Confluence Investment Management

Weekly Geopolitical Report

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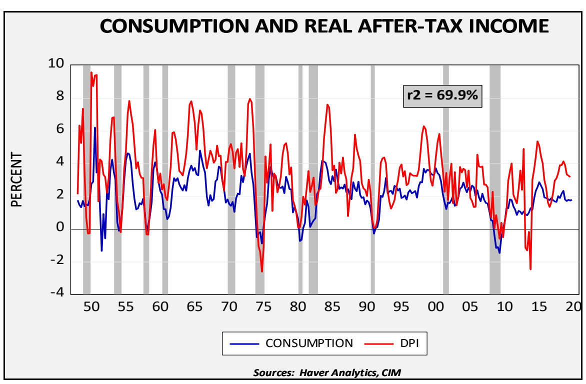
May 4, 2020

Revisiting Scheidel's Horsemen: Part III

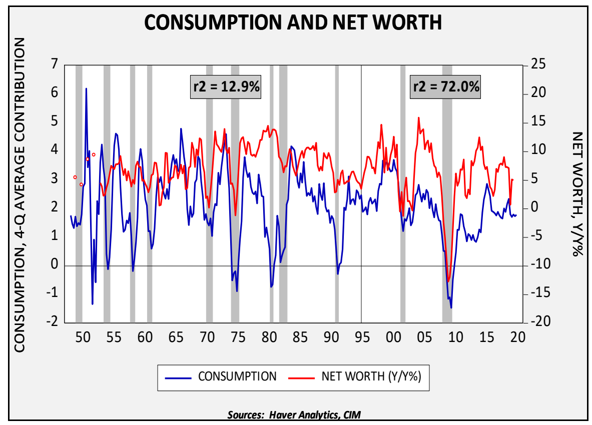
In Part I of this report, we discussed Scheidel's thesis on the events that reverse the normal trend of inequality and used this analysis to frame the COVID-19 pandemic. In Part II, we introduced the equality/efficiency cycle and discussed the first issue that would be affected by a shift to equality. In this final Part III of the report, we will address the other four issues, discuss inflation and conclude with market ramifications.

Key Factors Tied to the Inflection of the Equality/Efficiency Cycle

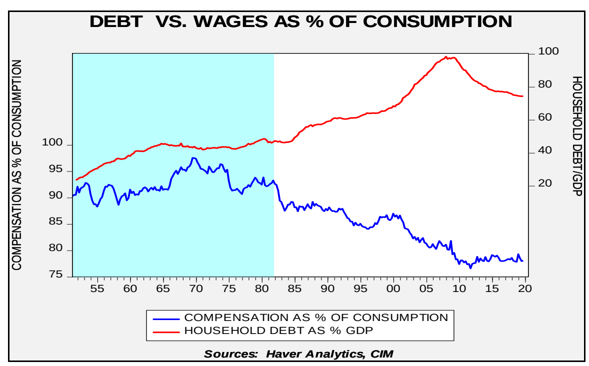
The second major issue is the labor/capital imbalance. A characteristic of the past 25 years has been an increasing dependence on the wealth effect to support consumption.



This chart shows the four-quarter average of the contribution of consumption to the annualized change in GDP along with the yearly change in after-tax income. As one would expect, consumption is highly correlated to after-tax income. On the other hand, household net worth did not have a significant impact on consumption from 1947 to 1994. However, since 1995, household net worth has become a significant factor to consumption.

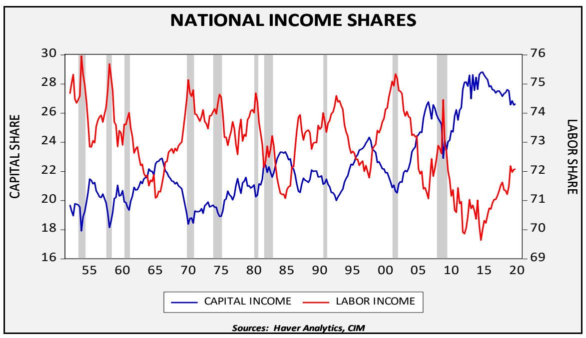


Why has this occurred? Incomes have become increasingly deficient relative to consumption.



This chart shows household debt/GDP along with the percentage of consumption that was funded by employee compensation. From the early 1950s into 1982, compensation funded between 90% and 95% of consumption. As that percentage fell over time, households accumulated debt to maintain their standard of living. Some of that debt funded household investment, such as housing. In 2005, as housing prices peaked, debt accumulation had become unsustainable.

Since the mid-1990s, the Fed has been forced to rescue the financial markets because asset prices have increasingly affected the real economy. For the economy to escape this trap, more buying power needs to be funneled into lower income households. Referring to the debt vs. wages chart above, more of consumption needs to be funded by wages.



This chart shows the percentage of national income that goes to labor (wages and proprietors' income) and capital (profits, interest, dividends and rent). During the Cold War, capital income generally ranged between 18% and 23% of national income. But, since the Cold War ended, the capital share has steadily increased, making a new peak in each expansion, while the labor share has declined. Reducing the travails of the financial boom/bust cycles will require more spending to be driven by income and less by capital gains. This brings us to the third major issue.

The third major issue is the primacy of shareholder value. From 1932 into the 1970s, public corporations had multiple social goals.[1] The seminal work on this framework was from Adolf Berle and Gardiner Means.[2] Berle and Means postulated that under public shareholder ownership, shareholders as a group were too diverse and dispersed to affect the management of the company. Instead, public corporations were managed by a group of professional managers. This created what became known as the "agency problem," where managers could run the company for their own benefit or the benefit of themselves and labor against the interests of the owners. This position on corporate governance dominated the landscape until the 1970s.

A less formal challenge came from Milton Friedman, who argued in the *New York Times Magazine* that the only legitimate goal of corporations is to maximize profit. A more formal challenge emerged in 1976 from Michael Jensen and William Meckling, who suggested that management's interests should be aligned with shareholders.

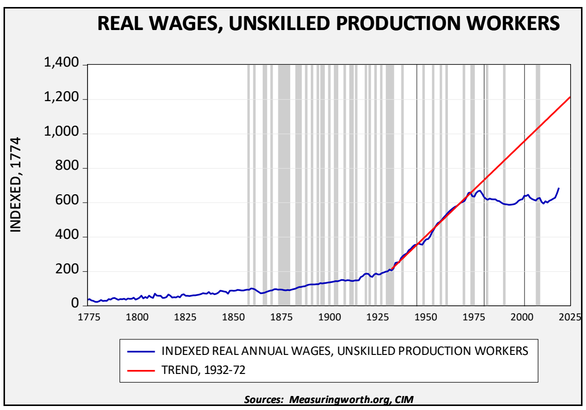
By the early 1980s, the primacy of shareholder value began to take hold. A number of changes emerged. First, the early 1980s became the era of the corporate raider. These investors would acquire a company by accumulating a controlling interest in a public company, often funding the purchase with high-yield debt. After the leveraged buyout, the new owner would streamline the company, often through layoffs and wage cuts. Managers, seeing what the raiders wrought, began taking steps to fend off a raid by engaging in the same management actions as a raider would undertake. The idea was that if the management in place wouldn't take these actions, someone else would.

[1] A good synopsis of how corporations were managed in this era: Galbraith, John K. (1967). *The New Industrial State*. Princeton, NJ: Princeton University Press.

[2] Berle, Adolf A. and Means, Gardiner C. (1932). *The Modern Corporation & Private Property.* New York, NY: Macmillan Company.

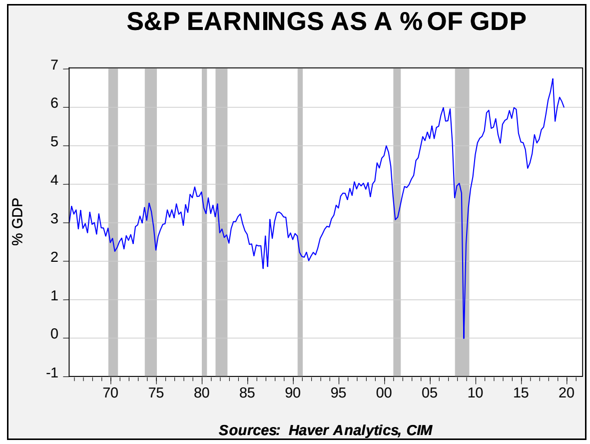
Second, pay structures for managers changed to align their interests with ownership. Before the 1980s, there were three interest groups—labor, management and owners. By tying management compensation to the stock price through grants and options, there were only two interest groups—labor and the unified management/owners. Management now has an incentive to persistently boost its company's stock price. This can take the form of structuring the business to generate short-term earnings growth, rising dividends and, more often, stock repurchases.

The impact on workers' pay is notable.



Real annual wages rose slowly into the 1870s, flattened into the turn of the century, then rose modestly until WWI when they lifted. The pace of growth slowed again into the early 1930s, then rose sharply with the New Deal. By the late 1970s, wages fell below the uptrend established in 1932-72 and have lagged ever since. If the trendline had been maintained, real wages for this category of worker would have been 168% higher.

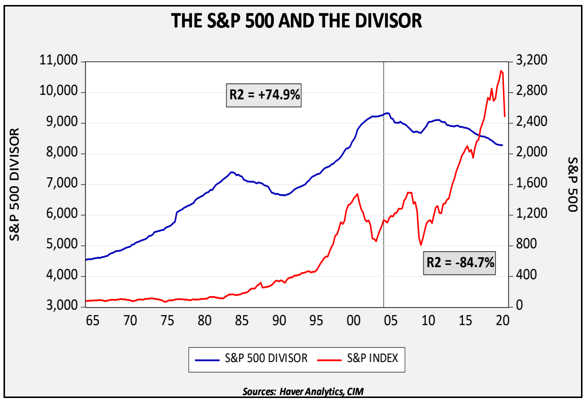
As one would expect, margins increased as well.



Total S&P 500 earnings ranged between 2% to 4% of GDP from 1965 to the mid-1990s. Since then, they have increased with each business cycle and are now 6% of GDP.

Since the 1990s, we have seen a series of market events that have required monetary and, at times, fiscal support. As we noted in the above section, if it is politically impossible to follow the path of the Hoover administration, such actions are perfectly legitimate. However, when these actions are coupled with shareholder primacy, they begin to appear as if policy is designed to privatize earnings and equity returns but socialize the losses. Consider the current situation. Firms have been buying back stock at a strong clip, so much so that the divisor on the S&P has fallen in a bull market. The divisor of the S&P keeps the index from making discrete jumps when firms take actions such as issuing or buying back stock, or when firms merge, or when shares enter and leave the index. In general, a rising divisor usually signals an increasing share count, while a falling divisor reflects the opposite.

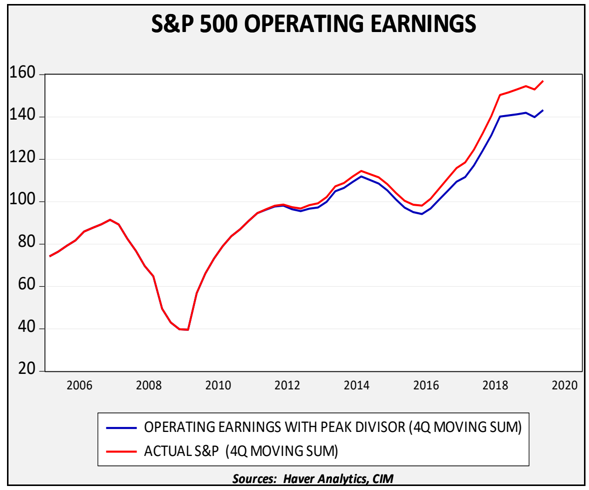
Generally speaking, one would think that firms would want to issue stock during bull markets. After all, bull markets are usually accompanied by a rising P/E multiple; the inverse of the multiple, the earnings yield, means that one would be issuing stock during periods of high earnings yield, meaning the issuer is getting a high yield for his stock. That was the pattern from 1964 until 2000. The correlation between the divisor and the S&P 500 was 74.9%. However, since 2000, the correlation has become sharply inverse, at -84.9%, suggesting that the higher equities rise, the less likely firms are to issue stock.



So, companies have been buying back stock, sometimes borrowing money to make the repurchase. As the COVID-19 pandemic has triggered a financial crisis, we are seeing firms suddenly scrambling for liquidity to maintain operations. To continue borrowing for buybacks during this time has the appearance of squandering cash and borrowing capacity to reward shareholders, then running to policymakers for aid during downturns.

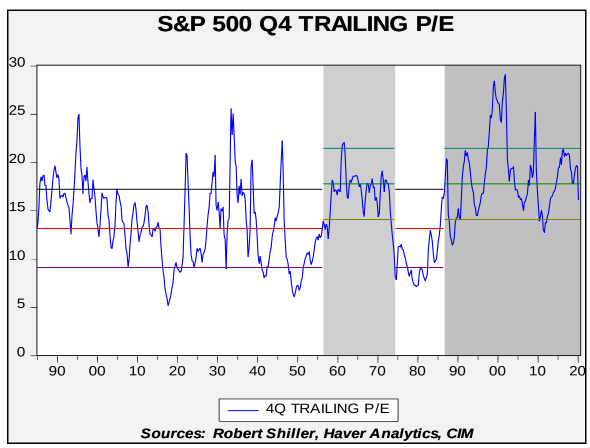
Both dividends and buybacks are now under increased scrutiny. We are seeing a number of articles questioning the wisdom of these actions. It would make sense that shareholder payouts will slow dramatically in the wake of the pandemic.

Another way of thinking about this is the impact of a falling divisor on S&P operating earnings.



Using the S&P operating earnings number on a four-quarter rolling basis, the latest actual is $157.12; if the divisor had been constant at its relative high in Q3 2011, earnings for the same period would have been $143.28.[3] In other words, earnings per share is boosted by the decline in the divisor, which is affected by stock buybacks.

The primacy of shareholder value has also affected P/E multiples.



[3] It is important to note that there are two sources of operating earnings for the S&P 500, Standard and Poor's and Thomson/Reuters. The latter also owns I/B/E/S, the primary source for earnings estimates. We use Standard and Poor's due to its longer history; in general, Thomson/Reuters tends to be about 7% higher than Standard and Poor's.

Since the 1870s, the average four-quarter trailing P/E has been 14.7x. But, on the above chart, we show two periods when there was a persistent rise in the multiple, 1957-1973 and 1988 through the present. In both these periods, the P/E averaged 17.7x. We believe the two periods had somewhat different characteristics, but one common factor to both was that inflation volatility was low. The 1960s period was also supported by a long expansion, which was unusual for that era. The current period of an elevated multiple coincides with the end of the Cold War, but we also believe it was supported by shareholder primacy. If that model of corporate management is rejected, not only will margins decline, but the incentives to hold stock may be adversely affected as well.

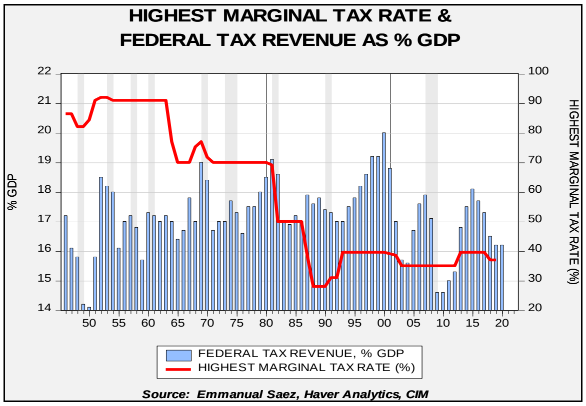
The country is asking lower wage workers to risk their health stocking grocery and warehouse store shelves, driving delivery vehicles, providing takeout and working in medicine. Widespread sacrifices during WWI led to increased suffrage, tariffs and immigration restrictions, and it is not unreasonable to think something similar will occur in the wake of COVID-19.

The fourth major issue is globalization. Our work has suggested for some time that globalization was in decline. Globalization requires a hegemon that provides global security and the reserve currency. The U.S. has been reducing its security commitments, criticizing NATO nations for their lack of defense spending and reducing its footprint in the Middle East. Providing the reserve currency requires persistent current account deficits to provide dollars to the world; the implementation of tariffs is a direct contradiction of hegemonic policy.

As we noted in our recent *WGR*, "On Optimization," firms have deployed far-flung supply chains, sourcing production in the most efficient and profitable manner. The COVID-19 pandemic has exposed the risks of that network. Americans have discovered that key medical supplies are not produced at all, or are only partly sourced, in the U.S. As nations attempt to secure their domestic supplies of these critical goods, they have implemented export bans. Suddenly, nations dependent on imports found themselves scrambling to find food and medical supplies. In the aftermath of the pandemic, we would expect supply security to prompt import bans and domestic suppliers to receive import protection and subsidies. Simply put, the COVID-19 pandemic will accelerate the retreat from globalization that was already underway.

The fifth major issue is tax policy. The second and third issues, the capital/labor imbalance and shareholder primacy, respectively, beg the question of what is to be done to address these items. It is highly likely that these two issues will be addressed through increasing marginal tax rates on higher earning households.

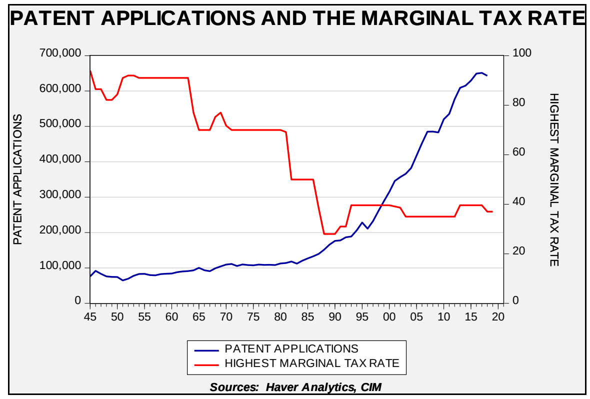
Higher marginal tax rates are a populist policy tool. Left-wing populists, such as Sen. Warren (D-MA) and Sen. Sanders (I-VT), offered to boost tax rates and introduce a wealth tax. But it is also notable that right-wing populists tend to favor higher taxes on the wealthy. For example, Steve Bannon, who was once an advisor to President Trump, proposed this idea. Usually, these tax hikes are offered as a way to "pay for" various social programs or other spending. However, there is only modest evidence in the postwar era to substantiate that higher marginal tax rates lift revenue.



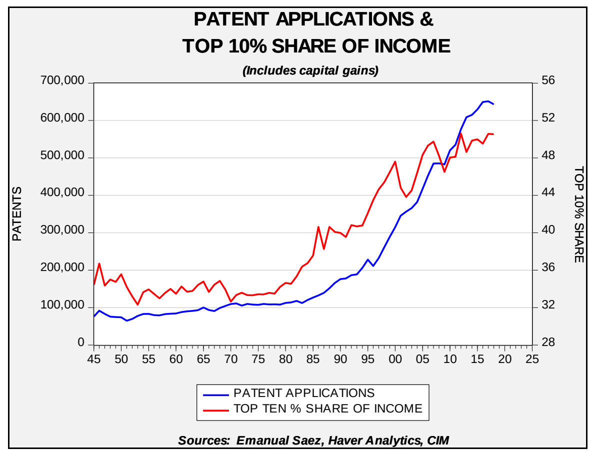
This chart shows the highest marginal tax rate along with federal tax revenue as a percentage of GDP. Since 1946, the average revenue to GDP is 17.1%. It averaged 17.0% when the highest marginal tax rate was 70% or higher and 17.3% when it was lower than 70%.

Thus, the reason for a high marginal tax rate isn't about raising revenue; it's about changing behavior. First, there is less incentive to make lots of money if the government is going to tax away much of the income. Second, there is less incentive to manage to shareholder value if all the pain involved with doing so ends up enriching government coffers. In other words, the human cost of managers treating workers as mere inputs is harder to justify if the government captures the excessive gain.

There are obvious downsides to raising the marginal tax rate—there is less incentive to take risk. One of the ways to measure this risk is to assume that patent applications are a measure of risk-taking. After all, why go to the work of applying for a patent if the gain is limited by the tax rate? This element can be seen in the path of patent applications and the highest marginal tax rate.



In the postwar period, patent applications tend to track the top 10% share of income.



So, the costs of reducing inequality will be a less dynamic economy and, eventually, higher inflation.

What About Inflation?

Inflation generally occurs when the amount of money in the economy exceeds the availability of goods and services. If the U.S. moves to an equality cycle, inflation is more likely, but the key unknown is when. Let's start with the equation of exchange:

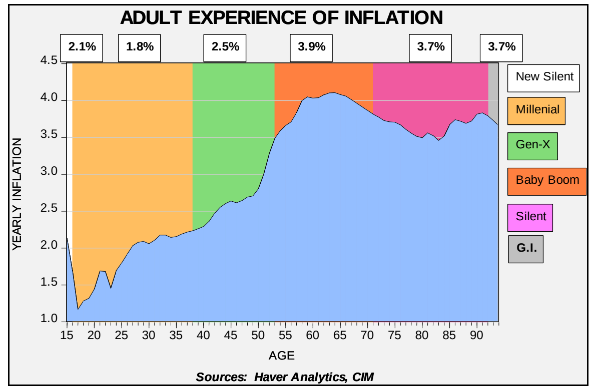
$$MV = PQ$$

The money supply times its velocity equals the price level times available goods and services. During efficiency cycles, Q tends to rise significantly. Q measures the productive capacity of the economy and under conditions of deregulation and globalization, available supply tends to rise. If the money supply and velocity stay the same, deflation will result. To prevent this outcome, the Fed usually increases the money supply.

If equality measures occur, Q will eventually decline. In the absence of tighter money, inflation will result. However, the degree of inflation will depend on V, or velocity. If Q falls, M stays the same but V declines, and the impact of inflation would be significantly less. To a great extent, velocity is a function of how much money an economic actor wants to hold. Much of that decision is driven by fear and future inflation expectations.

On the fear part, let's look at the experience of a current 40-year-old American. When that person turned 20, they watched the tech bubble burst, followed by a housing boom which ended with the Great Financial Crisis eight years later. Twelve years after that, they are living through the COVID-19 pandemic and the accompanying financial crisis. It would be reasonable to expect that person to be risk-averse and, if given the opportunity, to hold larger cash balances.

The second element of velocity is inflation expectations. Milton Friedman postulated that inflation expectations are developed over a lifetime. The following chart shows the adult (16+ years old) experience of inflation for Americans aged 16 to 95. The aforementioned 40-year-old has an adult experience of inflation of 2.3%. Without fear of higher inflation and raised to expect bad things to happen on a periodic basis, it would be reasonable to expect that the triggers of high inflation, essentially rising velocity into falling output and rising money supply, will probably not occur for a rather long time.



Ramifications

There is nothing certain about what we have described. It is possible that COVID-19 will pass through the world with only a modest impact. However, we already know that the virus is going to trigger the sharpest decline in GDP since the Great Depression. At present, we expect the worst of the economic impact to be short-term. However, other elements of the event may persist. If true, we could be in one of those rare events that ends an efficiency cycle.

That world, the equality world, would be less friendly to investors. However, prudent investors don't invest to the world they want, they invest to the world they get. At Confluence, we lean toward the "is" in David Hume's "is/ought" observation,[4] meaning we invest for the world that "is" rather than the world that "ought" to be.

So, what should investors do? First, watch carefully to see if populism expands. Second, start preparing for an investing world where interest rates stop falling and P/Es and margins decline. These preparations would entail the following:

1. Consider bond laddering. If rising inflation fears trigger rising rates, long-duration bonds will lose value. That will be adverse for bond funds but an

[4] Hume, David (1739). *A Treatise of Human Nature*. London: John Noon. p. 335. Retrieved 2011-12-06.

investor that holds a ladder will swap out a maturing bond for a new, higher yielding one each year.

2. Consider adding precious metals to the portfolio. These offer diversification and can protect one from rising price levels and, most notably, negative real bond yields.
3. Small caps could flourish. Large companies will likely face regulatory and societal burdens that will prevent them from maximizing shareholder value. Smaller companies will probably be able to avoid such problems.
4. International investments could do well. Some nations may be able to maintain an efficiency stance; in addition, we would expect financial repression to be bearish for the dollar. After all, some degree of financial repression was in place during the 1970s and this policy proved to be profoundly dollar bearish. A weaker dollar tends to be bullish for international assets.

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May 4, 2020

Confluence Investment Management LLC

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