Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

By Bill O'Grady

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Reflections on Inflections: Part I

History seems to move in broad cycles. Beliefs come into and fall out of favor. Despite evidence of these cycles, people tend to "forecast with a straight edge." In other words, we assume trends that are in place will remain in place forever. And, thus, it can come as a shock to society when trends shift.

One key reason why people tend to be surprised by inflection points is because we are mortal. Once we identify the trends in place there is an incentive to buy into those patterns. There are pundits who warn us that changes are in the offing but they are often warning us well in advance of the shift, and thus can either become like "Cassandras" who always signal calamity or like "stopped clocks that are right twice a day."

In Part I of this report, we will offer some observations about inflection points—points in history when conditions change and a new regime of policy and thinking becomes dominant. These observations will lay the groundwork for Part II, where we will examine in detail what we believe are two coming inflection points. As always, we will conclude with market ramifications.

Characteristics of Inflection Points

If something cannot go on forever, it will stop.

-- Herbert Stein

Herbert Stein, a University of Chicago economist, was the chairman of the Council of Economic Advisors under Presidents Nixon and Ford and taught economics at the University of Virginia. His quote is a reminder that trends that seem "impossible" will eventually end. The trick is to figure out "when" and "how" they will end.

One way to frame this problem is the difference between the "short run" and the "long run." Technically, in economics, these terms refer to situations of capacity. In the short run, supply and demand are defined as constrained; in the long run, both adjust. For example, in the short run, gasoline demand is thought to be highly price inelastic, meaning that declines in supply lead to sharply higher prices.[1] In the long run, consumers react to higher prices by investing in conservation. They will favor fuel-efficient cars, adopt public transportation, relocate closer to work, etc. To some extent, some adjustments simply represent the shift from the short run to the long run. Although these sort of changes are sometimes referred to as inflection points, this type of adjustment isn't what we are discussing in this report.

We define inflection points as moments when three- to five-decade (or longer) trends reverse. Some examples include a change in global hegemons, the industrial revolution, the digital revolution, the Roosevelt-led progressive era and the Reagan-Thatcher era. Here are some observations about these major changes:

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[1] Strictly speaking, it means that a 1% change in supply leads to a greater than 1% change in price.

***Although there appears to be a pivotal event that marks the change, in reality, conditions had been changing before the crucial event and created the groundwork for the inflection point.*[2]** Examples of this factor abound. Franklin Roosevelt's transformation of the U.S. political system and economy would probably not have occurred without his cousin Teddy's progressive movement.[3] A pivotal event in the Reagan revolution of deregulation and globalization was the PATCO strike, when the president fired the air-traffic controllers. However, President Carter had started deregulation with reforms to transportation and financial services. In addition, he appointed Paul Volcker as Federal Reserve chairman, who pursued a hard money monetary policy that likely doomed Carter's reelection.

These precursor events offer clues to analysts that changes may be underway. However, it takes a rising level of such events to eventually trigger the inflection point. And so, as analysts point out a progression of events that could signal an inflection point, it is unknown before the actual change whether that event is the one. In other words, it is only in hindsight that one can clearly know when an inflection point has occurred and identify the precipitating event.

Inflection points are psychological in nature; thus, successful prediction is mostly an intuitive process. Two writers I view as having the best insights on this process are Malcom Gladwell[4] and Ben Hunt.[5] Gladwell's insight is that new ideas tend to spread like epidemics—trends are fostered by three groups: "connectors" who know lots of people, "mavens" who gather knowledge and "salesmen" who persuade. When the three groups interact, they can sway the general population about a new thing. Hunt writes extensively on game theory and especially on the "common knowledge game" where "missionaries" tell us what "everyone knows."[6] Missionaries, in Hunt's taxonomy, are opinion-shapers; they are seen in the media after an event telling us "what it means."

I am not sure that either of these thinkers can predict inflection points in advance. Gladwell's three key groups may only be known with certainty after the event; sometimes, they tell us something is going to happen and it doesn't. Hunt is doing a lot of work on parsing news flow with a sophisticated computer program that shows when a trend is "getting hot." However, the trend may also "cool."

Both of these thinkers point out that there is an element of mass psychology in which a new idea emerges and an old idea is discarded.[7] Thomas Kuhn introduced the idea of "paradigm shifts," where a previous scientific idea is supplanted by a new one.[8]

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[2] "I'd look at one of my stonecutters hammering away at the rock, perhaps a hundred times without as much as a crack showing in it. Yet, at the hundred and first blow it would split in two, and I knew it was not that blow that did it, but all that had gone before." -- Jacob Riis

[3] Franklin and Theodore Roosevelt were distant relations, fifth cousins to be exact.

[4] Gladwell, M. (2000). *The Tipping Point: How Little Things Can Make a Big Difference*. New York, NY: Little, Brown & Company.

[5] https://www.epsilontheory.com/

[6] One of my positions is that the *New York Times* is less of a newspaper and more of a signaling device for American elites. This isn't to say the paper never breaks news stories but its primary power is to signal when a tipping point occurs among the "people that matter."

[7] Kuhn, T. (1962). *The Structure of Scientific Revolutions*. Chicago, IL: University of Chicago Press.

[8] Such paradigm shifts have a generational element to them. Max Planck noted that, "Science advances

Essentially, inflection points tend to occur when enough opinion leaders convince the larger public that the old order is unsustainable and current conditions must change. At the time of the inflection point, it seems that nothing will ever change; therefore, it comes as a shock when it does.[9] But, the consensus of opinion of enough people with power eventually "tips" and leads to an inflection point.

A key factor in inflection points is the persistent underestimation of opportunity costs to the new direction and an overemphasis on the costs of the current policy. Inflection points occur to address a serious problem. Inflation, slow economic growth, inequality and racial tension can cause all sorts of problems. Policy, economic and social changes can address these problems. At the same time, change causes disruption. In theory, those who benefit the most from the change would be expected to support those who suffer the most. In reality, such adjustments rarely occur without significant societal unrest.[10]

The industrial revolution led to enormous economic growth but it concentrated economic power in the hands of the few owners of capital. The reactions varied; Charles Dickens called for the owners of capital to be kinder to the poor.[11] Karl Marx supported violent revolution and one actually swept Europe in 1848.

Any reasonable understanding of the change wrought by inflection points would be clear on the costs of such change. The Reagan-Thatcher Revolution was bound to foster rising inequality in exchange for lower inflation. But, using Gladwell's groups, policies that foster inflection points require salesmen. One doesn't sell a policy change by leading with the costs. The policy gets sold by focusing solely on the future benefits. And, because the public is clamoring for a problem to be fixed, when a policymaker puts forth a path forward, the changes are adapted at the inflection point.

Using Kuhn's and Planck's observations, often the leaders of the new policy at the inflection point are seen as a new generation of leaders overcoming the intransigence of the old order. To bring in the new era, the old order must be swept away. For a while, the costs of addressing the problem are less than the benefits gained. For example, when Roosevelt implemented polices designed to boost demand during the Great Depression, many feared inflation would return.[12] Still, even with all the stimulus policies of the New Deal and the debasing of the dollar to

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one funeral at a time," reflecting the notion that, "a new scientific truth does not triumph by convincing its opponents and making them see the light but rather its opponents eventually die and a new generation grows up with the new idea it is familiar with."

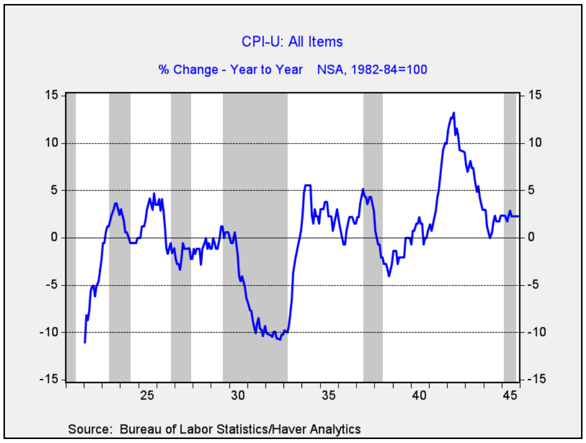
[9] A classic example of this phenomenon is reflected in a paper by Arthur Burns, Volcker's predecessor as Fed chair. On September 30, 1979, he delivered a paper titled "The Anguish of Central Banking," in which he essentially argued that the political class would never allow central bankers to deliver monetary policy austere enough to quell inflation. On October 6, 1979, Volcker announced the Fed would no longer target interest rates but the money supply, which led to a massive rise in interest rates, essentially the type of policy that Burns suggested was impossible about a week before. See: http://www.perjacobsson.org/lectures/1979.pdf

[10] For example, Walter Scheidel's historical analysis of inequality suggests this problem is only resolved by mass mobilization war, revolution, state collapse and pandemics. Scheidel, W. (2017). *The Great Leveler: Violence and the History of Inequality from the Stone Age to the Twenty-First Century*. Princeton, NJ: Princeton University Press.

[11] This was the key message of *A Christmas Carol*. Dickens, C. (1921). *A Christmas Carol and the Cricket on the Hearth*. New York, NY and London: The Macmillan Company.

[12] https://www.americanheritage.com/content/big-picture-great-depression

gold, inflation did not break above 5% until the run-up to WWII.



From the end of the Great Depression through 1939, CPI averaged 0.6% on a yearly basis. Inflation remained mostly contained until the mid-1960s.

A rational view of policy would take opportunity costs into account. It should come as no surprise that the policies designed to combat inflation, namely, deregulation and globalization, would favor capital and boost inequality. But, it could take years before the opportunity costs rise to a level that triggers an opposite reaction. The reaction is delayed, in part, because it takes time to fully implement the changes, even after the inflection point. And, the economy and society tend to adapt to changes, with thought leaders touting the benefits of the changes and blaming those who suffer the opportunity costs for their inability to adapt. But, eventually, the benefits of the policy change are taken for granted and the costs become the focus. This lays the groundwork for the next inflection point.

Conditions leading to inflection points can be seen well in advance but persistently pointing them out can make a pundit appear as a "Cassandra," always warning about a crisis that never seems to come. It is fairly easy to see conditions that can't last. At the same time, these same conditions can seemingly persist a lot longer than one expects. Once the inflection point is reached, change can also happen quickly. Here are two illustrative quotes:

When asked how he went bankrupt, Hemmingway responded, "Slowly at first, then quickly."
-- Earnest Hemmingway

In economics, things take longer to happen than you think they will and then they happen faster than you thought they could.
-- Rudi Dornbusch

Michael Pettis is often criticized as being a China bear when he points out that investment-led development models eventually falter because of malinvestment, excess capacity and bad debt.[13] Pettis isn't wrong. Every nation that has followed investment-led development is, at some point, forced to make painful adjustments. This adjustment was part of the Great Depression for the U.S. and explains the three decades of economic stagnation seen in Japan since 1989. ***However, when an analyst points out these issues, the general public believes the crisis must occur imminently.*** In reality, as Hemmingway and Dornbusch point out, the process can take a long time and the warnings can become ineffective, seemingly like stopped clocks that are right only twice daily.

However, that doesn't mean the warnings shouldn't be noted. It should be realized that the timing and sequence of the inflection points may be nearly impossible to predict perfectly in advance. About all one can do is indicate when conditions favor a change.

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[13] https://carnegieendowment.org/chinafinancialmarkets/

Part II

Next week, we will conclude this report by observing two trends that we believe are aging and are likely approaching inflection points. We will conclude the report with market ramifications.

Bill O'Grady
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