



Quarterly investment outlook

Inflation and growth: An Investor's playbook

Q3 2021

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Foreword

Developed markets' continued vaccine rollouts and a corresponding easing of lockdown measures buoyed equity markets during the second quarter despite already starting the period at elevated levels. Global stock markets rose by over +6% in Sterling terms and whilst the US was again the best performing region, European and UK stocks were not far behind. The outlier in developed markets was Japan whose vaccine programme lags well behind that of western markets, while emerging markets were also below average for similar reasons. Gold rallied strongly during the quarter before selling off to end up +2.4%, and Gilts posted a positive +1.2% return as yields remained stubbornly low, as a consensus of any inflation being 'transitory' seems to have been reached (for now) in markets.

For some time now we have commented that markets were pricing in expectations of lockdown measures being eased, and some sort of return to normality bringing about better fortunes for corporate earnings. We are now seeing that hypothesis play out in part as a very strong earnings season went some of the way to justifying stock market valuations. That said, markets remain expensive by historical standards and will rely on the continued reopening of economies being unaffected by unwelcome virus developments even with the now familiar backdrop of very accommodative monetary policy. Dispersion in fortunes between geographies and sectors remains a pronounced feature of equity markets, with the US remaining the most expensive market by virtue of its weighting to technology firms, and we expect active managers to be able to add value in this environment. By contrast to the US, the UK market continues to look markedly inexpensive as analysts expectations for better earnings in financials and industrials go unrewarded, and investors remaining seemingly undrawn to dividend paying stocks.

This dispersion amongst equity markets reflects the different paces at which economic regions are tackling the pandemic crisis, and it is a reasonable assumption that the coronavirus will continue to be the biggest single differentiator between countries' economic fortunes for the rest of the calendar year at least. Lockdown measures in the largest economies are easing, workers are returning to jobs, and though in some areas the Delta variant is leading to an increase in Covid cases, vaccine rollouts mean that this wave of infections is proving less deadly. Vaccine supplies though remain a challenge for large parts of the world meaning that the now familiar economic problems will remain in those countries. While the situation is undoubtedly improving and swiftly so, we concur with the Bank of International Settlements' view that we will see a "strong but uneven recovery".

The possibility of higher levels of inflation, and how long these might persist, are the main questions vexing markets at present. For over a decade extraordinarily accommodative monetary policy has kept financial assets high whilst not fuelling inflation in the real world. That economies have not fallen apart during the pandemic is due to quick governmental action, but at a heavy price in terms of fiscal deficits. The US at least looks likely to continue to spend beyond its income, and with the cost of borrowing presently so low others might be tempted to follow. Such fiscal expansion, cash saved by households during lockdowns, remaining pressures on supply chains, and the growing urgency to tackle climate change are all potential sources of inflation.

At our June meeting the Investment Committee voted to make no changes to our portfolios. We continue to feel that the bond market offers little value and thus maintain our overweight to equities and infrastructure assets. We continue to hold a balance between value and growth stocks, and favour the UK on a valuation basis.



David Baker
Chief Investment Officer, UK

Inflation and growth: An Investor's playbook



Investing during the past twelve years has been underpinned by a basic principle: market participants have been encouraged to take risks, mainly to offset the trust shock that came with the 2008 financial crisis (GFC).

Each time equity prices have fallen significantly, the Federal Reserve, the world's de facto central bank, would suggest an increase in money printing, or actually go ahead with it if volatility persisted. Bond prices, meanwhile, kept going up, as central banks and pension funds were all too happy to relieve private investors of their bond holdings even at negative yields. Market risk was all but underwritten. The Federal Reserve always knew that the strategy came with limitations and often tried to disengage from it. It ceased asset purchases in early 2015. Consequently, for two years until 2017, US stocks gained a mere 3.9% per annum, as opposed to the 10%-11% in the previous years.

Still, the US tax reform swiftly projected after the Republican party's 2016 electoral gains spurred a significant stock rally for a year and, for a brief time, equity returns and Fed asset purchases decorrelated. The Fed took advantage of the bullishness and started reducing its balance sheet very slowly in early 2018. Until it resumed asset purchases in September 2019, US stocks yielded a total of just 4.15%, or 2.5% annualised. On resumption, and with the balance sheet more than doubled from \$3.7tn to nearly \$8tn after Q3 2019, US stocks have gained nearly 50%, or 25% per annum. With one brief exception, (Trump's tax reforms), monetary accommodation has consistently been the 'only game in town' for risk assets.

For years, our basic approach to investors has been that 'over the longer term you should be comfortable with some risk (appropriate to one's profile), as risk is encouraged and underwritten by central banks. During downturns we would re-emphasise the point and wait for the Fed to step in.



George Lagarias
Chief Economist, UK

When asked 'what can end this singular factor that would drive asset prices up or down?' the answer was 'we don't know yet, but it's our job to tell you when we see it'.

We believe that this is a time worth considering the question again.

In 2021, a new US president, Joe Biden, was sworn in. Markets rejoiced in his choice for the Secretary of the Treasury, Janet Yellen, a former Fed Chair and a policy dove. Ms Yellen, fully aware that the Fed could not forever alone shoulder the burden of the economy, came up with a very ambitious plan to proceed with unprecedented fiscal stimulus. The money reserved for investors was now to be redeployed in the real economy.

We immediately recognised this development as a potential paradigm shift. In the next few pages, we will discuss how possible, or plausible, it is that the way we have invested in the past decade, may have come to an end. We will examine four scenarios: a) A return to 'Secular Stagnation', b) A brief 'Stagflation' (stagnation + inflation) interlude, c) A 'Managed Growth' scenario, by which the US government achieves its exact objective and d) a 'Breakout Velocity' scenario that would see a re-empowered consumer and a material pickup in investments in the real economy.

However, before one proceeds with reading, we need a caveat: When asked to rethink how the post-Covid world might be reshaped, one needs to see the present and the past as it is, not as it should be. This publication maintains a healthy modicum of irreverence for historical narratives on the nature of inflation and fiscal stimulus that may pose a challenge to economic orthodoxies.

Introduction

‘Hope’, or ‘bullishness’ as stockbrokers often call it, is the beating heart of capitalism. Spending money hoping to make more money, ‘risking’ in other words. Our financial system is so encouraging of risk and efficiently allocating capital that it even allows for spending money without having it in the first place, ‘leverage’ or ‘credit’. When people become more comfortable with risk, leverage begins to balloon to the point of becoming speculative, which leads to the famous ‘boom and bust cycles’ often observed in western economies. ‘Hope’ has been missing in action since the onset of the 2008 financial crisis. ‘Secular stagnation’, a traumatised and conservative investor and consumer mindset, has set in. In this paper we argue that authorities are taking significant risks to restore the bullishness that is so fundamental to liberal capitalism. In the next few pages, we will try to assess whether they stand a chance of success.

A brief history of Secular Stagnation

In the twelve years leading up to the pandemic an unusual dichotomy occurred, between the real and the financial economy. Whereas the stock market soared on the back of unprecedented monetary stimulus, real economic growth has been lacklustre and demand-driven inflation absent, leaving yield curves flat and a huge debt overhang in the West increasing.

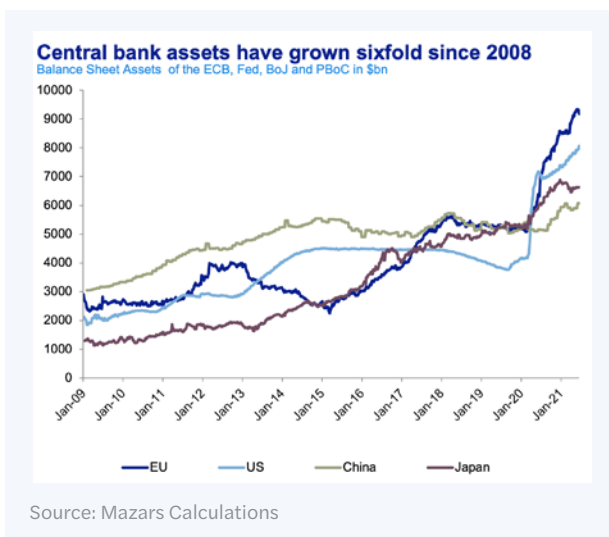
The fallout of the global financial crisis of 2008, arguably one of the biggest ‘busts’ in modern history, saw banks, the primary purveyors of capital and money creators in the economy, scale down loan creation in an effort to repair their balance sheets. New regulatory frameworks, like Basel III, the Frank-Dodd Bill and the Volcker rule essentially shackled banks to ensure that simple depositors would not be faced with inordinate risks. As a result, or even maybe concurrently, traumatised consumers also sought to decrease their own risk and repair their household balance sheets. Demand and supply for loans for consumption and mortgages was reduced and loan/value rates decreased across the board. Savings and financial investments increased, and spending decreased. Lacklustre demand did not go unnoticed by businesses

which scaled back their own expansion plans and kept wages stable. As a result, consumers didn’t see a significant rise in real purchasing power for almost two decades and inflation disappeared altogether. Growth in western economies fell almost 3% from 5% per annum to less than 2%.

This period, characterised by consumer reluctance to spend, has often been dubbed ‘Secular Stagnation’.

Capital must flow however, or what is the point of capitalism? The role of money creation passed back from commercial banks to the well itself, central banks. Where previously new money entered the economy through loan creation (banks turn idle deposits into active capital), now it was simply printed through a convoluted process which became known as ‘quantitative easing’ (QE). But with banks still constrained and largely unwilling to extend themselves, the primary transmission mechanism was unable to turn that into real capital. The extra money did not end up in the real economy but circulated back into financial markets. Inflation took on a more innocuous form than higher prices at the shelves, that of ‘asset reflation’. Since 2009 central banks have injected more than \$19tn into global markets and equity prices multiplied.

The QE cycle began in the bond market. The Fed engaged in ‘Open Market Operations’, buying first mortgaged backed securities and then other bonds, corporate and sovereign, from banks and the state. Bond prices rose significantly, which means that yields (which move inversely of prices) crashed and yield curves flattened. Corporate spreads (the yield a company pays over its’ nation’s yield) tightened. High yield (sub-investment grade) bonds which offered more than 8% to 10% per annum twenty years ago, now offer as little as 4.5%. The UK and US 10-year yields fell to record lows, even near zero at times. Countries like Greece, with a debt burden of over 180% to GDP and no ability to print their own money, may now even borrow at a negative rate, i.e. investors would pay the Greek government to park their money in Greek bonds. At their peak, over \$19tn of global bonds yielded negative rates.



Introduction

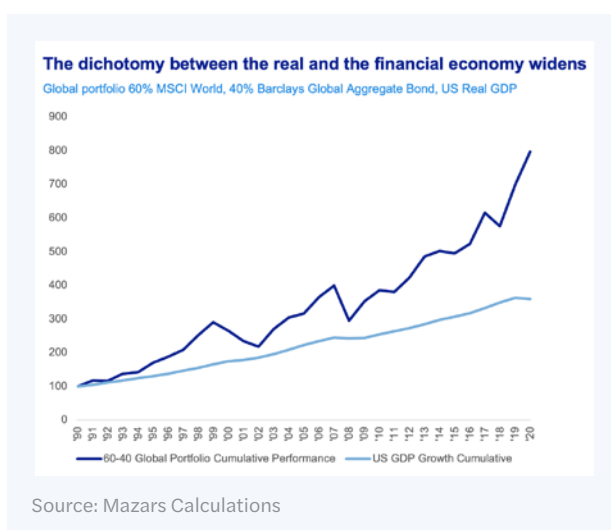
With returns on bonds consistently below inflation (negative 'real' rates) a lot of that money found its way into equity markets. Since the depth of the financial crisis, the S&P 500, the world's leading market indicator, rose almost six times in value, and nearly three times its previous peak.

In a world desperately looking for growth, tech companies, which featured growth rates of more than 10% p.a. for many years, were rewarded handsomely by investors. Consequently, the tech-heavy US market commanded much higher valuations than its European and Asian counterparts. For many years it was evident that the excesses in the real economy, which were often mirrored in financial markets, were now excesses in stock and bond markets which had become increasingly and noticeably separated from the realities of everyday economic life. Income inequality began to soar between holders of financial assets and those whose livelihood was more dependent on real economic conditions. With such good returns in financial markets, underwritten by the state no less, why would anyone take the risk of investing in a slumping real economy? Capital misallocation grew. It was not too long before consumer-voters noticed that the system was hardly working for them anymore, pushing previously fringe calls to disrupt it into the mainstream.

However, the system chugged along. Fearful of disrupting a long, painfully slow and fragile post-2008 economic recovery, central banks continued to fuel and underwrite risk in the financial markets, hoping that eventually the real economy would find its way back to growth. Over time, central bankers conditioned traders like Pavlov's dogs to respond to even the slightest signal from central banks, often ignoring any signal at all from the real economy, including corporate earnings. Fully cognisant that the financial economy could not permanently decouple from the real economy, central bankers eventually began to call on governments to step up and substitute monetary stimulus for fiscal stimulus, which would go directly into the real economy.

Already burdened by debt and fearful of the repercussions, governments chose to ignore those calls. Being the first to increase deficits to fund the economy risked also finding one's government in the crosshairs of 'bond vigilantes', as European nations realised in 2011. Being a member of the infamous PIIGS (Portugal, Italy, Ireland, Greece, Spain), a list of over-indebted Eurozone countries, meant the loss of some sovereignty and a breakdown of the current political order. The political risks of increasing borrowing shortly after the GFC were just too great. As long as financial markets were not at risk of crashing, the consequences of the slow disintegration of the real economy were beyond the horizon of a four or even eight-year term of most elected officials. In short, it was 'someone else's problem'.

Thus, quantitative easing continued to be the 'only game in town' for risk assets for more than a decade. The cornerstone of this house of cards was low inflation, which meant that no central bank would be forced to raise rates and would be able to combat any sign of volatility by increasing or even insinuating an increase, in asset purchases. This gave the banks and consumers time to repair their balance sheets. However, asset misallocation and sluggish investment also meant slow growth for the west. Secular stagnation became the 'new normal' after years of printing money to circulate it in a closed financial system and general unwillingness to generate or ask for credit.



Disruption no.1: The pandemic shock

It became clear that the economic and financial ecosystem, sleepwalking towards the next 2008-like existential crisis, was in dire need of change. With monetary authorities failing to encourage fiscal openings, voters took matters into their own hands, asking for ‘disruption’ across the political spectrum. Yet democracy is a system designed for equality not necessarily for optimal decision making. Many politicians who vowed ‘disruption’ had no real understanding, or even a plan of the system they proposed to change. It took a global pandemic, an external shock to the system, to finally challenge this orthodoxy. Central governments, which had for years drifted apart and failed to cooperate, were almost simultaneously forced to increase fiscal spending to mitigate the consequences of lockdowns.

With the deficit genie out of the bottle and ‘Bond vigilantes’ nowhere in sight, except for a brief stint in early 2021 (when the US 10-year rose from nearly 0.2% to 1.5%-1.8%, i.e. it’s pre-Covid-19 levels) global markets and economies are ripe for change. Inflation expectations (measured by the difference between inflation-linked and normal sovereign bonds) rose precipitously, especially in the US which has been more eager to run high deficits to mitigate the damage from the pandemic. At the time of writing, the US was running the highest fiscal deficit (15%) since the end of the Second World War. The UK was just slightly behind with 14%, while Europe remains constrained near 7%, still much higher than the ‘Stability Pact’s’ mandate of no more than 3%.

The ‘brief inflation’

Global lockdowns stressed supply chains to near breaking point. The first hit came during the acute phase of the pandemic, which featured closed borders, disruptions in production followed by the collapse of Chinese demand in Q1 2020 and a steep recovery in the next two quarters. In early 2021, Chinese demand for shipping containers grew so much that it caused major shortages around the world.

Despite vaccination progress across the G7 and gradual exits from lockdowns of the world’s largest economies, global demand conditions remain erratic. This is causing

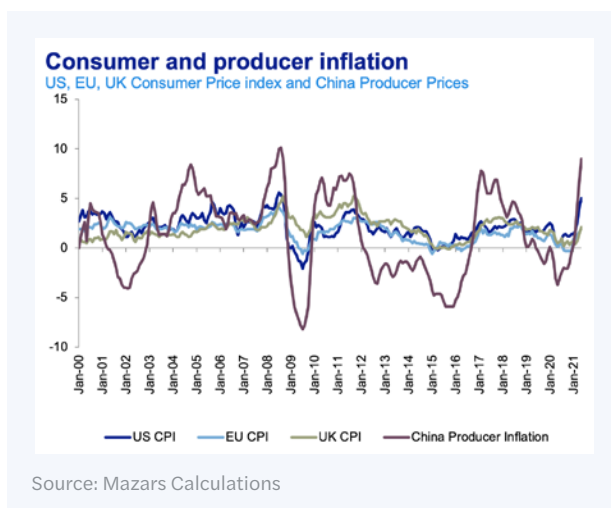
further strain on damaged supply chains. The pandemic has rolled back globalisation, the key driver of lower prices across the globe for decades. Supply chains are not only more localised, but also unable to cope with the spike in demand from the developed world as G7 nations now simultaneously wake up from the pandemic-induced coma with an appetite to spend. Producers are reporting significant shortages in materials, causing price spikes in most global markets. Frictional unemployment is rising, especially in lower paid jobs, as a lot of skilled and unskilled workers are reluctant to go back to their previous employment. As a result, companies are being forced to pay higher wages and offer permanent jobs to lure workers back, especially in hospitality services.

Apart from supply issues, inflation is being driven higher by pent-up demand across the developed world. Companies which had exhausted their inventories didn’t stock up, uncertain about the lockdown measures. As stringency conditions ease across the board, the race to re-stock, along with the extra demand, is causing a surge in input prices.

Higher demand for goods and services and lower supply of both plus labour shortages are an explosive cocktail for higher prices, which may look bigger under the magnifying glass of the current news cycle.

For investors used to the Fed running the ‘only game in town’ however, what matters is not so much the expected impact on corporate margins or the price of goods on the shelves, but what the Federal Open Markets Committee (FOMC) thinks about all of that. For the time being, the American, and arguably the world’s, rate setting body considers all these factors transitory. Supply chain disruptions and frictional unemployment are textbook examples of slack in the

economy, which Fed Chair Mr. Powell and co. expect will be resolved in the next few months. The Fed has lived with higher inflation before and it has indicated that it doesn’t expect a rate hike until 2023.



Disruption no.2: The big fix?

In mid-May, US President Joe Biden unveiled his spending plan. Emboldened by his success in passing a \$1.9tn Covid Relief bill in his first days as President, Mr. Biden proposed an additional \$4.1tn spending plan. This combines a \$2.3tn infrastructure and 'jobs' plan and a \$1.8tn education plan, which aims to ensure two years of free college for all Americans. The plan would have a ten-year horizon and would be expected to stimulate the economy by roughly 1.7% of 2021 GDP per annum for a decade.

Immediately, markets began to wonder: can this Roosevelt-esque plan spur growth and break the 'secular stagnation mindset? We believe the plan is on the right path. Most of the money for the infrastructure bill would be targeted towards improving current failing infrastructure, broadband investing and R&D spending. Moreover, the government plans for a moderated redistribution of wealth to pay for it. This would see higher taxation on very high-income households, which have benefited from Quantitative Easing over the past twelve years and likely have a smaller propensity to spend, with the proceeds directed towards those on lower incomes but with a higher propensity to spend.

Additionally, the US government is counting on increasing corporate taxation at home and pushing for a global minimum tax rate, which should be able to reach companies like Amazon and other global tech behemoths who operate in international waters.

The plan was not tied to taxes however. Failure to pay for it with tax receipts would almost certainly lead to higher deficits and increased borrowing, with the debt most likely to be gobbled up by the Fed. This would fit the definition of so-called 'helicopter money'.

The 'Just So' plan

Janet Yellen, the former US Fed Chair and current Secretary of the Treasury, has made her intentions clear. She wants to

- Stimulate the economy just enough to spur growth
- Wilfully increase inflation in a controlled manner. This would steepen the long end of the yield curve and cause rates to rise slightly.

"If we ended up with a slightly higher interest rate environment it would actually be a plus for society's point of view and the Fed's point of view. We've been fighting inflation that's too low and interest rates that are too low now for a decade [...] we want them to go back to a normal interest rate environment, and if this helps a little bit to alleviate things then that's not a bad thing -- that's a good thing." she said.

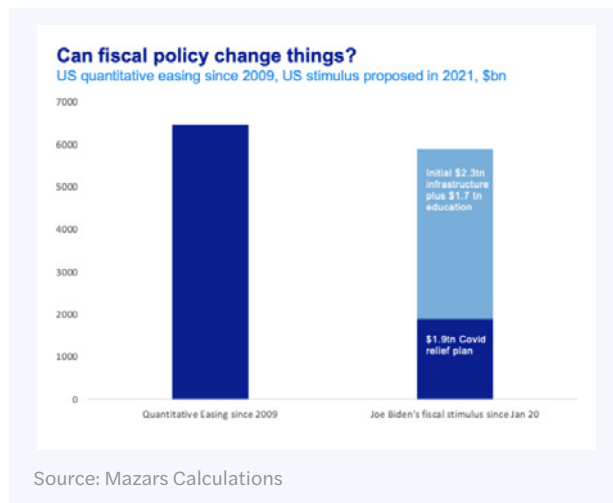
During her tenure at the Fed, Ms. Yellen often pleaded with governments to step up fiscal spending. It is clear that what she failed to achieve as Fed chair, she aims to achieve from a Treasury perspective: to 'normalise' the yield curve. A steeper yield curve would, in theory, encourage lending and unleash some of the economic powers that have been dormant for a decade. Investors would stop relying too much on Fed stimulus, which only circulates in a closed ecosystem and inflates asset prices for a finite number of companies, and would be able to invest more in the real economy for a better return. Also, pension funds and annuities, which rely on steep yield curves, would get a reprieve. Asset misallocation would stop, as cheap funds would not be available across the board, but rather targeted to the most productive companies. This would put pressure on 'zombie companies' and better fund those with real growth prospects.

The lynchpin of the plan, however, is control of inflation. In this environment of faster growth, Ms. Yellen makes two key assumptions which need to be tested: **One, that the Fed will be able to control higher inflation without panicking markets, and two that low supply of credit is a mere result of flat yield curves.**

The plan assumes just enough growth to steepen yield curves and thus no more inflation than can be handled. It also assumes that when capitalism breaks down, the state is able to fix it.

Our principles

The post-Lehman period was a decade of secular stagnation. The pandemic and the fiscal stimulus that ensued may be potent enough forces to change that. From where we are we see four distinctive scenarios: a) An immediate return to 'secular



Disruption no.2: The big fix?

stagnation', b) A stagflationary period and gradual return to 'secular stagnation', c) Managed growth and inflation which could backtrack or eventually lead to d) 'Breakout velocity', a return of sustainable growth-driven demand to the economy.

We assume that other western economies, primarily the UK who want to increase stimulus to counterbalance the effects of Brexit, are likely to follow the US, lest they face significant currency appreciation which might hurt trade, adding to the general pressures of sluggish growth. If the 'debt genie' is out of the bottle for the US economy, then it is easier for other economies to also incur more debt, with the US firmly in the 'debtors' camp.

Before we analyse the scenarios, we need to lay down certain principles which guide that scenario creation.

Re-rating episodes

Equity and bond valuations in the past decade have been underpinned by a singular thesis: increasing liquidity by central banks means that an increasing amount of cash is seeking returns within a limited set of opportunities. This justifies higher equity valuations and is a source of constant demand for bonds, even at negative yields.

As long as the present paradigm, secular stagnation, is preserved, then we would not expect any significant rise in volatility. However, the introduction of a new scenario would probably cause a re-rating episode.

We define a re-rating episode as a brief period of sharp volatility until the new fundamental reality becomes the central narrative for risk assets. Usually, this would last anywhere from one to twelve months, less than in the past as algorithmic trading shortens re-rating periods. It would be characterised by sharp drawdowns and then a rebound in equity prices. However, any 'rebound' would be characterised by significant sector rotation versus the previous paradigm.

Bond prices would probably not recover wholesale. Under any of the alternative scenarios (stagflation, managed growth, breakout velocity) we would expect higher inflation and at the

end of the re-rating episode, a steepening of the yield curve, so at the very least higher yields at the long end.

The end of a re-rating episode should be the basis of the next phase for investment market fundamentals.

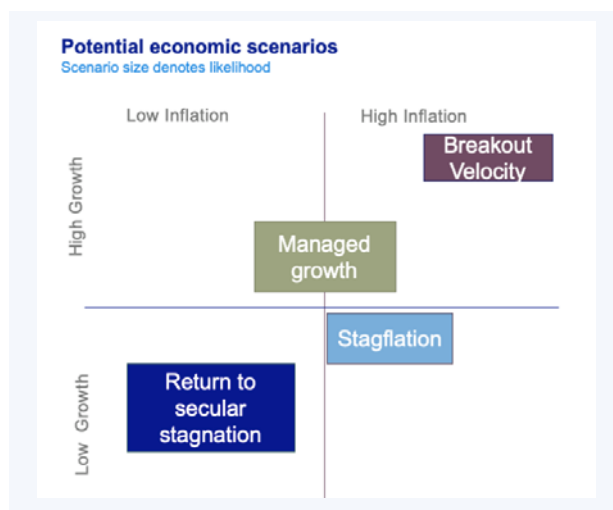
We must caution asset allocators, however, that this is not an opportunity to sell risk assets at current 'high' levels and buy them at lower. For one, we can't be certain that a paradigm shift will occur at all. Also it would be very difficult to time the peak and the trough. UCITS regulated mutual funds and managers at best make marginal gains during a re-rating episode.

Certain 'fast money' vehicles, like hedge funds, could potentially benefit more. But how does one pick the winners? At every paradigm shift there are always those who 'saw it coming', and become the 'gurus' of the new age. Scion Capital's Michael Barry (the real-life manager behind the movie 'The Big Short') is a posterchild for this. Unfortunately, these managers are usually the few that, amongst thousands, were statistically bound to get it right. Picking them in advance is almost impossible.

Instead of trying to time or take risky bets in less regulated investment vehicles, long term wealth managers should make sure that clients are fully aware of a change in paradigm when it is happening, explain what this means for returns going forward, and incorporate new sets of fundamentals in their analysis. The question they should honestly ask at every major turn should be: 'does the system still reward long term risk takers in capital markets?' As long as the answer is 'yes' asset allocation works.

Good versus bad inflation

Investors are right to fear inflation: The Fed's 'Open Market' strategy, quantitative easing, works insofar as money printing doesn't cause inflation. If it does, then the Fed would need a new set of tools, and the paradigm would change. Inflation usually causes rate hikes. It is debatable whether the Fed could hike rates in the real economy, but maintain accommodation in the financial economy.



Disruption no.2: The big fix?

However, as far as rate hikes are concerned, not all inflation is created equal. Rates rise to prevent the economy from overheating. This usually happens during an economic environment when credit is extended, causing a surge in demand faster than the total availability of goods and services can increase to meet it.

Demand-driven inflation is usually tied to credit expansion. However, since the 2008 Global Financial Crisis, caused by the usual over-expansion of credit and greatly exacerbated by the misuse of derivatives, the ability of banks to lend has been significantly curbed.

Rate hikes are a useful tool to stop banks from lending and cool the economy. But how would they work against supply side inflation? In our stagflation scenario, most of the inflation envisaged comes from damaged supply chains and de-globalisation. How would making money more expensive fix supply chains and extend them to other countries?

The last twelve years saw another kind of inflation: asset inflation. Ostensibly, this is innocuous. Quantitative Easing was money printing remaining in a 'closed' circuit. This inflated the value for bonds and equities. The S&P 500 almost tripled its value since the pre-2008 peak. Is this something rate hikes could counter? Possibly, but why would anyone want to stop equity and bond prices from increasing, as long as they didn't pose a systemic risk to the economy? Higher rates could be used to counter inequality rising between those who owned risk assets and those who didn't, but that would seem punitive and possibly undermine liberal capitalism.

What does this all mean for investors: **It means that rate hikes and monetary tightening are not the answer to every inflationary problem.**

While inflation is something to be feared, it does not mean the automatic end of last decade's paradigm. The Fed and other central banks have been very creative in dealing with novel problems in the past 15 years, moving beyond the blunt tool of a central rate. But adjustment may take time. Markets often don't know what to think of new strategies.

Quantitative Easing worked since late 2009, but it took more than five years for investment managers to be convinced about its efficacy. This was enough time for the mutual fund industry to lose its edge, and give way to the rise of passive investing.

Portfolio managers should not repeat the mistake. It should look at the proposed solutions carefully even if this means forgetting economic theory. Assigning the right probabilities to the success and failure of new tools introduced by central banks to adapt to a paradigm shift, will be the definitive factor in the success or failure of the wealth management industry in the next few years.

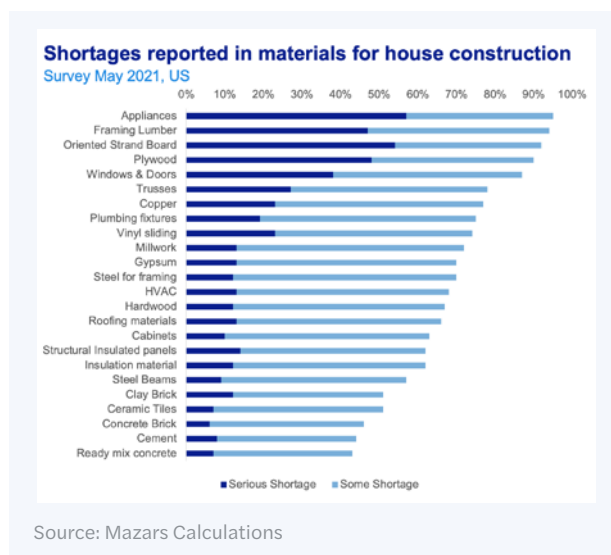
Forget double-digit rates

The 70's and the early 80's saw rates reach higher than 15%. In none of the scenarios we envisaged, even the stagflationary scenario, are rates going that high. The main reason is the large private and public debt overhang. In the 70's, global developed market debt-to-GDP was around 30%. Now it is closer to 100%, and that's mainly because of European reluctance to take on more debt. Private and public debt are close to 386% of global GDP.

And then one has to think about how people will react to rate hikes. The millennial generation, which holds just 9% of global wealth as opposed to the Boomer generation which held 25% at the same age, is suffering from a 20-year stagnation in real incomes. New borrowers have never experienced a significant rate hike, and they can barely afford their house, a consequence of a QE-driven multi-year rally in house prices and other real assets. A brief calculation suggests that if UK interest rates jumped by 5% (an average mortgage rate going up from 1.5% to 6.5%), mortgage payments would rise by 68%. Thus, someone paying £1,600 would face payments of £2,700.

The difference would be significant for most borrowers. A 10% interest rate would result in a virtual doubling of payments. The social consequences would be simply unpalatable.

What does this mean for investors? That the 70's and the 80's, which featured interest rates up to 15%



Disruption no.2: The big fix?

are not the most trustworthy guide for investors. It is questionable whether, whatever the inflation, central banks can even combat it with higher rates at this point. In fact, absence of inflation in the past twenty years and the GFC have shifted the real goals of central banks altogether. Under the mandate of fighting unemployment, central banks are now much more focused to curate national growth. A national focus leaves the future independence of central banks in question.

Analysing our scenarios, we will only use some but not all the lessons of the 70's and only in a very broad context.

Banks and big state

The debate between whether 'big state' should be a feature of liberal capitalistic economies has been raging for decades. On the one side of the argument one would find John Maynard Keynes, FDR's 'New Deal' and Lyndon Johnson's 'Great Society'. On the other, Andrew Mellon, the '20s US Treasury Secretary, the US forced departure from the gold standard in the '70's, Reagan, Thatcher and Milton Friedman.

It would ostensibly seem that FDR's 'New Deal' won the argument, bringing the US economy back from the biggest shock it ever experienced, the Great Depression in the 30's. However, we feel that a more careful read of history would disprove that. The US economy did improve after Roosevelt's election in 1932 and the first unemployment benefits. However, it was back in recession by 1937. It took the total destruction wrought by the Second World War, and the need to reconstruct the whole of Europe and parts of Asia for the economy to boom again.

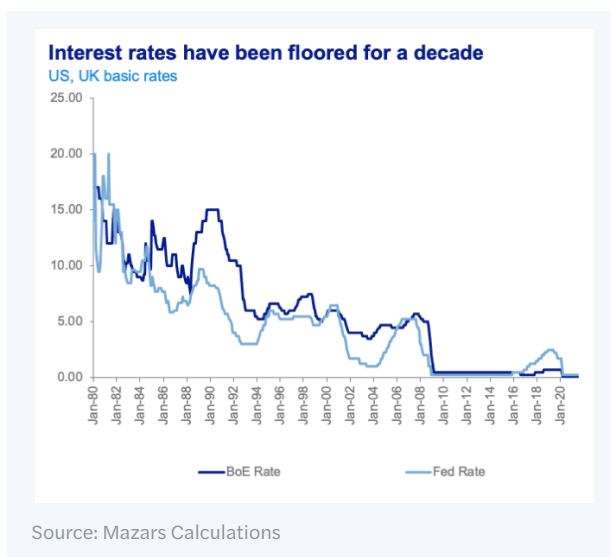
In the late 60's, Lyndon Johnson tried a great fiscal expansion project again. Initially it worked, but within a few years, the economy was in the doldrums and the US was forced out of the gold standard.

Ronald Reagan and Margaret Thatcher attributed the economic success of their programmes to breaking the unions and 'trickle down' economics. However, another more careful

read of history would reveal the gradual erosion of the Glass-Steagall act, a 1930's regulation that prevented banks from leveraging deposits to create credit. As US banks deregulated, others followed. The 90's and the 00's, the two decades of great economic expansion and unprecedented affordability of houses, technology and consumer discretionary items were marked by the combination of two factors: an exponential increase in availability of credit and deflationary pressures brought forth by the industrial ascension of China. As for 'trickle down' economics? During the decade of QE, when money printing benefited holders of risk assets (usually higher income consumers), savings rates went up and real investment remained lacklustre. Income inequality became so pronounced that it challenged the established political order and caused organisations like the IMF and the OECD to warn developed nations about the long-term repercussions. Wealth didn't trickle down. It was stored and invested in financial assets.

Glass-Steagall didn't remain dead. It rose again in a different form. After the Global Financial Crisis, policy makers vowed to 'never again' allow banks to hold such sway over the lives of their constituents. The Dodd-Frank Act, passed in 2009, was aimed at restricting the ability of banks to mitigate risk to other banks. One provision, the Volcker Rule, was specifically aimed at stopping banks from making speculative investments, which, apart from improving bonuses and profits, also allowed the institutions to further extend credit. The act also repealed the exemption from regulation of security-based swaps. This meant less of an opportunity to leverage the bank, but also fewer modern tools to

mitigate risk. Another piece of regulation, Basel III, a global voluntary regulatory framework, is aimed at making sure that banks hold adequate capital, stress test regularly and make sure their collateral is liquid enough to cope with loan losses. It does not just make sure that banks remain fit. It wants to make sure they show up at the gym every week. As a result, banks could no longer take too many risks with loan provisions, as the collateral



Disruption no.2: The big fix?

requirements were higher, and they were much more limited in how they handled the risk.

Credit: What is it good for?

For an economy to grow, it primarily needs **population growth**. Fertility rates for western societies have been dismal for decades. Failing that, it needs a **technological breakthrough**, which exponentially improves productivity (like steam which brought the industrial revolution or the internal combustion engine which gave birth to mass production). Unfortunately, technology hasn't produced breakthroughs like that in decades. Quantum computing, artificial intelligence, new forms of energy (like fusion or 'green hydrogen') always seem to be ten to fifteen years away. Nuclear energy is tainted since Chernobyl. The last solution is **credit expansion**. If a society can't create wealth at a fast enough pace to satisfy the population, it might as well borrow it. Concomitant with that course of action are booms and busts. Credit always seems to follow a familiar pattern, where it starts off benignly, but over time it proliferates and then implodes. Hyman Minsky famously described those five-to-six-year cycles, although the timeline could vary.

However, neither theory or practice support the state being the primary actor for economic growth. In eastern communist systems, big state, by and large failed. The Soviet Union eventually collapsed, as did all the satellite states. When the iron curtain fell in the late '80s the depth of corruption and malaise in the population was revealed. Some would argue that western liberal capitalism is again fighting for supremacy against the state-driven model of China. However, it is questionable whether one can compare China, a huge country that only in the last few years decided to industrialise, against the West, industrialised for over two centuries. As such, Chinese growth rates don't necessarily prove the supremacy of a state-driven model, nor do they in anyway imply that if the West adopted a more centralised way of government, output and wealth per person would increase. At any rate, the model is coming under increased scrutiny. First, low returns from state owned enterprises meant

chronically lower valuations for Chinese companies. Second, the virtual dismemberment of Jack Ma's Ant Group and Alibaba indicate that political concerns might supersede business interests and thus growth potential. Third, competitive tensions with America are quickly heating up over the issue of the pandemic, which could seriously question China's ability to provide global, or even regional, leadership.

From a western perspective, 'big state' has time and again proved its efficacy as an emergency backstop, when capitalism falls short and the 'invisible hand of the market' fails to materialise. But it has never really proven its worth as a long-term purveyor of growth. A well-organised state can provide the business rules, the environment, the policing and even the impetus for growth. But, in the modern world, it is questionable whether it can substitute private enterprise. Twelve years of quantitative easing, in essence the state underwriting investment risk, have been very beneficial for equity and bond markets. Conversely, the real economic benefits of the practice, other than the initial stabilisation of the financial system, have not been proven. If anything, the dichotomy between the real and the financial economy became so pronounced, as to question the importance of equity and bond markets in the good functioning of the capitalist system altogether.

Where can credit come from. Private investors hold a record amount of dry powder, nearly \$3tn, a nine-fold increase over the past 20 years, according to a report by Mercer. But that capital is more inclined to go to high growth innovative companies and not to run-of-the mill enterprises that form the backbone of a western economy.

The level of growth in the '90s and 00s in western societies proved the value of unfettered credit

creation in creating economic impetus. The longer-term repercussions of the practice are also well known. And the fact remains that twelve years of restrictive legislation have made banks fearful of extending lending. During the recent Covid-19 epidemic countries tried to extend credit by underwriting as much as 95% of loans. In the US, banks were still reluctant to take a risk



Disruption no.2: The big fix?

even for the remaining 5%. And where risks were taken, to absolutely credit-worthy businesses, it is questionable whether the provision of capital was entirely needed to keep the business afloat, or just used as a precaution.

What does this mean for investors? Simply answering an old question: **can there be a recovery without banks? The answer, after a decade of secular stagnation, is 'just barely'**. For an economy to thrive without population growth or a technological edge, it must accept credit as its lifeblood and the best mechanism to allocate capital. This is why we distinguished two scenarios, that of 'managed growth', a shorter-term period where Ms. Yellen's efforts to kickstart a different cycle in economic growth through targeted stimulus succeed, and 'Breakout Velocity', a more permanent situation which would require some bank-deregulation before it became reality.

A US-centric world

This publication is produced by a British wealth manager, yet even the lightest read would find its content relates more to Americans. This is because we believe that, despite the increasing fragility of the post-WWII international order, the global economy is still very much US-centric. This means that the world's largest economy and home to the most potent consumer sets the tone for what other similar economies, like the UK, will do. Higher interest rates in the US are often, though not always, followed by higher interest rates in the UK. It is the same with fiscal easing. If the US stimulates unilaterally, the Dollar would weaken. This would leave Sterling and the Euro more expensive in terms of trade against a major trading partner. To balance their currencies other countries would have to follow.

The assumption in this paper is that they will. That the world remains US centric and that, forced to choose, western societies will prefer the liberal capitalistic model than the Chinese state-driven paradigm.

Having said that, we also fully understand that massive fiscal stimulus is easier for a country that holds the global reserve currency. When other countries run high deficits, this will have an effect on

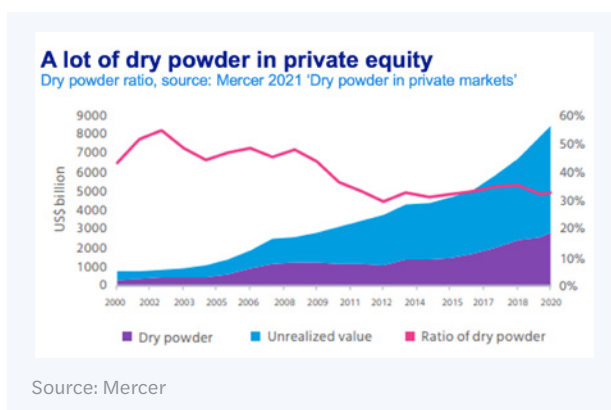
their currencies and be a source of external inflation. Thus, the US may lead and others follow, but there are limits to how much and for how long.

This time is (always) different

When faced with an uncertain future, we tend to look to the past for answers. However, we feel the need to clearly state that looking at the past can be used only to draw ideas, and not definitive conclusions about the future.

A post-pandemic world is dawning. The first time in modern history that the most powerful economies on earth simultaneously shut down for any reason. The after-effects are unknown. As are the after-effects of a first-time global agreement on corporate taxation, expected in June. It is also a time of unprecedented globalisation. As such, even de-globalisation is a new concept. It is a time of unprecedented debt. Combined private and public debt to global GDP now exceeds 386% by some calculations. Never in modern times have economies in the East threatened the primacy of their western counterparts. Never have we seen such a divide between the real and the financial economy. Never have we had to calculate the effects of environmental shifts in economic projections, at such a large scale.

This moment in history is unique. In fact, history, economic or otherwise, is not about perfect cycles. No one goes back exactly where they were in the past. It is simply about similarities between the present and the past that may allow an informed assessment about the future. What this means for our own scenario building? That we will not look to the past to derive an exact footprint of the future but to gauge the reactions and heuristics of markets, especially when a certain set of conditions occurs. But this will be done on a tactical and not a strategic basis.



The four scenarios

Scenario 1: A return to secular stagnation

The status quo, whatever the circumstance, is the most prevailing scenario. The pandemic may have disrupted business models, but in and by itself it is not an event which would conceivably force either consumers to ramp up spending over the longer term or banks to increase credit. If anything, the outright effect of a pandemic, on top of a forever-economic-crisis would be to exacerbate caution and attitudes towards risk.

The first scenario assumes that either the US spending bill doesn't go through, or if it does it is significantly compromised versus its' original scope.

At the time of writing, questions were raised as to how much spending the Democratic Party could get through the Senate, where committees are equally distributed and some Republican concessions would be required. At any rate, the end result would be a tighter fiscal policy than projected and retraction of the Covid-19 era stimulus.

Economic implications

This scenario, a mirror version of the recent past, would see developed real market growth at 1.5%-2%, emerging market growth settling at around 5%, and US inflation (core consumption expenditures rather than the CPI basket) below 2% (currently at 3%). While post-pandemic de-globalisation forces would remain potent, lack of significant demand for goods and services would, over the longer term, counterbalance whatever inflationary forces arose.

In this scenario, consumers would continue to prefer saving to spending and remain in balance sheet repair mode, with savings rates north of 6%.

Investment in the real economy would remain subdued, after a modicum of supply chain re-localisation is completed.

In this environment, monetary stimulus or major shifts in corporate and private tax laws would probably continue to drive risk assets, more than underlying earnings, which themselves should not be too exciting. Investors should continue

to invest more in the financial rather than the real economy, because this is the place where risk is explicitly underwritten by the government. New venture creation would remain subdued, especially for run-of-the-mill ventures, like clothes stores, dining, and other business models facing their own existential issues. Private capital would of course pour its amassed dry powder in companies with high potential growth rates, such as the technology, telecoms or green energy sectors. Capital misallocation would continue to feed inequalities, which should continue to exacerbate political tensions. The labour market could well continue to feature near zero structural unemployment but that does not mean that NAIRU (Non-Accelerating Inflation Rate of Unemployment), i.e. the threshold at which unemployment becomes inflationary, will be hit. The reason is low labour mobility, low participation rates and a long-time propensity of employers to substitute higher wages with work perks, such as agile working, cars for employees, cheap loans, in-house nurseries and other non-wage forms of compensation suited to a lower growth world.

Banks would remain constrained in terms of loan creation, due to both regulation and low demand for credit, by both corporations and consumers. As a result, house price growth would eventually deflate once various government support programmes end and building material prices flatten out.

The government debt pile would remain high, and governments would have a difficult time reducing debt levels, especially at this low growth / low inflation environment. However, markets are comfortable with the idea of elevated debt levels, as

long as interest payments don't eat too much into growth (this should not happen until 5 years' time) and as long as low and even negative rates allow governments to refinance at low rates.

Markets continue to be supported by central banks
S&P 500 and Fed Balance Sheet Assets



Source: Mazars Calculations

The four scenarios

Scenario 1: A return to secular stagnation

Investor's playbook

The implications for a reversion to a secular stagnation environment for risk assets are all-too-familiar to investors.

The combination of high private and public debt burdens and a generation of borrowers who haven't seen significant rise in interest rates make significant rate hikes prohibitive.

Nor would there be a need for hikes, with long term inflation persistently below 2%, even in the face of low unemployment. Interest rates could be raised by 1.5% to 2% at peak, with an average rate nearer or below 1% during this period. Monetary policy would continue to constitute the most significant pillar for risk asset growth and the Fed will continue to expand its balance sheet at times of asset distress, without much hope of contracting it afterwards. Brief and paced quantitative tightening attempts will probably be made in times of economic expansion and market bullishness, but they will be outweighed by the breadth of quantitative easing.

Overall, central banks should be able to continue to suppress volatility, as long term inflation would not be enough to impede market actions.

In this scenario, yield curves would continue to remain flat and corporate spreads tight (a result of ample liquidity). After a Covid-related surge in default rates (5.5% speculative grade defaults in 2020, up from 2.5% average in the previous decade) we would expect long-term corporate defaults to drop to near zero for investment grade bonds and 2%-3% for speculative grade. Having said that, we also expect dispersion within these numbers, with energy default rates subsiding, after a spike in energy prices, while certain consumer segments and leisure will continue to come under increasing pressures as the sectors restructure as a result of the pandemic. Corporate spreads should eventually tighten again, as the liquidity blanket encompasses all sectors.

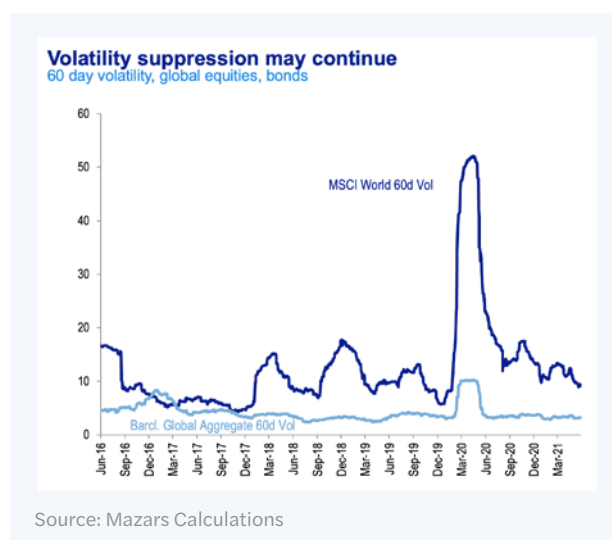
Given low bond yields and the 'failure to launch' for the long end of the yield curve, we would expect equity

returns to remain above average, as the asset class increasingly represents a finite (and often dwindling due to share buybacks) opportunity set for a large amount of money.

While currencies are very hard to predict, in this scenario we would expect a stronger Dollar, as right now much of the stimulus has been priced in. The Pound, on the other hand, could weaken, as realities of a harder Brexit begin to emerge. The Euro could once again find itself in hot water, not due to the ECB's stance, which will probably continue to be very supportive, but because of the fiscal effects of lower stimulus on economies already strained by years of austerity and high debt.

Equity risk premiums (what investors get paid to take risks, defined by the difference in average market returns against the risk free rate) should remain elevated in the next few years, as equity returns could be higher than normal and sovereign bond returns low. This means that a balanced portfolio would find it very difficult to justify an overweight in bonds for the foreseeable future.

In this environment, 'Beta' strategies (those that attempt to time the market) and passive investing could very well continue to drive returns for many balanced portfolios. Traders and tactical asset allocators would wait for 'dips' -however shallow- to add to their risk assets. Eventually market attention would tilt back to 'growth', as private money would naturally focus on high growth (listed or unlisted) companies, and investors would be happy to pay a premium in a world that is growing less than average.



The four scenarios

Scenario 2: Stagflation – ‘That 70s show’

This scenario makes two assumptions:

- a. That the post-Covid world will be a variant of the previous ‘secular stagnation’ one, but with more inflation.
- b. That US, UK and other fiscal stimulus efforts will not go nearly far enough to break the ‘secular stagnation’ mindset and unleash dormant economic forces over the longer term, but over the shorter term they could cause an inflationary surge in demand.

In our scenario, inflation remains at roughly double the level of the Fed’s target, 4%-4.5% for long enough to make the central bank uncomfortable. However, depending on the degree of supply chain disruptions, we would not generally expect it to last more than 2-3 years. It’s a scenario that, all other things being equal, eventually leads back to secular stagnation.

The question most frequently asked is ‘where will inflation come from?’. A reasonable question considering that since 1982 inflation only briefly ever surpassed the 5% mark.

In the past few years, we have often said that we do not subscribe to Milton Friedman’s aphorism that “Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output”. Friedman’s assumption was that when people have money they would spend it. But quantitative easing was about monetary expansion that was specifically designed not to reach consumers, but financial markets. Thus, consumers had neither the means, nor the inclination to increase spending despite the record rise in money supply.

So where could this inflation come from? We consider a variety of sources:

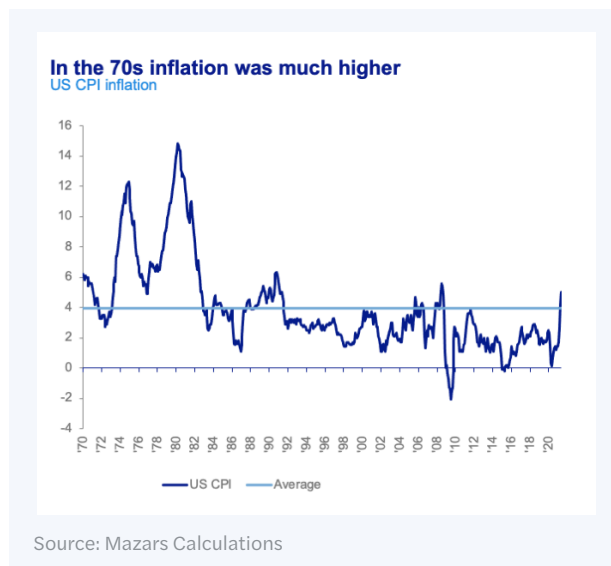
1. **Covid-related fiscal stimulus retracted but not fast enough** to prevent a surge in industrial demand, as governments could simply not go far enough in terms of stimulus, not spend the money in the right way, or even make a U-turn for reasons of

political expediency. Meanwhile, emboldened entrepreneurs and corporations will have logged big orders to beat competition and not find themselves waiting in the queue for goods and services.

2. **Green energy initiatives:** the shift towards the Paris Agreement target, with the US re-entering the agreement in 2021, will have some definitive inflationary implications. According to the IMF, more than 6% of global GDP (over \$5tn) is being spent on fossil fuel subsidies. This means governments making tax or other cuts to keep prices at the pump low. Withdrawing these subsidies would be a necessary first step towards a ‘greener’ future. However, this would also inevitably cause a spike in energy prices which would feed along supply chains. Apart from government subsidies, corporations across the world are trying to implement ESG (Environmental, Social and Governance) mandates. This means more costs, initially, which could be passed on to consumers. While some industries would see increased growth, we would consider that the costs to supply chains and hits to margins, some of which would translate to higher prices, would initially far outweigh the monetary gains from a more environmental-friendly approach.

The next three sources of inflation are really one scenario, that of supply-side inflation, with different degrees of intensity.

- 3a. **Supply chain issues becoming chronic:** supply chains have been seriously disrupted by the pandemic. While we assume that most problems will be resolved, the fact of the matter is that the pandemic is still very much alive and with every passing day the scars left in supply chains are deeper, and perhaps more permanent. Already, chip shortages threaten the supply of new automobiles until mid-2022. We would expect disruptions to continue for some time, causing, if not widespread, then targeted inflation in certain industries.



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Scenario 2: Stagflation – ‘That 70s show’

3b. De-globalisation. Covid-19-related travel and trade restrictions and growing animosity between nations over vaccine distribution and blame over the pandemic, on top of already brewing trade wars across the world, make for a very explosive mix. This could conceivably threaten globalisation, at least in the short term. Supply chains are already being re-localised. Globalisation has been the key deflationary driver in the past two decades so it stands to reason that de-globalisation would have the opposite effect. After four years of US efforts to ‘re-shore’ industry, the EU is already considering an approach which would see ‘strategic industries’ re-shored back to the continent. Having said that, even in this scenario, we would expect de-globalisation forces to eventually subside, at least at a corporate level.

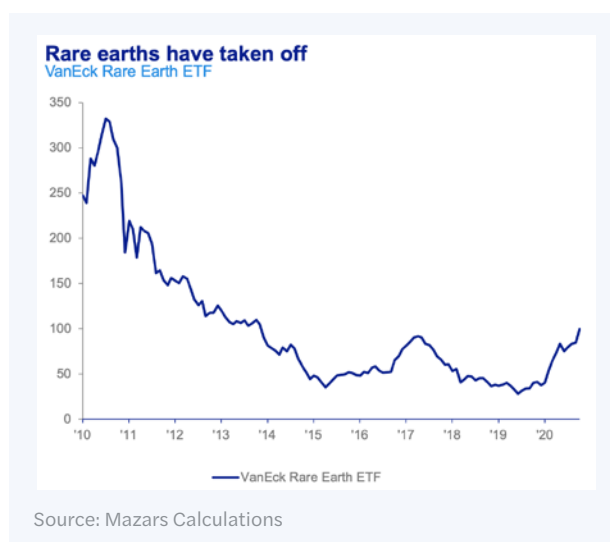
3c. Strategic resource inflation. An extension of the previous scenario would be a full-on trade war between the East and the West, which could see an embargo of some key exports to the west, similar to the 70’s. The most likely point would be the rare earth metals. Rare earth metals are mostly used as important chemical catalysts and magnets. They are essential in the production of electronics, green technologies (wind turbines and hybrid cars), car converters, X-Ray and MRI systems, aircraft engines, visual displays and others. 85% to 90% of the rare earth trade originates from China. In the 70’s, two oil embargos from the east to the west, one after the Yom Kippur War in 1973 and the other after the Iranian Revolution in 1979 caused massive spikes in inflation. Shortages in the many products that depend on rare earths could do the same. While China has built a strategic reserve of these materials, it is questionable whether western economies have made the same preparations.

At this point we need to make a geopolitical acknowledgement. China and the US have had a strong inter-dependent relationship for decades. China would be the world’s cheap manufacturer, and

in return for the growth, it would gobble up US debt and export deflation. After the Global Financial Crisis, China realised it needed to reduce its exposure in the US financial system. It was time to move from the secondary economy to the tertiary. The US, on the other side, discovered a new buyer for its debt: its’ own central bank. As a result, the relationship changed. Over the years it became increasingly antagonistic, to the point of a trade war confrontation. Expecting China to go back and export deflation to the world is probably a misguided effort towards mean reversion.

There are also places from where we do not necessarily expect inflation. Generic commodity prices which are spiking at this point (like oil and lumber) should see a normalisation in demand patterns. In the case of oil, the US is now a net exporter of oil (especially at prices over \$50) and generally the West has at least 90-days strategic reserves to prevent a repeat of the 70’s. In this case, even if prices remain elevated, the pervasive effect of an inflationary cycle (prices going up and spiking unexpectedly for a long time) will probably be avoided and price hikes will be a one-off. In this scenario, we also do not expect to see low unemployment driving inflation. For one, unemployment levels could be higher. Also, employers have adjusted to a low growth world and they have learned to provide alternative means of compensations. Evidence from the past few years suggest that the Phillips curve (the inverse relationship between very low unemployment and inflation) is simply not working. Finally, we do not expect major changes in the monetary system, such as the ‘Nixon Shock’ in 1971, the departure of the US from the Gold Standard and the introduction of ‘fiat’ currencies, which could well have been another major source of inflation in the 70’s.

In this scenario, we do not expect to see either inflation anywhere near 10% or 15%, like in the 70’s, or rates peaking at 20% like in the early 80s. Why? Because a lot of the above scenarios suggest supply-side inflation. Supply chains are much more sophisticated today, so that



The four scenarios

Scenario 2: Stagflation – ‘That 70s show’

type of inflation could be more easily countered with re-globalisation efforts than it would with higher rates.

We tried to analyse what the environment will look like. We have used the 70’s as a very broad proxy for economic repercussions and asset prices in a ‘stagflationary’ world. However, we have to note that our conviction is low as the 70’s featured a very specific set of circumstances and we would not expect the repetition of those exact same conditions. In other words, ‘stagflation 2022’ could look very different to ‘stagflation 1972’.

Economic implications

The stagflation scenario is by definition one of slow growth, c. 1.5%-2.5% in the US and maybe 5% in the emerging markets. While not too dissimilar from ‘Secular Stagnation’ in terms of output, it assumes that the above-mentioned factors (fiscal stimulus, green energy, supply side) cause inflation higher and for longer than the Fed had planned. We would assume US Core Personal Consumption Expenditures around 4%-5%.

In this scenario, consumption would remain subdued and instead ‘savings’ would be transferred into financial markets and real assets. The ‘savings rate’ could remain high, 5%-6% but a lot of that money could find themselves in the financial markets or gold, despite the latter’s insufficient record as an inflation hedge.

Except for real estate, we would expect investments in the real economy to remain fairly subdued. After an initial bout of investment due to re-shoring, a result of persistent supply chain disfunction, we would anticipate companies will grow operations mainly through acquisitions rather than risk expanding organic capacity.

It would be interesting to see if a 70’s scenario would also bring with it the fabled ‘Philips curve’ which was constructed to express conditions in that exact time. However, even if it did re-appear, unemployment is projected to remain higher than the average of the previous decade, around 7% in the US and the UK and higher yet in Europe, which features different employment structures.

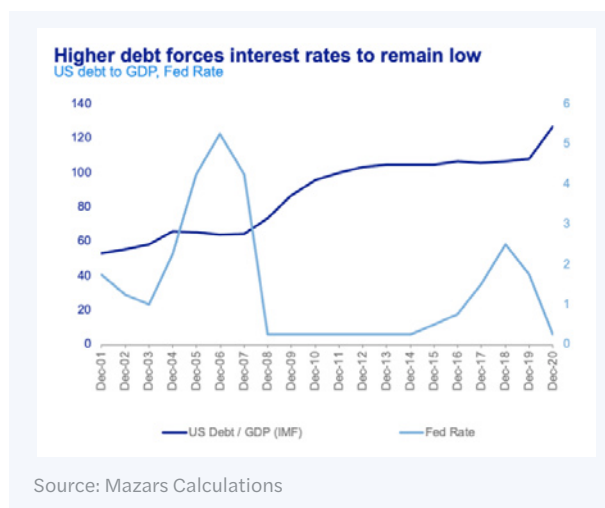
Stagflation could see a rise in long-term rates which would increase availability of credit, but not necessarily demand. While it makes sense to borrow at an environment where inflation is running hot but rates can’t go very high due to high existing debt burdens (in fact overall real debt levels should drop), low growth would probably hinder demand for commercial loans. In this environment we simply don’t see much room for healthy new venture creation.

Investor’s playbook

A stagflation scenario would see higher interest rates, from 3% on average to a 6% peak. However, given the private and public debt burdens (US public debt to GDP was 30%-35% in the 70’s and 127% today), we don’t think that central banks can conceivably approach double digit interest rates like in the 70’s and the early 90’s. In that spirit, we would not expect significant quantitative tightening, as this happens only in times of market and economic bullishness. Similarly, we don’t expect further easing, as it could fuel inflationary pressures. Thus, stagflation would be a scenario which would render the current Fed policy irrelevant very quickly and without much time for markets to adjust.

As with any scenario that materially deviates from the status quo, we would expect a modest re-rating episode for all risk assets. Overall equity volatility should be higher than in the past decade (around 15% up from 12%-13%), as central banks will have to stop risk suppression. Equity returns should fall from a present 9% to 10% to a 5%-6%. However, we expect equities to remain the most attractive non-real asset class.

The re-rating episode should have significant repercussions for bond yields, until they settle at levels higher than today. Having said that, because of expanded central bank balance sheets, overall yields should be lower than average for the same levels of inflation in the past. The yield curve should be volatile and somewhat steeper. Corporate spreads will be wider, as risk suppression stops. We would expect higher default rates in the high yield space, around 5%.



The four scenarios

Scenario 2: Stagflation – ‘That 70s show’

As a result of stimulus retracted, the Dollar should eventually be stronger. Conversely the Euro, moving less due to economic fundamentals and more due to outside stress factors, would find itself in danger in such a scenario. It is not inconceivable that some European countries will seek to regain control of their monetary policies in times of economic distress. All other things being equal, the Pound would be slightly stronger versus the Euro and weaker versus the Dollar.

Equity risk premiums overall should be lower than present, as risk free rates would rise and market returns would fall. Still, asset allocation would remain equity-heavy, at least until bonds yields reach a new equilibrium where long term yields would be closer to equity dividend and earnings yields.

In this environment Alpha (stock picking) would be much more important than Beta, and managers should be able to benefit from various inflation trades. In a secular stagflation environment, overall returns will be muted for some time (at least 2-3 years) so investors would probably prefer to sell on strength than buy on weakness. Historically value should outperform growth. However, some growth companies should continue to benefit from higher valuations, as investors would find refuge from inflation in earnings growth.

The four scenarios

Scenario 3: Managed growth

In mid-May 2021, Janet Yellen suggested in an interview that higher rates would be good for the economy overall. Earlier comments also cautioned the Fed to prepare for higher rates if the economy overheats.

This is the ‘managed growth’ scenario, the idea is that the government stimulates the economy ‘just so’, at the pace of 1.7% of 2021 GDP for a decade. The plan would see a normalisation of a number of economic variables like the yield curve, to pre 2008 GFC levels and eventually unleash dormant economic forces. The economy would achieve growth higher than the previous 2%-2.5%, possibly up to 3.5%. In this scenario, inflation would remain tame, but still higher than the Fed’s 2% target, possibly at 2.5%-3%, just barely low enough for the Fed to tolerate before it would embark on a significant rate hike cycle. The idea is that the top interest rate would not exceed 3.5% to 4% to avoid stifling growth.

Ms. Yellen is no stranger to ‘secular stagnation’. A former Fed Chief herself, she knows that the lopsided effects of stimulating the economy only on the monetary side end up benefiting mostly stock markets. Conversely, the effects of QE on the real economy, beyond restoring faith in the banking system, are questionable, and possibly really just lead to significant asset misallocation.

How would the government pay for it? Mr. Biden’s plan seeks to raise taxes for high income families and corporations. In theory, a modicum of wealth redistribution would decrease savings rates (higher income households have a higher propensity to save) and correct some of the inequality excesses from the twelve-year quantitative easing period. In practice, however, we suspect that a razor-thin majority in Congress would prevent tax hikes, especially for corporations. This would mean that the government would have to rely on the Fed to create ‘helicopter money’. The Treasury would issue new debt and the Fed would be happy to buy it in exchange for cash. The result would be even more expanded central bank balance sheets and higher deficits, c. 5%-7% for the next three to five years and debt.

The risks with this scenario are a) its underlying assumption that the state can direct growth in a western liberal economy and b) it’s laser-focused requirements on specific growth and inflation with little leeway at either side. The state’s ability to correct excesses of the free market is well documented. But its ability to do much more is very much in question (see previous section ‘Banks and Big State’). This means that Ms Yellen’s scenario, which assumes that growth and inflation can remain within limits manageable by the Treasury and the Fed and not breach the Fed’s targets at either way, is a very targeted one. ‘The best laid plans of mice and men’, a cynic might call it.

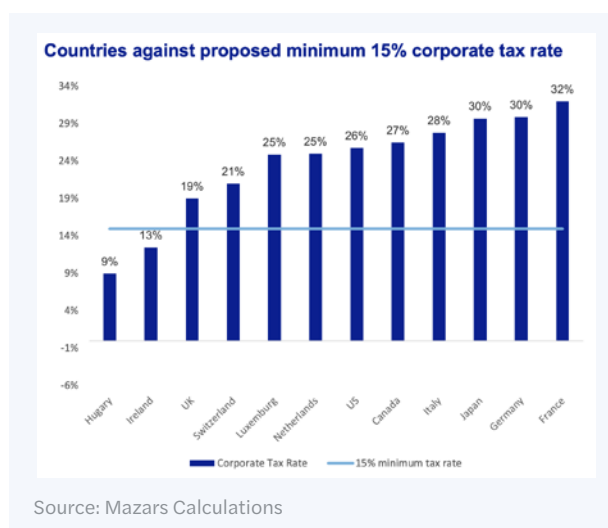
Still, we believe that the proposed stimulus by the Biden government is the best chance for the economy to break ‘secular stagnation’ to date. A \$2.3tn plan directed towards research and infrastructure over a decade would create jobs and improve productivity. A \$1.7tn plan to send people to college for at least two years should not be discounted as a ‘long term’ project either. The effects on improving the demand and supply of higher end jobs in the US, as well as the levels of civic satisfaction could potentially become evident within the next 3-4 years.

A caveat: It is highly questionable whether US political realities in Congress will allow the plan to go through as a whole, in increments or whether key pieces of legislation will have to be removed. At the time of writing, it looked like the plan would be confined to \$1tn in infrastructure, a quarter of the original intention. We believe that if that ends up being the case, the probabilities of a return to ‘secular stagnation’ grow much larger.

Economic Implications

In this scenario, assuming that the plan goes through Congress as a whole in the next two years, western economies could see persistent growth at 2.5%-3.5% per annum for at least half a decade, and emerging economies experience growth of nearly 6%. Overall, economies which benefit from higher exports should see improved output.

US inflation, measured by core personal consumer



The four scenarios

Scenario 3: Managed growth

expenditure, does not surpass 2.5% to 3% and doesn't force the Fed behind the curve, triggering emergency rate hikes.

Breaking the 'secular stagnation' mindset, would mean that people reducing savings rates from 6%-7% to maybe 4% - 5% and becoming more optimistic about consuming goods and services even if they can't afford them right now. As consumption and consumer optimism pick up, so would real investment. Allocations to productive real assets would increase, as opposed to investments in the financial economy. Higher rates and lower QE would mean a smaller safety net for investors in the stock and bond markets, changing the risk/reward proposition which for a decade drove investors away from investing in the real economy. This would mean an increase in organic capacity for businesses, which in turn would mean more jobs and higher inventories. To expand, companies would again look towards having an edge in manufacturing costs, so they would once again seek to off-shore parts of their supply chain, kickstarting globalisation again.

Employment would not only expand, but the quality and pay of jobs would improve materially. In fact, in this scenario, inflation is 'good' as it comes from wage growth and not supply chain pressures. Inflation would also probably be exported from the West to the East, as companies might compete to gain access to better labour in Asia.

Breaking 'secular stagnation' and improving confidence would also mean a material rebound in demand for consumer and business loans. Banks, albeit still constrained, would benefit from a steeper yield curve and increase lending, creating new money in the process. The private market would also step-up provision of money for businesses, although they should still be careful with their dry powder as higher risk loans come without any assurance of a bailout. However, with banks on the conservative side we would expect more financing for established businesses and new venture creation to focus on growth businesses.

In this scenario, house prices across the G7 economies would pull up, a result of more fiat currency creation and thus a greater appetite for real estate from an investment standpoint. We would also expect higher consumer demand for houses, a result of improved confidence especially amongst the younger consumers.

Debt of course (currently 127% of GDP for the US and 114% for the UK) would rise significantly, however most of it would be low interest and owned by the country's central banks. This would mean that debt restructuring, like an extension and/or lower coupons, would be easier.

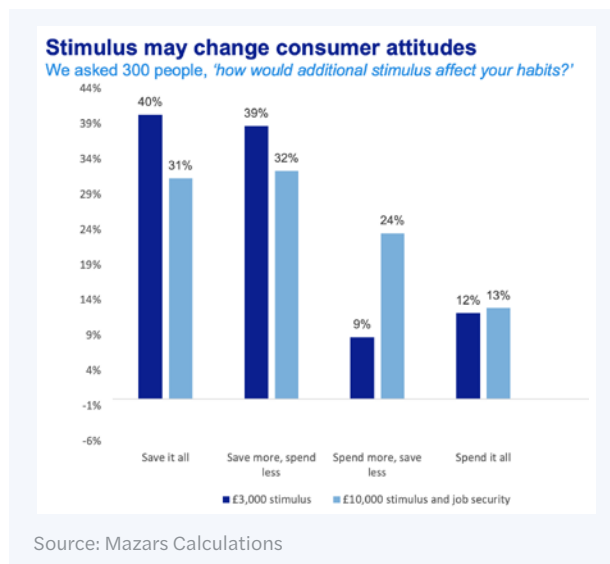
Investor's playbook

As we discussed, we would expect an average interest rate of 2%-3% and a terminal interest rate of around 4%. This scenario would also feature a significant re-rating episode, which would mean a sharp and short price correction for both bonds and equities, significant sector and style rotation, with headline equity indices eventually adjusting to new fundamentals. Overall, we would expect long term equity returns to be around 6%-7%, proof that prices can rise under a non-QE regime but also lower than the 8% average due to the absence of leverage. Bonds would eventually settle at a steeper and higher yield curve than today until a point when a fixed income overweight for a balanced portfolio might again become plausible. We would expect corporate spreads to widen

Apart from higher rates, the Fed would sustain an expanded balance sheet, and much like in 2018-2019 it would take advantage of economic and

financial 'Green Shoots' to try and reduce the size of its portfolio. Having said that, we would not expect a significant further expansion of asset purchases, beyond what may be required during the re-rating episode to keep markets calm.

We would expect to see a sharp increase in default rates, not just because of Covid-related issues, but also due to generic sector rotation and also due to an improvement in targeted



The four scenarios

Scenario 3: Managed growth

financing (as opposed to Fed-led blanket financing) of corporations with good fundamentals. In other words, this scenario could see the demise of many 'Zombie' companies and material improvement of capital allocation across the board.

More export-oriented economies, all other things being equal, should see stronger currencies. Initially, we would expect a weaker US Dollar due to more expansive fiscal policy, but as the Fed withdraws stimulus and rates go up it could strengthen. If the UK follows the US down the same path we would expect a similar course for Pound Sterling. Growth should help the Euro stabilise, but the limitations of the currency union would probably again put a ceiling at its price and its ambitions to become a global reserve currency.

Overall, we would expect lower risk premiums than today, as the risk-free rate would rise and market returns would be slightly lower. Balanced portfolios would probably remain equity-heavy until bond yields reach an inflection point where they would again become attractive to hold. Thereafter, balanced (60/40 or otherwise) portfolios would present better opportunities again.

In this environment, Alpha would probably outweigh Beta, which means that a reversal of the narrative of higher efficiencies for passive instruments. We would remain agnostic in terms of value versus growth, as value could be preferred on the inflation side (a heuristic), but growth would still see a significant influx of money.

Overall, this scenario would again require investors to 'buy and hold' diversified portfolios over the longer term, with few trading opportunities.

The four scenarios

Scenario 4: Breakout velocity

‘Boom and bust’ are concomitant with capitalism. Credit excess follows credit expansion, after which comes the bust and the reset. Arguably, the 2008 global financial crisis was the biggest bust since the Great Depression. Lehman Brothers may have transformed from investment bank to, virtually, a hedge fund, but in the minds of the electorate it remained a ‘bank’. Allowing banks leeway to repeat the mistakes of 2008, a certainty as the derivative genie can’t go back into the bottle, was political poison.

Thus, the economic reset saw banks shackled and consequently consumers become more conservative. **However, it often feels that for more than twelve years the global economy has been operating in ‘safe mode’.** The political unpalatability of busts altogether meant that excess growth had also been taken out of the system.

The last scenario is a variation of the previous one. In the ‘Breakout Velocity’ we assume that dormant private market economic forces wake up, creating a virtuous cycle of investment, consumer sentiment and spending. The inability of banks to act as a satisfactory transmission mechanism of fiscal policy during the Covid-19 crisis should act as an alarm bell and ultimately a catalyst for countries to re-think and weigh the moral hazard of banking de-regulation against its economic benefits.

There are two ways to go from here: either the creation of new national banks, investment vehicles which will manage the governments’ fiscal programmes, competing with commercial banks, or the reset of the banking system itself.

The problem is that private banks can’t compete with national banks, with the latter also usually becoming a vehicle for crony capitalism. All banking systems originate from national banks which, after a point, broke up and privatised. Going back to national banks to spur investments, would mean resetting the banking system back to the 1850s.

In this scenario, policy makers realise that pent-up demand will fizzle away and that bank-driven private credit creation is necessary

to create a virtuous cycle of consumption and investing in western economies. So, they decide to partly and gradually de-regulate banks. We argued about the logic of this move in our section above (Big State and Banks).

Bank de-regulation would increase the flow of money in the real economy and banks would act as a trustworthy and amplifying transmission mechanism of fiscal policy, allowing for higher growth -and ultimately a more painful bust and system reset. Governments would decide on treating busts and resets as a natural part of capitalism and create rules about how to handle them, instead of trying to avoid them altogether. This would also mean global rules to deal with excess private debt and mechanisms to re-distribute wealth after a bust,

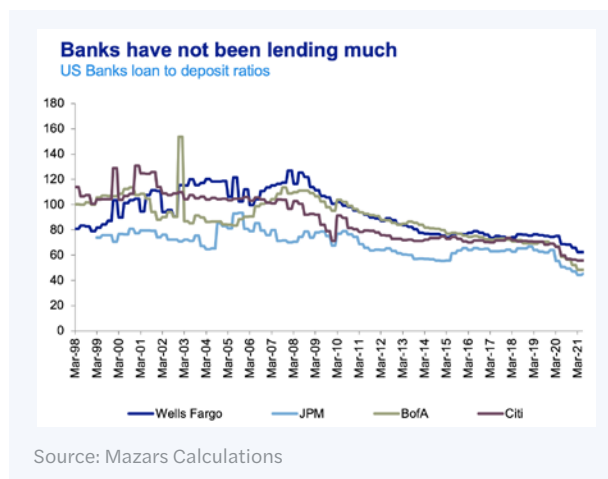
Economic implications

The result of this scenario is higher and more long-lasting growth rates for developed markets c. 3.5% and above. Emerging markets should continue to grow at a 6% pace in the next few years as well. The scenario would also bring about higher inflation, c. 3%-3.5%. However, this would be mostly ‘good’, growth driven inflation.

Bank de-regulation should increase the flow of credit in the economy, rendering businesses more likely to expand and consumers more bullish. Savings rates would drop to 2%-3%.

Credit availability should convince CEOs to keep expanding organic capacity, creating new jobs and further empowering consumers in the process. Investments in the real economy would materially increase, while the focus on M&A and higher growth companies as a target of financing would diminish. Overall, the proportion of allocation to financial assets against real assets versus the previous decade should diminish.

To successfully expand, companies would start to compete globally again, kickstarting globalisation to reduce costs. This should counterbalance increasing wage pressures on inflation in the West. The East, conversely, could see a modicum of inflation resurgence due to increased competition for labour.



The four scenarios

Scenario 4: Breakout velocity

Credit creation would be at the heart of this scenario. This would mean more new venture creation, and diversification away from 'fast growth' sectors currently dominating the 'Private Equity' financed market. More smaller businesses would mean more confident consumers. The confluence of consumer confidence, increased credit creation and demand for real assets should have a very positive effect on the housing market and house prices in the next few years.

We expect fiscal policy to remain expansive, with deficits over 5%-7% for the next few years. However, as real growth returns, tax receipts should increase and reduce those fiscal deficits. The downside of the scenario is, of course, an even faster debt surge and an expansion of private and public balance sheets, which would speed up the eventual reckoning between creditors and debtors.

Investor's playbook

As growth and real demand pick up due to credit, interest rates will gain popularity as a once-again useful tool to manage inflation. We would expect a higher peak interest rate, around 5%, and a shorter term average interest rate of 3%. We expect developments to drive the adjustment of the Fed's policy and communication faster than the previous 'managed growth' scenario.

In this scenario the Fed eventually manages to step away from 'Open Market' operations, quantitative easing, although it would still maintain an expanded balance sheet. 'Green shoots', periods of market exuberance and economic expansion, would be fertile ground for quantitative tightening, but we would expect any material reduction of Fed assets to be many years away. Until that time, central banks will continue to re-invest in maturing securities.

Risk assets would, in this scenario too, experience a significant re-rating episode which would also see a rise in default rates. Following a volatile patch, equity returns should return to a long-term average of 8% return. Yields curves would both be expected to move upwards and steepen at the long end. Corporate yields would widen back to historical averages.

The gradual removal of the Fed's hand from the market should bring overall equity and bond volatility levels back to their long-term average, circa 15% and 8% respectively.

In this scenario we expect heavier equity investing until fixed income yields return to average before balanced (60/40 or otherwise) portfolios once again feature prominent (on occasion overweight) positions in bonds. However, this allocation comes with a caveat. Better capital allocation would mean that zombie corporations, or those with low productivity, would have trouble re-financing themselves. With default debt levels growing, we are approaching a level when some sort of debt relief is required before growth is hindered. In this scenario, more so than the others, bond allocations should come with protections, like CDS or other tools.

In a 'Breakout Velocity' scenario, we would expect better and more selective allocation, which should give 'Alpha' managers an edge over passive managers. We would remain value-growth agnostic and believe markets would focus on rewarding 'good' companies. But 'good' won't just mean high growth anymore.

Finally the trading rule would be to 'Buy on Strength', i.e. follow what the market rewards over the long term.

Conclusion and takeaways

The four scenarios we have described are not equally weighted. In terms of probabilities we still believe that the present paradigm, secular stagnation, has the highest probability of being dominant over the longer term. Why? Entropy. For growth to become so persistent as to break 'secular stagnation' it would require a material and bullish shift in the mindset of business leaders and consumers. A pandemic is hardly the catalyst for that shift. And the record of fiscal policy turning into a consumer/investment virtuous cycle is questionable. It is obvious that the stagflation scenario can revert back to secular stagnation. What is less obvious is that the 'managed growth scenario' may also revert to secular stagnation if it doesn't turn into a virtuous cycle. We believe that for a material shift to occur in the way people spend, a similar-size shift needs to happen in the way people think about risk and for that to happen we would need to see major changes in regulations and the business environment.

In this exercise, we examined all scenarios. Secular Stagnation and Breakout Velocity are really the more longer-term hypotheses. Stagflation and Managed growth are interim 2-3 year periods when things are either going to improve, or deteriorate. Research shows that fear of loss is a much more potent force than the joy of gain (Kahneman), which makes secular stagnation a powerful gravitational force.

Having said that, what changes the future will bring are unknown. Two successive US governments have questioned the post GFC status quo in their own way. The Republican White House restructured the US tax code and reduced corporate taxes. The Democratic White House is focusing on providing fiscal stimulus to ramp up bullishness. That both parties acknowledge the problem and attack it (even from different angles) leaves hope that 'secular stagnation' might eventually break.

The scenarios above constitute a 'playbook' of sorts of how to recognize and approach each of the environments we described.

Conclusion and takeaways

Takeaways in a nutshell

- Our job as asset allocators is to invest with a certain set of principles and assumptions. A major change in the investing environment could challenge those assumptions. We believe that the US's fiscal stimulus plans materially increase the probability that this change might happen.
- From where we are we see four distinctive scenarios: a) An immediate return to 'secular stagnation', b) A stagflationary period and gradual return to 'secular stagnation', c) Managed growth and inflation and d) 'Breakout velocity', a return of sustainable growth-driven demand to the economy.
- Secular stagnation is a powerful force. It will take an equally or more powerful force to challenge it. Fiscal stimulus might be it. We have yet to ascertain that.
- The more compromise on fiscal stimulus, the less traction scenarios based on stronger growth gain.
- Rate hikes and monetary tightening are not the answer to every inflationary problem.
- Non-growth, post-pandemic inflation forces (supply-side inflation) may persist for the next 12-36 months.
- New monetary tools are bound to emerge. Assigning the right probabilities to the success and failure of new tools introduced by central banks to adapt to a paradigm shift, will be the definitive factor in the success or failure of the wealth management industry in the next few years.
- In a US centric world, expect America to be an example. Having said that, extended fiscal stimulus will challenge non-reserve currency economies more than the US.
- Expect higher volatility and re-rating episodes, especially as the 'secular stagnation' scenario is challenged.
- The 70's won't likely repeat themselves. Forget very high inflation and double-digit interest rates.
- The past is not a repeatable pattern. It is but a generic guide. This time is (always) different.
- The pandemic is not over yet. The longer it lasts, the more different the post-Covid reality.
- Big state is an important catalyst for a paradigm shift. But for the secular stagnation mindset to break, it will take private enterprise bullishness which may not happen without further availability of credit.
- It's difficult to have a boom without banks. It's also difficult to have a boom without a bust.
- Expect central banks to maintain expanded balance sheets under any scenario. It will take a lot of 'Green shoots' (periods of combined economic and market bullishness) and a number of years before central bank balance sheets are reduced in any significant way.
- As long as the real and the financial economy remain separated, tightening in the former does not necessarily translate to tightening in the latter.
- Central banks have become too intertwined with policy making and shouldered the responsibility to foster national growth. Their independence going forward should not be a given.
- We are exiting the phase where China is the purveyor of disinflation to the world (in exchange for growth) and we are entering a phase where a more mature China becomes an antagonist to the West.

Asset allocation

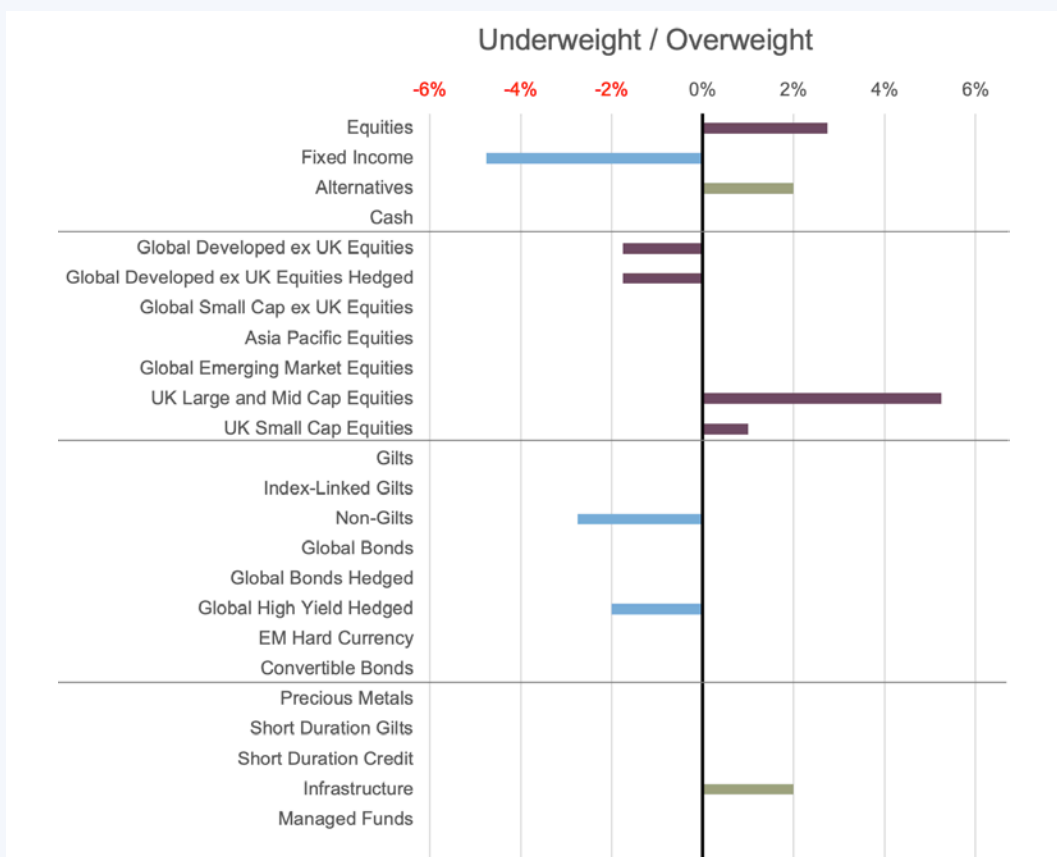
Economic data remains exceptionally volatile. On the one hand, after March we are seeing a fast-paced recovery around the world as vaccination rates improve. On the other, with many parts of the emerging world, where a lot of production takes place, are still suffering. Imbalances in the global economy are exacerbated by the chaotic and unpredictable nature of local lockdowns. A heavy strain is put on supply chains, forcing higher output. Supply constraints combined with pent-up consumer demand are pushing inflation upwards.

Governments are still in spending mode and are considering a departure from the fiscal orthodoxy of the last twelve years. Extensive borrowing which has supported employment and consumption may now be used to push the world out of 'secular stagnation'.

But investors are now worried. Higher long term demand-side inflation might mean higher rates and quantitative tightening, risking the 'only game' in town for risk assets, central bank accommodation. Central bankers are reassuring for now, as pent-up demand and supply constraints are too temporary to

cause a fundamental shift in monetary policy. But a huge amount of cash flooding the real economy, could be a game changer for both central bankers and the way money is invested.

In the past few months, we have moving towards our new Strategic Asset Allocation, while also shifting some weight towards value to better balance our value-growth exposure. We remain slightly overweight equities and risk, in the belief that even a central bank-guided market can still deliver returns. In terms of geographical allocation, we haven't made large deviations from the new benchmark, and rely more on our fund selection to create alpha. Within equities we are overweight the UK. Our underweight in fixed income continues as a result of structurally low yields. In terms of Sterling, we keep close to the benchmark. We maintain a healthy exposure to gold, as the asset class remains uncorrelated with equity markets and would tend to gain in times of aggressive monetary accommodation. In terms of alternatives, we maintain exposure to infrastructure, which we believe might be a beneficiary of increased fiscal spending in the next few years.



Source: Mazars Calculations

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