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Featured G

The Pendulum of Policy and Politics

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Prior to joining Brandywine Global a decade ago, I spent 20 years as Managing Editor at BCA Research, an independent macro research boutique based in Montreal, Canada that has been around since 1949. Around the time that I joined BCA, the firm published an essay written by British historian Paul Johnson, "Has Capitalism a Future? A Historian's View." The rhetorical title of that essay captured the prevailing pessimism of the era. The buzzword 35 years ago was stagflation—stagnant growth, repeated recessions, and high and rising inflation. At the time, the economic stress points were obvious and included excess demand, overregulation, and various supply-side rigidities, including labor unions and ever-increasing government presence. The inflexibility of these factors blocked the formation of aggregate supply, undermined productivity, and ultimately fostered rising inflation.

Stagflation was a phenomenon that developed over a period of 15 or 20 years and was promoted, at least initially, by America's joint pursuit of the welfare state and the war in Vietnam. Oil shocks and the collapse of the Bretton Woods system, the pioneering agreement for monetary and exchange rate management set in 1944, all conspired to fuel ever-rising inflation. By the early 1980s, the pessimism inherent in investors' outlooks was deeply reflected in asset prices. Gold soared on the back of a collapsing U.S. dollar. The yield on 30-year Treasurys shot up to over 15% by 1981, while the earnings yield on the S&P 500 Index rose to similar levels. Amid economic difficulty and bearishness, Johnson cast serious doubt on the survival of free-market capitalism.

What actually followed the era of stagflation was nothing short of historic. Instead of capitalism disappearing into irrelevance, the extremes of that time provoked a profound shift in the pendulum of policy and politics. Paul Volcker took over at the Federal Reserve and embraced a radical new plan called monetarism to fight inflation. The British voted Margaret Thatcher into office in 1979, and Ronald Reagan became the fortieth American President in 1981. Reagan and Thatcher drove an economic revolution characterized by sweeping supply-side reforms aimed at reintroducing laissez-faire capitalism. It was a prescription for boosting economic prosperity through market competition, deregulation, low taxes, and free trade. Corporate profit margins started to move higher by the mid-1990s, inflation melted, and job creation surged. Stocks and bonds also boomed

In hindsight, the 2008 Great Recession telegraphed another historic transition period. We are in an economic environment characterized by oversaving, overcapacity, and overabundance. Free trade has proliferated since the 1990s, hugely benefiting the developing world while hurting the middle-income classes in the developed nations. Price inflation has veered toward price deflation. Technology is driving the price of conventional energy lower and increasing the abundance of alternative energy sources.

On the political front, Americans seemed to stop believing in the American Dream after the Global Financial Crisis. And to some extent, the world stopped believing in America. The financial crisis and its aftermath have undermined confidence in the Anglo-Saxon model of laissez-faire capitalism as the route to achieving greater prosperity. Meanwhile, it has alienated a population where the middle class has been severely squeezed, and the income gap has escalated. Political extremism is regaining popularity, and class warfare is more evident today, reflecting the deep polarizations within society. The U.K. is contemplating an exit of the European Common Market, while Euro-skepticism has never been this vocal—all symptoms of our time.

The financial crash and its aftermath have exposed the underbelly of capitalism. Capitalism is incredibly efficient, but the gains are distributed unevenly. Winston Churchill long ago observed "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism the equal sharing of miseries." Based on the Gini coefficient—a measure used to calculate how skewed the distribution of income is in a country—the U.S. distribution of income has reached the level often associated with civil war in many countries.

Today, the new buzzwords are secular stagnation and deflation. Nominal gross domestic product (GDP) growth over the last eight years is running at levels that would have been considered recessionary during the previous three decades. The problems are deficient demand and excess supply, lack of credit growth, and fiscal austerity, not to mention waning population growth. Once again, financial markets are priced to reflect the extremes. Bond yields in many developed markets are zero or less. Thirty-year Treasurys are bouncing along the 2.5% yield level, which has contained this market since the 2008 crisis. U.S. equity market multiples are very high, yet the risk premium remains well above levels that existed throughout the period leading up to 2008. All these things conjure up images of the early 1980s, except everything is upside down.

We believe something is coming. The political strains are evident across the world. The American primaries, if nothing else, have revealed how angry the population is with the status quo and Washington's inability to foster positive change. In the world of macroeconomic policy, the most radical proposal in vogue these days is the "helicopter drop," or money-financed fiscal spending. At the moment it is still an idea, but the need to lift economic growth from secular stagnation will become so strong that politicians and governments will be forced to resort to radical policy to get the world economy going again, in our view. What that means for asset markets clearly depends on the nature of the policies that are implemented in coming years. However, in all probability, it strongly suggests that we are passing through the secular low points in interest rates and bond yields.

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