chart shows the income shares for the bottom 90% of households compared to the top 10%, based on income tax data. Note that income inequality was rather high prior to the Great Depression; the top 10% claimed more than 44% of income from the early 1920s into WWII. However, after the war, the combination of regulation and high marginal tax rates led to a significant reduction in the share captured by the top 10% of households.

By the mid-1960s, inflation had started to become a serious problem for the U.S. economy. We note that similar issues were found in all the industrialized economies. By the late 1970s, it had become a crisis. To address it, President Carter began to implement deregulation. President Reagan accelerated the process further by adding sharp cuts in marginal tax rates. American policy, along with improved technology, supported globalization.[3] That period is marked with a vertical line on the Income Shares chart. The inflation problem was resolved but replaced by an inequality problem.

The rise of populism, seen across the West, is a symptom of the inequality issue. The top 10% of households have clearly benefited from globalization, deregulation and low tax rates. Deregulation has led to the nearly unfettered introduction of new technologies, paving the way for massive industry disruption. For those who can cope, the economy works well. Unfortunately, for an increasing number of citizens in the West, the economy doesn't seem to be working for them anymore.



(Source: Branko Milanovic, Medium)

This is the famous "elephant chart" from Branko Milanovic; it shows that income growth in the two decades from 1988 to 2008 was substantial for the emerging economies. For the working and middle classes in the West, income growth was nearly non-existent and only the highest income brackets in the West enjoyed income growth near world levels.

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[3] Baldwin, R. (2016). *The Great Convergence: Information Technology and the New Globalization*. Cambridge, MA: Harvard University Press.

We are now seeing the political backlash from income inequality. Brexit, the "yellow vests" in France, the rise of anti-immigration parties in Europe and the elections of Barack Obama and Donald Trump are all symbols of rising populism. This isn't a fluke; capital-friendly policies were overturned in the U.S. during the presidency of Franklin Roosevelt, although one could argue that the regulation of monopolies that began under his distant cousin's administration was the harbinger of this inflection point.

It appears the trend toward equality is underway, but it is not yet at a level that portends a complete reversal. Barack Obama turned out to be more moderate than expected by his early supporters. Donald Trump is clearly moving toward deglobalization but is also actively deregulating the economy and executed major tax cuts. Brexit may still not occur. Populist parties in Europe have had the most success in Eastern Europe, which are new democracies; Italy is the only Western European nation governed by a populist coalition. Thus, so far, the populists haven't gained enough political power to reverse the efficiency policies that began in the late 1970s. But, once American politicians can openly discuss a 70% marginal tax rate, one should assume that the inflection point favoring equality is approaching.

Conclusion

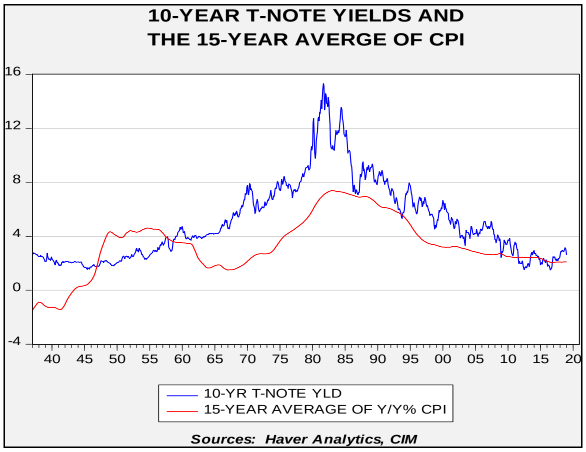
Although these two inflection points are separate, they interact with each other. Globalization will decline without an active superpower. Security will erode and there won't be a workable reserve currency to conduct international business. Populism, with its anti-trade and anti-immigration policy stances, will also reduce globalization. This efficiency cycle has been supported by American hegemony. If the U.S. retreats from this role, it will weaken efficiency. If domestic populism grows, it will undermine support for the superpower role. At times, it can be difficult to parse the two trends. It is conceivable that the U.S. could maintain hegemony and address the concerns of populists but that would require the top 10% to support policies that will directly harm themselves. There has been no evidence that the upper income brackets are prepared to make this sacrifice to maintain U.S. hegemony.

Market Ramifications

Notably, this section could be its own report. But, at heart, if either of these inflection points occurs, it will result in higher inflation. Rising inflation will have adverse effects on most financial assets.

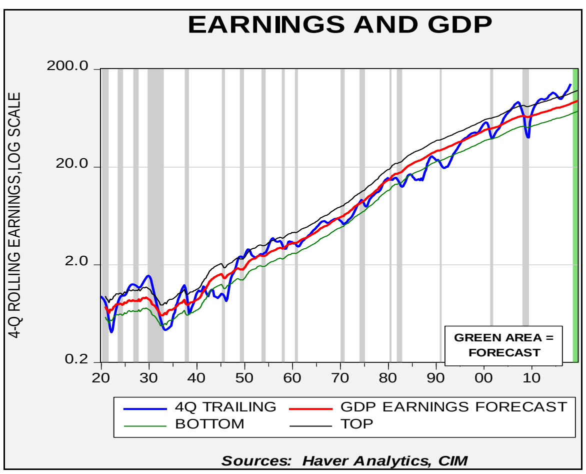
For bonds, inflation expectations are key to market performance. If investors worry about accelerating price levels in the future, they tend to demand higher yields to compensate. On the other hand, if future price levels are expected to be steady or decelerate, bond investors will likely be willing to accept lower yields. It is nearly impossible to determine inflation expectations *ex ante*, but we use a 15-year moving average of the yearly change in CPI based on observations from Milton Freidman that people tend to develop their inflation expectations over a long period of time.

The chart below shows the relationship of inflation trends and long-duration Treasury yields. Note that when this inflation measure trended higher, especially beginning in the mid-1960s, long-duration yields steadily rose with each business cycle. Since the early1980s, as inflation turned lower, yields have steadily declined. If inflation begins to rise, a secular bear market in bonds would be likely. It may be a number of years before the level becomes particularly painful, but the downtrend in yields that bolstered financial asset prices since the early 1980s would be over.



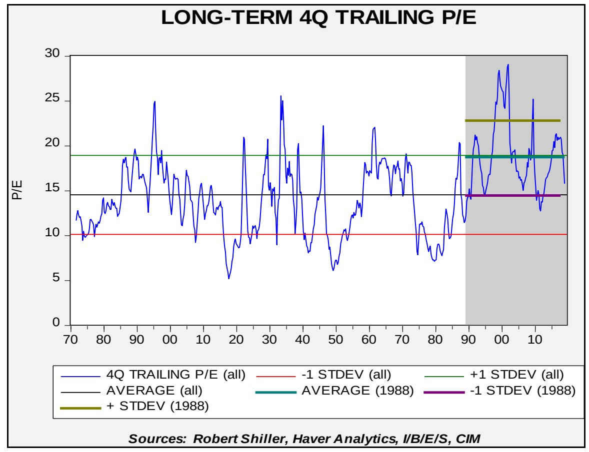
In terms of equities, we have seen both margins and multiples expand, with much of the rise occurring in the early 1990s.

First, let's look at margins.



This chart shows S&P earnings per share since the 1920s, regressed against nominal GDP. The purpose is to build a proxy that explains how much of earnings is being accounted for by the economy. In the 1920s into the early 1930s, when we were in an efficiency cycle, margins were elevated; earnings were far above what economic activity would justify. As the equality cycle expanded in the 1960s, there was a prominent decline in margins. However, after the 1990-91 recession, margins steadily improved in each business cycle. Margins are currently elevated.

Second, let's examine the P/E multiple.

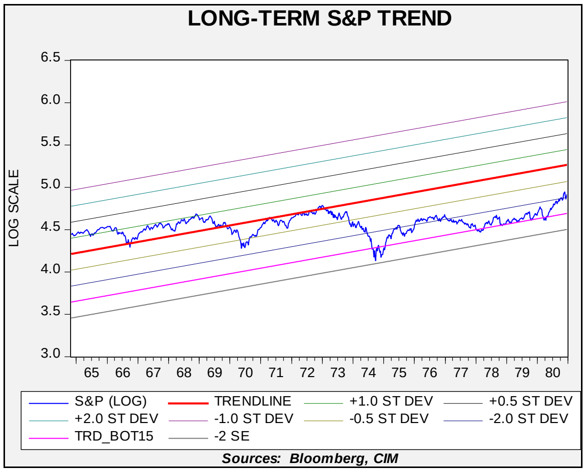


This chart shows the four-quarter trailing P/E from 1870 to the present. In the late 1980s, the growing realization that inflation was down and capital-favoring policies had become the norm,[4] coincident with the U.S. victory in the Cold War, led to an upward shift in the P/E that is shown in the gray section of the chart. Essentially, the multiple shifted higher. There were only two periods when an investor could buy at the long-term average in this period shown in gray.

The combination of a rising multiple and higher margins has been quite supportive for equity markets. Rising populism would likely reverse both. For perspective, earnings merely equal to GDP forecasts would be around $90 per share for Q4 2018; match that with a "normal" P/E of 14.5x puts the S&P 500 at 1363, well below its current level of approximately 2600.

[4] The election of Bill Clinton signaled the apex of this policy shift; even a Democrat was market-friendly and there was no voice for populism that had any power.

If history is any guide, the bear market that comes from falling margins and multiples would not be short and sudden, but drawn out over months or years.



This chart shows the weekly close for S&P 500 from early 1965 to late 1980. We have regressed trend lines through the data at 0.5 standard errors from the trend. In 1965, when inflation was just starting to accelerate, the market was trading at +0.5 standard error above trend. In the 1970 recession, it dipped to a bit more than -0.5 standard error and only rose back to trend in the recovery. In the next recession, when inflation was raging, it fell from the trend to nearly two standard errors. After that, the market had fully discounted its predicament and ranged around -1.5 standard errors into the 1980s. Of course, once the efficiency cycle kicked in, the market moved back to its long-term trend and eventually reached a full +2.0 standard errors above trend at the peak of the tech bubble.

What would that look like now? One standard error below trend would put the S&P around 1700 and -2.0 would put it at 1170. But, we don't expect that type of market action immediately when the equality cycle begins in earnest. Instead, we would look for an elongated bear that takes several years to unfold.

Obviously, this projection looks quite unpleasant for investors. At the same time, we caution that the equality cycle hasn't started yet and the U.S. remains the global hegemon. The full turn in the equality cycle may be several years away. An investor will be ill-served to fully adjust to this change now. However, as we have tried to show, the trends in place do support the idea that the efficiency cycle is probably waning and will likely end sometime in the next decade.

What can investors do? Bond laddering is the best answer in fixed income. In equities, firms with market power that can maintain positive real earnings should outperform. Alternative assets, such as gold and commodities, along with their related equities, should also do well. But, the environment will not be like what we have seen since the early 1980s. Passive investing will suffer; broad equity markets will struggle. For now, there is no immediate reason to move portfolios for what we have described. At the same time, it makes sense for investors to begin thinking about how they want to react when the twin inflection points of the end of U.S. hegemony and the shift to the equality cycle begin to dominate.

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January 14, 2019

Confluence Investment Management LLC

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