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***Updating the Big Picture*: Westminster Asset Management Investment Strategist Peter Lucas reviews expectations outlined in 2020 and considers how events have impacted his predictions.**

Almost two years ago, in a series of five articles (which can be viewed on the Westminster website **here**) I laid out my long-term expectations for the major asset classes. It was not an optimistic set of documents. In them I described a world that would be increasingly defined by three major extremes: in income/wealth inequality, global debt levels and market valuations. Although each of the extremes had the potential to be destabilising in their own way, it was the possibility that the three might feed into each other that was a particularly worrying prospect. My thesis can be summarised as follows:

1. Extreme wealth/income inequality and decades of stagnant living standards would cause voters to abandon the centre ground. I described this process as "the rise of the populists", whereby opportunist politicians would tap into this frustration, offering 'new' policy solutions (which were not actually new and had been debunked years ago). A return of 'big government', nationalism and protectionism would foster increasingly fractious international relations and generally higher levels of inflation.
2. Years of easy monetary policy had left equity and bond markets in overvalued territory. I described this approach as 'kicking the can down the road', whereby central banks had effectively frontloaded economic growth by encouraging borrowing and inflating the financial markets. Rich valuations were a recipe for poor market returns in the long run and, if there is wealth effect, weaker economic growth as well.
3. Record levels of debt, particularly for peace time, would lead to a more volatile economic environment, as well as higher than normal risks of deflation and inflation. The financial crisis left policy makers keenly aware of the destructive consequences of deflation, leaving inflation as the more likely outcome in the long run.
4. Higher inflation would be bad news for overvalued financial assets. Bonds would be most vulnerable in the first instance, but as we saw in the 1970's high equity market valuations do not sit well with accelerating inflation, despite equities' inbuilt inflation protection. High inflation, rising interest rates (combined with high debt levels) and falling markets would further sap economic confidence, leading to more 'genius' solutions from our populist politicians. Rinse, and repeat.
5. There were two bits of good news amongst the gloom. First, markets might be happy to see higher inflation in the first instance because it would mean that the risks of deflation (the main concern of the day) had diminished. And second, it would still be possible to make reasonable returns, but it would require a different way of investing. The traditional bond-equity portfolio that had worked so well for forty years would no longer be appropriate.

The last two years have been eventful to say the least and many of the above predictions appear to have come good:

- Governments have rediscovered a taste for meddling that we haven't seen for decades.
- Globalisation has been replaced with new priorities: onshoring, self-sufficiency and shortened supply chains.
- To describe international relations as fractious would be a gross understatement.
- Inflation has risen to levels not seen since the 1970's and early 80's.
- Bond markets have corrected sharply, experiencing their worst drawdown in living memory. Interest rates are rising or are about to rise almost everywhere.

But correlation does not equal causation. Just because the outcomes have broadly been in keeping with my expectations does not necessarily mean that the original thesis was correct. So, the question I want to address in this article is this: was the thesis correct, or was this just a bunch of coincidences? Or to put it another way: the Green Agenda, the COVID lockdown policy, Russia's invasion of Ukraine and the West's aggressive sanctions response have been instrumental in these outcomes, but were they part of the story or were they unrelated external shocks?

To some extent I say that it doesn't matter one way or the other. When we look back at economic and political history, we see that it unfolds in very long-term cycles. In geopolitics, mistrust begets more mistrust. In economics, government meddling leads to (usually negative) unintended consequences, which leads to calls for more meddling. It certainly feels like these trends are developing a momentum of their own, with negative consequences on both fronts.

It is unfortunate that so many have developed a distrust of the free market, together with a belief that it is incumbent upon governments to correct its 'obvious' flaws. After all, how can a system that resulted in the global financial crisis, obscene levels of inequality and property prices beyond the reach of many working families be considered in any way optimal? In my view, they are drawing exactly the wrong conclusion. These bad outcomes were a result of bad monetary policy, which itself is an anti-free market policy. Do central bankers know the right level for interest rates, any more than the Soviet Union knew the right number of tractors to produce? In my view what is required is more free market rather than less. But what I say counts for nothing because we are now in the 'distrust' side of the cycle, which will probably continue until we experience another 'Winter of Discontent'.

There is another factor that was not included in the original thesis, namely the need for governments to distract the populace from the obvious economic problems. Once upon a time, governments could placate voters with borrowed money. But with debt levels through the roof, that is no longer an option. What better way to distract voters than a war? A war on COVID, a war on climate change and now a real (proxy) war with Russia. The measures taken during the pandemic and now with the invasion of Ukraine, certainly seem extreme by historical standards. Is that a coincidence? I don't think so.

So, my contention is that recent events are very much consistent with the original thesis. I draw no pleasure from that, given the long-term implications of the economic and political trends that have been set in motion. Looking on the bright side, I believe that there will still be great investment opportunities in the likes of commodities, value shares and inflation-linked bonds, but it requires an investment approach that has its sights set firmly on the future rather than the rear-view mirror, and that is sufficiently flexible to capitalise upon them.

In my next article I will explore the unintended consequences of the sanctions applied to Russia and the increasing vulnerability of the Eurozone economy and the euro.

Peter Lucas

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