

# Everybody Ready for the 2020s?

Could the next decade get even more surreal than the last? You betcha!

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## Key takeaways

- The '20s are just around the corner, and they promise even greater strangeness than the 2010s.
- Among other factors, the effects of the demographic tidal wave sweeping much of the world will endure for years to come.
- Deflationary forces from this "silver tsunami" are already visible in the form of low to negative bond yields and extreme monetary policies.
- Is extreme fiscal policy next, and would it mark the end of central bank independence?
- If so, investors will want to pay special attention to both tails: the right (inflation) and the left (deflation).

I find it hard to believe that an entirely new decade is but a few months away: the 2020s. Wow, how time flies. But first, (cue metaphor) ...

I am a huge David Lynch fan, and I can't tell you how thrilled I was when the 1990s' *Twin Peaks* returned to the airwaves in 2017 for a third season (*Twin Peaks: The Return*). The series was even more deliciously weird than I remember it from 25 years ago. I must have watched each of 2017's 18 episodes at least three or four times, attempting to put the pieces of the puzzle together. Lynch's films are highly non-linear dream-states that seem to make little sense, and a whole fan-based cottage industry has sprung up to float competing theories of what it all means.

But behind the apparent chaos lies order, and Lynch's films can be entirely coherent, in their own surreal way. Case in point: I was browsing through Facebook while waiting to board a flight recently when I came across a post from a *Twin Peaks* fanatic claiming to have solved every last clue of the series. What followed was a 4½-hour YouTube chronicle (four and a half hours!) of this

super-fan bounding down the rabbit hole, decoding every hint, expounding every nuance of the story line, and knitting it all together into one grand meta-narrative. For this *Twin Peaks* nerd (me), it was a dream come true. (Spoiler alert: The *Twin Peaks* redux is, apparently, a commentary on American culture and its thirst for consumable violence.)

Anyway, this long-winded metaphor is intended to draw a parallel to the investment landscape we are all trying to navigate these days. *Twin Peaks* is as nonlinear as it gets, and in my view our post-crisis markets (i.e., since 2008) have been at least conceptually comparable. In a way, we are all just would-be sleuths chasing down clues to help us decipher the markets' mysteries, casting about for that elusive meta-narrative that might pull the whole story arc together in real time.

The 2010s have proven surreal enough, showcasing everything from financial repression<sup>1</sup> (low to negative interest rates coupled with QE—or rather, “not QE”) and a \$13+ trillion mountain of negative-yielding debt to the potential for “helicopter drops”<sup>2</sup> or even outright debt monetization<sup>3</sup> (whereby the Fed essentially conjures money out of thin air); from escalating friction between the two biggest economies (and, arguably, military powers) in the world to the storm brewing ahead of a stranger-than-fiction U.S. presidential campaign—all amid the rise of the largest demographic wave ever to sweep the world. And yet markets sailed atop it all, seemingly immune to the elements. So, here we are on the cusp of a new decade, and the existential questions outnumber answers by a mile.

**Question:** How profound is the demographic sea change that threatens to overwhelm us, and how much does it explain the prevalence of low inflation, slow economic growth, dovish central bank policy, accelerating wealth inequality, and rising populism?

**Question:** Is an increasingly negative term premium<sup>4</sup> (recently as low as -100 basis points on the U.S. 10-year Treasury) plus trillions of dollars of negative-yielding debt merely a function of financial repression, or is it a manifestation of the demographic tidal wave? Alternatively, is financial repression a function of the demographic wave, perhaps to the point of suggesting that the two are one and the same?

**Question:** Given that the “silver tsunami” has many more years to go, will the relentless pursuit of yield in anything resembling a bond (demonstrated, for example, by a 20x forward price-earnings ratio on the utilities sector) extend to the extreme, or are bond proxies' rich valuations simply the outcome of defensive investor positioning after a 10-year bull market?

**Question:** Will the post-Great Financial Crisis era of slow growth and unconventional monetary policy ultimately result in significant expansion of fiscal policy and a loss of central bank independence? Are we headed toward Modern Monetary Theory<sup>5</sup> (MMT), wherein governments print as much money as they please?

**Question:** If indeed we are heading to an MMT kind of world in which the major countries are creating money out of nothing and enforcing financial repression, how does an investor pick winners and losers?

**Question:** If central banks lose their independence, transformed into mere debt-monetization arms of their MMT governments, will this generate rapid expansion in the money supply and therefore inflation, and in turn perhaps give rise to extreme negative interest rates (just the thing to help countries with a high debt-to-GDP ratio)? Or will the deflationary effects of a crashing age wave drown any efforts to offset its effects through MMT? In other words, will a demographically induced decline in monetary velocity offset any helicopter drops?

**Question:** If yields on U.S. bonds fall to zero (the FTSE World Investment Grade Bond Index ex U.S. already is down to a 0.16% yield), what will that do to the risk premia for equities and other risk assets (e.g., credit, private equity, real estate)? Will a 50x or 100x “bond P/E” (the inverse of yield) on long bonds cause equity valuations to soar (further), or will the United States’ stock market of tomorrow look a lot like Japan’s of today?

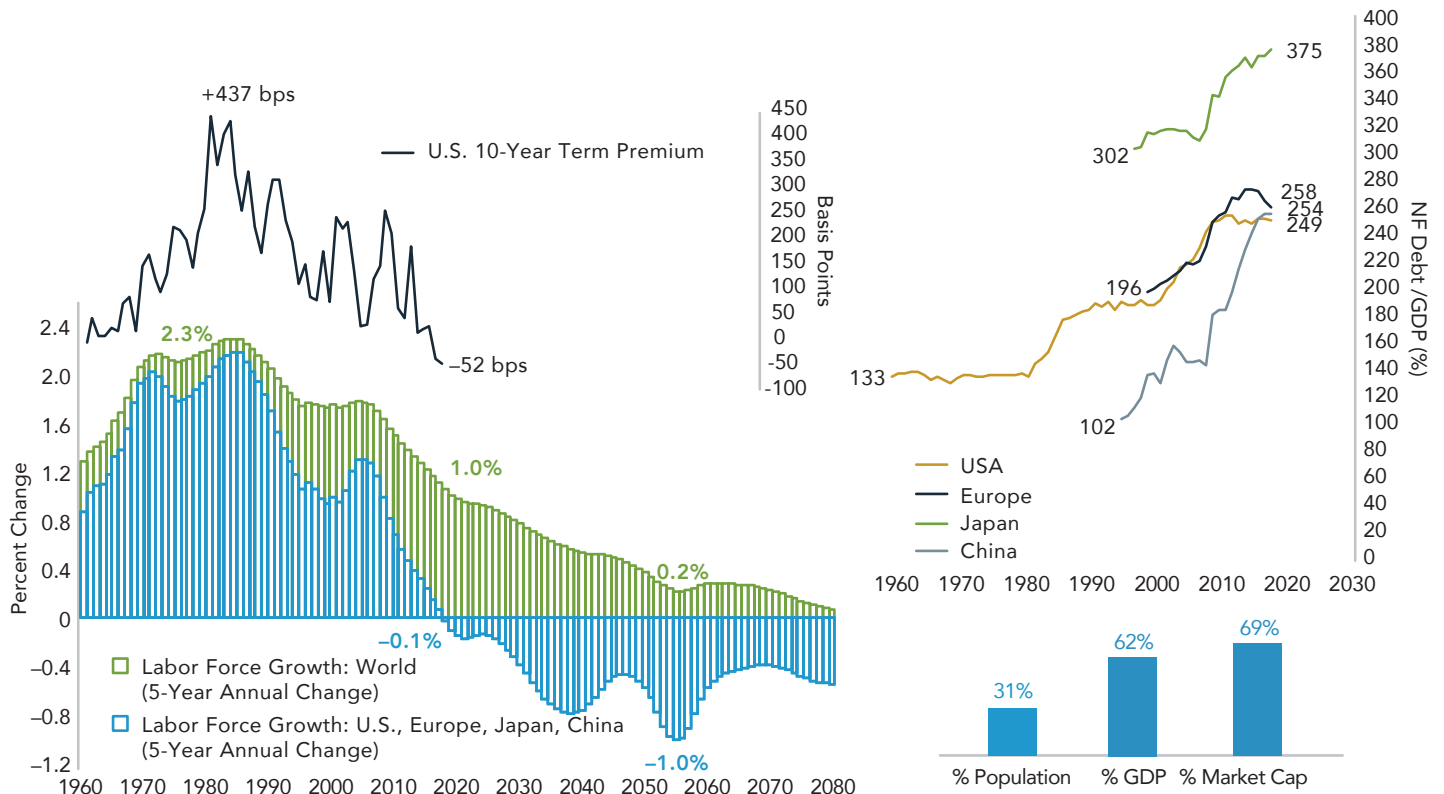
**What are the answers?** I know / don’t know, but the nice thing about demography is that it can offer us some forward-looking perspective. The UN publishes population data back only to 1950, but my guess is that the world has never seen a demographic wave like the

one we’re in now. To give some context, the slowdown in labor force growth currently underway affects mainly the U.S., Europe, Japan, and China (Exhibit 1). While those four regions represent only about 31% of the world’s population, they comprise 62% of world GDP and 69% of the world’s equity-market capitalization.

And this has been a very long wave. The five-year annualized growth rate of the world’s total labor force peaked in 1985 at +2.3%. In 2019, that stat sits at around +1.0%, and by 2055 the global labor growth rate is expected to have dwindled to just +0.2%. Looking again at just the U.S., Europe, Japan, and China: The labor growth rate of this subset also peaked

**EXHIBIT 1: Is the crashing age wave a never-before-seen event in human history?**

Select Data for Term Premiums, Labor Force Growth Rates, Non-Financial (NF) Debt to GDP Ratios, and Other Statistics



Non-financial debt: Aggregate debt owed by households, government agencies, non-profit organizations, or any corporation not in the financial sector; NF debt can include Treasury bills, industrial or commercial loans, and household mortgage and credit card debt. Bars in lower right panel represent the world share of specified statistics for the U.S., Europe, Japan, and China combined. Sources: Bank for International Settlements, United Nations; annual data as of 2018.

in 1985 (+2.2%) and has since averaged a decrement of about 6 or 7 basis points per year. The mean labor growth rate for these four major regions recently crossed the zero axis—and by 2055 is projected to have sunk to about -1.0%. A secular surge that affects two-thirds of the global economy is not something I want to bet against, especially considering that labor force growth is one of the two main drivers of potential GDP (the other being productivity growth).

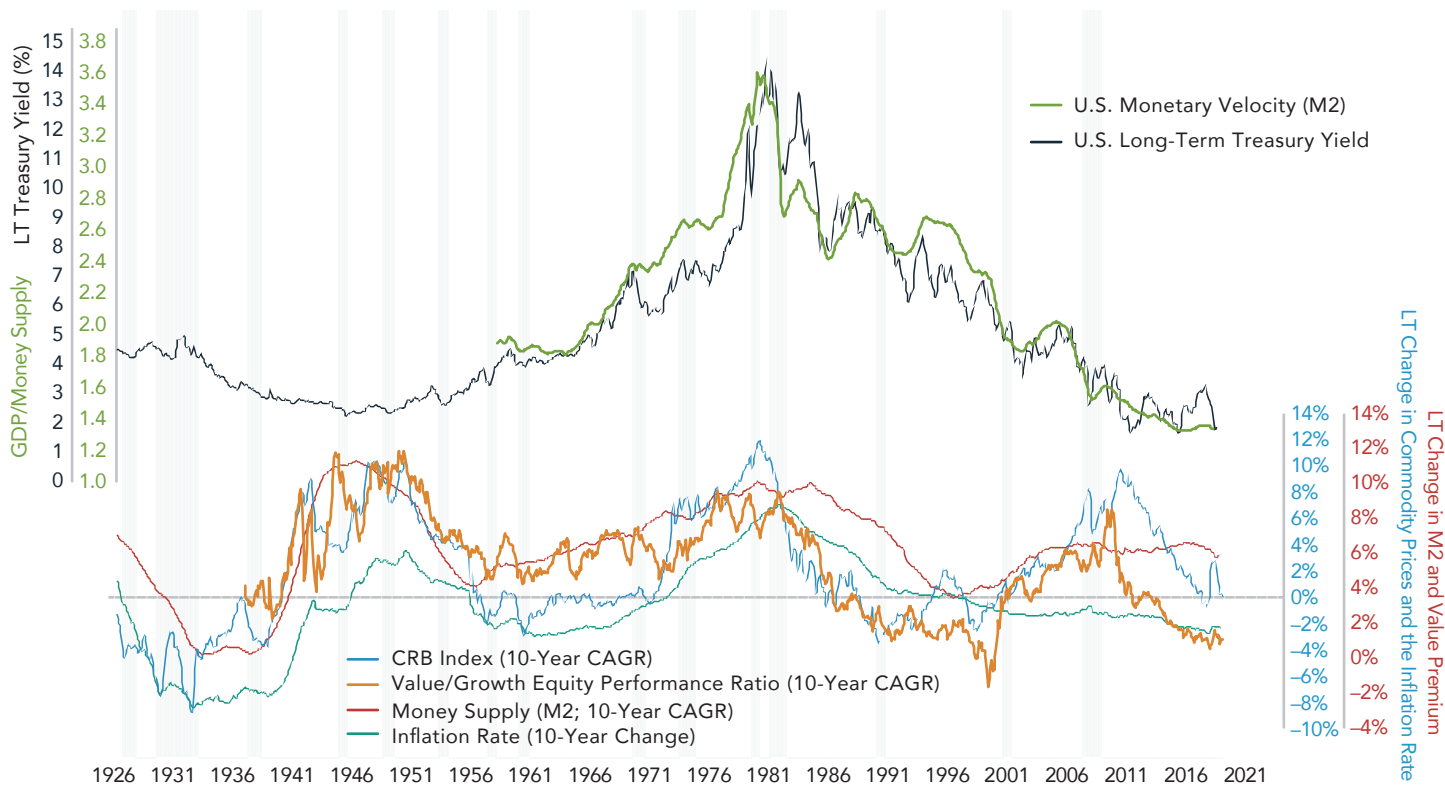
Whether governments in the affected countries are successful in creating inflation through MMT (despite the deflationary secular currents) is one of today's (and tomorrow's) most important strategic investment questions. If the answer is yes, then inflation protection

in the form of Treasury Inflation-Protected Securities (TIPS) and commodities—along with any currencies not affected by MMT, India's perhaps—could fare well for a long while, whereas the 60/40 stock/bond portfolio that has been so successful since 2000 could revert to the old days when stock prices were negatively correlated with bond yields. That's what inflation does, after all.

And we have some technical "evidence" to suggest that this is a plausible scenario. For example, we can chart long waves in action for the performance and synchronicity of such economic aspects as monetary velocity<sup>6</sup> and long-term Treasury yields; growth rates of inflation and the money supply; commodity prices; and the performance ratio of value- versus growth-

**EXHIBIT 2: Are certain long-term economic frequencies synched up and bottoming out?**

Phase Coincidence of Select Aspects of the U.S. Economy



LT: Long-term. Sources: Haver, FactSet; monthly data through 10/31/2019.

style equity investing (Exhibit 2). This “Kondratieff Wave,”<sup>7</sup> named in honor of Russian economist Nikolai Kondratieff’s work in the 1920s, can last 40 to 60 years, so it is hardly a precise measure on which to base investment decisions, but after a long drought for commodities, for example, the wave appears to be at a point where we could be looking at a long-term bottom. If that’s correct, it fits nicely with the narrative of higher inflation tied to some form of MMT in the years ahead.

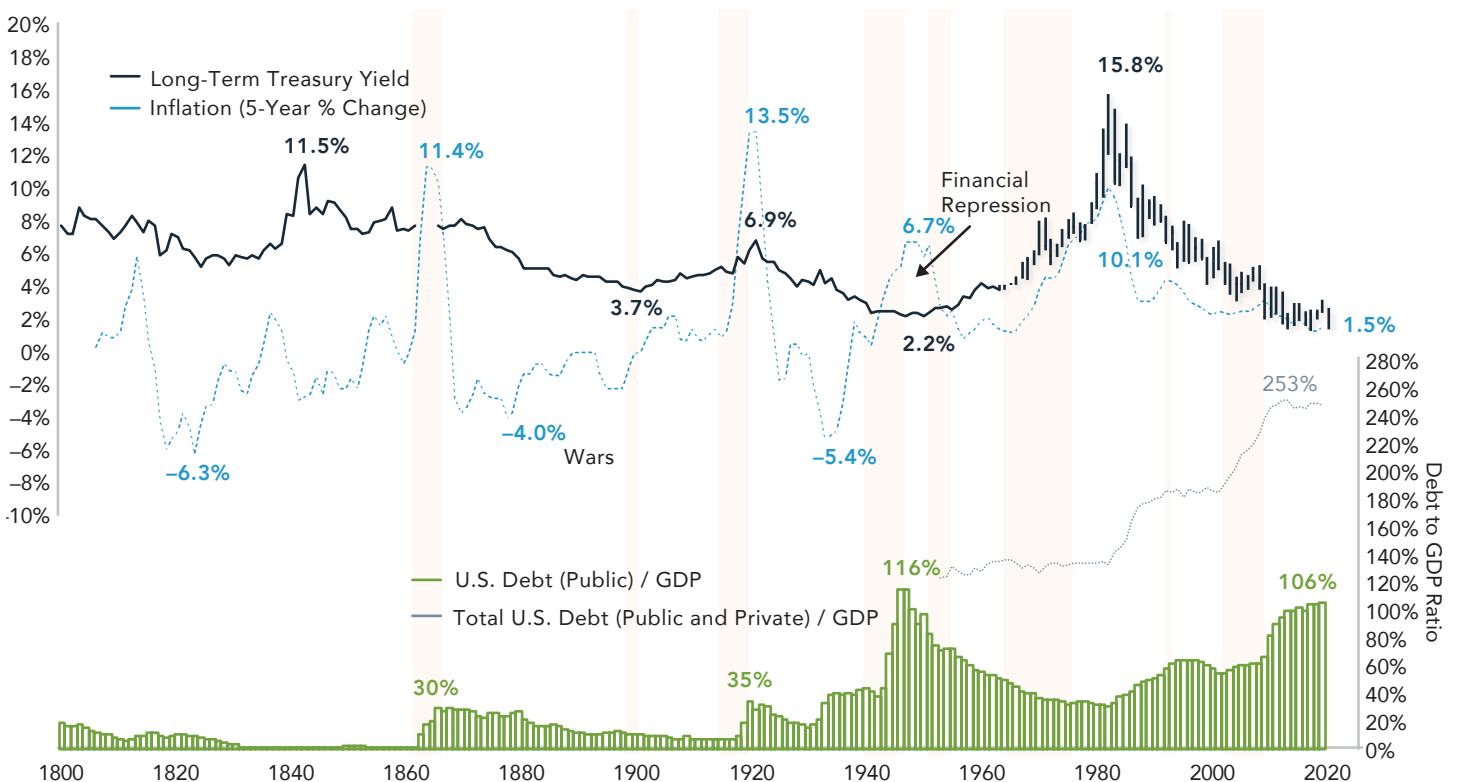
Does inflation mean that interest rates would rise? Well, not necessarily. In an MMT world where the Federal Reserve is monetizing U.S. debt and the aging population is starving for yield, the Fed may well be able to repress nominal rates at low levels while at the same

time pushing real (inflation-adjusted) rates further and further into the negative. So, in an extreme scenario, it’s not inconceivable that we could have both high inflation and low nominal rates.

That is exactly what happened during the latter half of the 1940s (Exhibit 3): Inflation spiked due to the demands of World War II, nominal yields stayed low (at around 2%), and real rates went sharply negative. This was possible because (1) the deflationary mindset from the Great Depression remained pervasive, and (2) the Fed—at the behest of the Treasury—was monetizing war debt and, at the same time, screwing interest rate caps on both the short (at 0.375%) and long (2.5%) ends of the yield curve. In other words, the Fed essentially

**EXHIBIT 3: Have we seen this episode before?**

A Long-Term History of Debt, Inflation, and Treasury Yields



CRB: Commodity Research Bureau Raw Industrials Index. Shaded areas represent wars. Source: Fidelity Investments; annual data through 2018 and year-to-date through 10/31/2019.

surrendered its independence to help finance the war effort. The result: low and stable yields regardless of huge gyrations in the inflation rate. (The Federal Reserve regained its independence in 1951 when the Treasury and the Fed agreed to separate government-debt management from monetary policy.)

That's the inflation scenario; however, if the deflationary effects of the age wave overwhelm the inflationary effects of MMT, then in all likelihood we are facing a continuation of the trends in place for the past five years or so: an emphasis on stable dividends and free cash flow against a persistent low-inflation backdrop; low yields and negative real rates; growth stocks leading value; domestic outdoing international markets; and "low forever" interest rates. In this scenario, the current rotation would be just a minor counter-cyclical ripple against a powerful deflationary tide.

But just as scary "peak oil" kept us on the edge of the end of (cheap) fossil fuel for decades, only to be crushed by the tech-triggered shale revolution, a middle way may prevail. Markets could well thread the inflation/deflation needle, with technology (AI, automation, robots) solving the demographics problem and U.S. yields keeping above water. After all, it's human nature to "figure things out," so maybe we will collectively solve the demographics conundrum in the coming years.

If that is the case, central banks may be able to retain their independence; bond yields could reset back to "normal" (around 2% to 3% for the U.S.); demand for income-producing strategies might abide at less-than-stratospheric extremes; and the S&P 500 could conceivably carry on cranking out a 5% free-cash-flow yield and a double-digit return. This trend has endured since the end of the Great Financial Crisis, and it often pays to assume a trend will extend, albeit with one important caveat: "The trend is your friend except at the end when it bends."

I have no idea what the 2020s will bring, but I want to be aware of—and prepared for—potential resolutions ranging from the mundane to the extreme. For now, I am sticking with the idea that the positivity of the 60/40 stock/bond paradigm should carry forward (it's worked for two decades, after all), and within equities I like that part of the market that combines competitive yield with reasonable valuation. But I also think the times call for some protection against the tails—whether inflation or deflation. Inflation protection could include TIPS and commodities (especially those selling at close to their cost of production). To guard against deflation one might consider some minimum-volatility<sup>8</sup> strategies, perhaps coupled with some long-duration debt.

Inflation or deflation? Bull or bear? Darkness or light? It's a range of possible outcomes worthy of a season 4 of *Twin Peaks*. Stay tuned!

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## Endnotes

<sup>1</sup> Financial repression, a term coined by Stanford economists Edward Shaw and Ronald McKinnon, refers to government policies that result in savers earning a return below the rate of inflation. A low nominal interest rate can reduce the government's debt service costs, while negative real (inflation-adjusted) rates diminish the (real) value of government debt. Financial repression also can help a government increase spending by increasing tax income or debt levels. Mechanisms for financial repression can include interest rate caps; government control of domestic banks and financial institutions; high reserve requirements; creation of a captive domestic market for government debt by promoting or requiring government debt as a reserve requirements; and imposition of capital controls.

<sup>2</sup> "Helicopter drop" ("helicopter money"), a term coined by economist Milton Friedman, refers to aggressive monetary stimulus financed by a central bank via an increase in the money supply and aimed at spurring higher inflation and economic output. Potential mechanisms include direct money transfers to individuals (such as "universal basic income"). Since its introduction in 1969, the idea of helicopter money has grown to encompass a range of policy ideas, including more conventional fiscal stimulus through increased government spending (e.g., on infrastructure projects), tax cuts, and even the "permanent" monetization of budget deficits.

<sup>3</sup> Government spending in excess of revenues (mostly taxes) creates a deficit typically financed by the Treasury via issuance of government debt instruments. Debt monetization is the financing of governmental operations by the central bank (and not by the Treasury) via its ability to create ("print") money by, for example, conducting open-market purchases of government bonds. When such bonds come due, the Federal Reserve can return any funds received back to the Treasury; thus in effect, the Treasury may "borrow" money without needing to repay it.

<sup>4</sup> The term premium is the excess yield investors require to commit to holding a long-term bond instead of a series of shorter-term bonds.

<sup>5</sup> Modern Monetary Theory (MMT) is a controversial idea that countries with a sovereign currency (such as the U.S.) are not operationally constrained by debt accumulation because such monopoly issuers can always create ("print") any monies needed to pay interest on debt (action which critics believe results in inflation or even hyperinflation). A government thus is free under MMT to implement projects or policies aimed at achieving full employment of labor, physical capital, and natural resources. Once an economy reaches full employment, inflation indeed becomes the main theoretical risk; however, MMT proposes that inflation can be controlled via taxes and debt issuance that reduce the money supply. Thus, the theory goes, as long as an economy can supply sufficient labor and capital equipment to meet aggregate demand without encountering excessive inflation, a government can spend without constraint to achieve its social and political goals.

<sup>6</sup> Monetary velocity measures the number of times within a specific time period that a dollar (monetary unit) is used by an economy's consumers and businesses collectively to purchase domestic goods and services. Monetary velocity usually is expressed as the ratio of U.S. GDP to the U.S. money supply. The money supply has several components, including M1 and M2. M1 measures currency in circulation (notes and coins, traveler's checks, demand deposits, and checking deposits). M2 includes M1 plus individuals' savings deposits, certificates of deposit, and money market deposits.

<sup>7</sup> Kondratieff Waves, named after Russian economist Nikolai Kondratieff, refer to long-term economic cycles (sometimes called "super-cycles") that last about 40 to 60 years. "K-waves," experienced by capitalist economies, are characterized by alternating periods of relatively high growth (periods of technological innovation) and relatively slow growth (periods of correction) that, together, result in extended periods of national prosperity. Economists and technical investment analysts have identified several K-waves dating back to the Industrial Revolution, with the latest cycle originating with the digital age.

<sup>8</sup> Minimum-volatility ("min-vol") strategies attempt to provide market-like exposure with below-market risk. Some min-vol strategies pursue this objective by buying securities that exhibit relatively low volatility and concentration risk (heightened exposure to a particular asset class, investment characteristic, or risk factor resulting from a heavily weighted allocation). A min-vol strategy does not eliminate risk exposure to volatility and may not prevent a loss in the event of a market downturn.



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