WESTMINSTER

ASSET MANAGEMENT

The Global Outlook from 2020 written by Investment Strategist Peter Lucas.

"We are all screwed…but not just yet". This was the deliberatively provocative way that I opened a speech on markets just a few years ago. Although much has happened between then and now, that tongue in cheek opener remains a pretty good summary of how I view the world today. What I described then, and what I still see today is a confluence of trends that could eventually lead to a crisis every bit as bad (if not worse) than 2008 and the one we are living through today. That is not to say that investing will be a fruitless pastime. Far from it. There will probably be good money to be made in the years ahead, but it may require a different way of investing. Traditional investment portfolios that have served investors so well for the past forty years, could prove to be as destructive to wealth as they were in the 1970s.

In a series of articles, I will lay out my medium/long-term view, examining the various challenges that face the global economy. Individually these challenges are worrying enough, but when taken together – with one potentially feeding another – they represent a major threat to economic and political stability.

In this first article I would like to briefly examine the period that followed the 2008 crisis, which effectively ended with the advent of the coronavirus. This was a period of low volatility, low productivity growth, low economic growth, low inflation, but generally good financial markets, particularly in America. This is a phase that I have called the 'eye of the storm' – an eerie period of calm that will ultimately give way to the inevitable second wave of the storm. Indeed, one phase sows the seeds of the other. By the way, as we will explain in future articles, this does not necessarily mean that markets are in peril in the next couple of years. Quite the contrary in fact.

In the aftermath of the financial crisis, huge fiscal deficits led to governments tightening their belts, for fear of incurring the wrath of the bond markets and responsibility for protecting the economy and promoting growth fell squarely on the shoulders of the central banks. Interest rates were reduced, in some cases below zero, and quantitative easing (buying bonds with printed money) was used to flatten yield curves, to encourage investors to take more risks, in the hope that would lead to stronger economic growth.

Although these policies presided over impressive bull markets in bonds and equities, economic growth was generally quite anaemic. There are several possible explanations for this. Firstly, ultra-low interest rates subverted the normal process of creative destruction, and the survival of so-called highly leveraged zombie companies acted as a drag on productivity and economic growth rates. Second, banks found it hard to function properly in an environment of flat yield curves (the gap between short-term and long-term interest rates determines their profit margin) and even worse, negative interest rates that could not be passed on to customers. Third, in many cases, easier monetary policy led to weaker currencies and/or higher commodity prices which undermined real household incomes. In short, monetary policy supported growth on the downside but also capped it on the upside.

Furthermore, this policy was storing up problems for the future. As we have seen several times through history, inflating the markets is not a great way of boosting the economy in the long run. It is great on the way up, but really all they are doing is boosting today at the expense of tomorrow – the better that markets perform today, the worse they will perform in future. Furthermore, it is a policy that has widened the gap between the haves (who benefited from rising markets) and have-nots (that suffered from falling real incomes). Indeed, income inequality has reached levels not seen since the 1920s. Overvalued markets and income inequality are key ingredients in the next phase of the story that I will explore in greater depth in my next article.

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June 2020

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