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Thematic Drivers

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There are multiple factors driving the market. Reflecting on where the market has been and where it's headed, we fit economic, market and global events into structural themes. With that analysis we then identify their investment relevance. The current themes at the forefront are the end of the debt supercycle and the 35-year bond bull market, de-globalization, rising income inequality and a global savings glut in a low-growth environment. These themes are intertwined, and we'll examine each in more detail below.

End of the Debt Supercycle & 35-Year Bond Bull Market

A decades-long period of using credit to keep the economy growing and asset prices rising is coming to an end. The use of negative interest rates in parts of the world demonstrates that policymakers are still hopeful that monetary policy shifts can drive economies.

Compared to historic standards, private debt-to-GDP ratios have not really increased; debt-to-income levels remain high, however, and any decline in private debt has been offset by increases in public debt. The key takeaway is that while credit growth has been slow, debt levels remain historically high and have a negative effect on economic growth. Deleveraging takes a long time to run its course. In the US, it started with the 2008 crisis.

The most recent debt cycle came to emerging markets last. The end could be seen when the commodity boom contracted and capital flows reversed, in turn starting instability in the credit cycle. This combination halted the supercyle in the emerging world, except for China who continues to have a love affair with debt.

So how will this all end? The perfect solution is for economic growth to accelerate and to pay off the debt. This is not likely, due to demographic changes and the sheer amount of outstanding debt. Another option is to write the debt off or create inflation to diminish it. We doubt that central banks could withstand the amount of inflation it would take to actually lower the real outstanding debt level. Since these solutions don't seem particularity attractive, the current low interest rates at least minimize debt servicing costs. This lack of action has its downsides: it penalizes savers, encourages speculation and artificially supports negative return projects. But, policymakers may see this as the best option to avoid another financial crisis.

The risk to the bond market is now to the downside. This does not mean we're calling for a bear market in bonds; that is still years away. Policymakers around the world are more likely to use reflationary policies due to growing populism. The combination of higher savings with low demand is creating a difficult problem to solve.

The effectiveness of quantitative easing (QE) is waning, causing central banks to become more creative. Debt monetization is a tool they haven't yet used. By announcing that the central bank is rolling over a portion of the debt issued in the QE program into perpetuity, that would automatically reduce the government debt-to-GDP ratio. If consumers believe that inflation will increase, they will be motivated to spend today before prices rise. For the ECB in particular, these are desperate measures and things aren't really that bad. In practice, all ECB would actually need to do is announce they won't reduce the size of their balance sheet even if inflation increases, and that will have the same effect. Essentially everything policymakers have done since 2008 has been one giant slippery slope.

De-Globalization

Globalization is under threat. Falling trade barriers have greatly benefited developing economies with diminishing returns for advanced economies. Deflation can be seen in lack of real wage growth and an increase in personal debt combined with the rising costs of education, health care and housing. The collective result puts more pressure on portions of the population. Recently there has been a rise in civil unrest and populism. Examples can be seen in the United Kingdom, Germany, France, Italy and the United States. We caution domestic readers that this did not start with Donald Trump. In fact, this is a global issue.

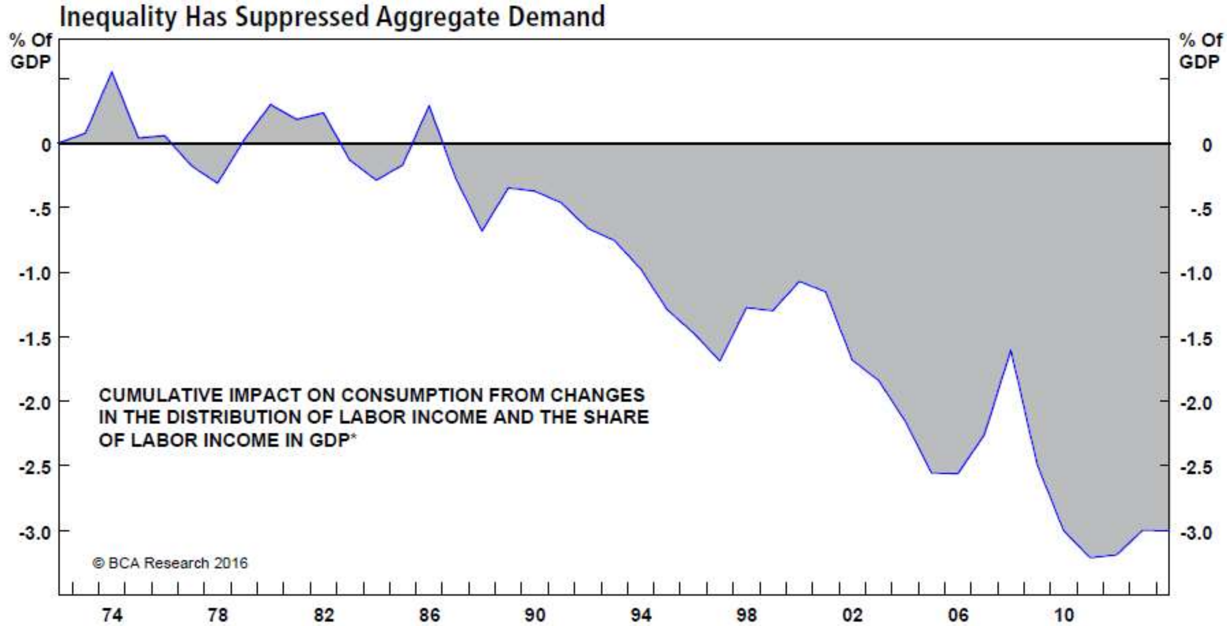
A paradigm shift is underway. Policy makers have spurned austerity measures in favor of stimulus to quell the rising tide of populism. Multipolarity, the intense competition between a few leading economies, strains globalization, especially in a low-growth environment. Enter a period of less trade, more government spending and high entitlement spending. Without globalization to pressure it downward, inflation will return. Higher inflation and more government spending will result in a stronger dollar given the relatively tighter Fed policy at home versus abroad.

As the global pool of workers has increased, the ability for companies in developed countries to look abroad for low-skill workers has affected the flow of income going to the domestic low-skilled workers. This has increased income inequality the greatest.

Income Inequality

Globalization is one of the main forces that has exacerbated income inequality. In fact, it is one of the few forces that is easier to adjust with policy decisions. The effects of shifting income from poorer to richer households and increasing amounts of income flowing to capital projects has depressed US aggregate demand by about 3% since the late 1970s. According to a recent IMF paper, rising inequality alone reduced real consumption by 3.5% from 1990-2013.

Inequality Has Suppressed Aggregate Demand



* SHOWN AS A CUMULATIVE CHANGE SINCE 1972. THE CHANGE IN THE LABOR SHARE OF INCOME AFFECTS CONSUMPTION VIA TWO OPPOSING FORCES: ON THE ONE HAND, A LOWER LABOR SHARE REDUCES OVERALL WAGE INCOME, THUS DEPRESSING CONSUMPTION; ON THE OTHER HAND, A LOWER LABOR SHARE RAISES CAPITAL AND BOOSTS THE VALUE OF EQUITY PRICES, LEADING TO A POSITIVE WEALTH EFFECT ON CONSUMPTION. IN LINE WITH STANDARD ESTIMATES, HOUSEHOLDS ARE ASSUMED TO INCREASE CONSUMPTION BY THREE CENTS PER DOLLAR INCREASE IN EQUITY WEALTH. A PERMANENT 1% INCREASE IN CORPORATE PROFITS IS ASSUMED TO RAISE EQUITY WEALTH BY $15.

Poorer households typically spend their paychecks compared to richer households who save more of their earnings. This was less visible when the US was growing at above average rates since the poorer households also relied on more debt to continue their spending. As soon as the debt window closed, it started to affect growth more broadly. Reducing income inequality could not only reduce the populist movement, it also could create a more sustainable economy going forward.

Global Savings Glut in a Low-Growth Period

Before the great recession when Americans were polled about the desire to save more money, only half wanted to. Today, now two-thirds say they want to save more. At the same time, companies are investing less in their businesses for a multitude of reasons. The weak recovery in consumption prevents a need for added capacity, the slowdown in the growth of the labor force requires less labor costs, and low commodity prices have reduced investment in the energy and materials sectors in particular. This investment type typically accounts for one-third of global cap ex for publicly listed companies.

Logically, global savings must equal investment. When both of these conflict, then interest rates decline to discourage savings. However, when nominal interest rates are already very low, there is a problem. Since globally deflationary pressures remain, this suggests that the neutral rate is actually negative. A classic "liquidity trap" is created when rates are near zero and the economy still doesn't recover. One option to fix this is to do nothing. As a result, investments will stay low, GDP will fall, unemployment will rise and savings will start to decline. This is not a popular decision and thus we don't foresee it happening.

Austerity measures are being swapped for stimulus measures around the world. Central banks continue to try and boost inflation. It can be observed how some economic trends started as deflationary are actually becoming inflationary. An example is productivity growth. At the start, slower productivity growth diminishes returns for companies to invest, resulting in lower wages. This will drag on demand and create a larger output gap. Eventually, however, with fewer goods created the supply will be affected, which will create inflationary pressures.

The demographic of an aging population also can have a dual effect. Initially, as the labor force growth slows, it serves as a disincentive for firms to increase capacity, and consumers slow the expansion of their balance sheet with a slowing of purchases of a new home or durable goods. Eventually, workers start to retire and reduce their savings along with the size of the labor pool. Europe is nearing this inflection point and Japan may already be there.

Conclusion

We foresee these broad structural themes to remain in place for some time. The ability for policy makers to engineer their way out of debt has diminished. The rise of income inequality is a direct effect of globalization, straining policymakers as they weigh nationalism versus globalism going forward. It appears the financial crisis may have structurally changed the attitudes consumers have about debt.

We do believe, however, that there are ways to position investments and take advantage of the markets as they digest and work through these drivers. Knowing that these are long-term and secular in nature, there are some general conclusions affecting large sectors of the market. Income inequality and de-globalization will challenge corporate growth going forward. A low-growth environment paired with high valuations means investors need to be more tactical in their positioning. A portfolio invested in a steady, long-term strategic asset allocation without a layer of tactical allocations involved is destined for low returns. With the bond bull market ending, a "balanced" investor could see half of their portfolio dragging down any positive returns in their risky assets.

All this to say, we are in a challenging return environment. Our Outlook follows with our more tactical viewpoints for the year ahead.