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Structural forces paint a challenging picture of the future, but not without opportunities for active investors

The world is battling its most significant inflation outbreak since the 1970's. Having missed the opportunity to get in front of the problem, many developed world central banks are now tightening monetary policy aggressively. Domestic demand is now slowing sharply as households and businesses face into sharply higher prices for goods and services and rising borrowing costs.

Central banks will eventually win the inflation battle. The only near-term question is how much pain needs to be borne as we seek the return to the relative economic nirvana of 2% inflation and maximum sustainable employment.

For us, the recent experience of Covid and the war in Ukraine have exposed critical questions about the longer-term challenges facing most developed and key emerging economies, exposing the risk of a prolonged period of structurally lower growth, higher inflation and the reversal of the long-term trend decline in interest rates.

Globalisation in retreat

The retreat of globalisation is not new news, especially since the 2016 "big bang" of US President Donald Trump's agenda to make America great again and the UK's decision to leave the European Union.

Over many decades, globalisation has been a significant contributor to increased trade flows, higher economic growth, reduced inequality between countries (though a part-contributor to increased inequality within countries) and lower inflation.

Covid and the war in Ukraine have exacerbated the retreat. Having experienced the disruption of broken supply chains, many businesses are now seeking the security of supply chains that are closer to home, even if it's not the cheapest option.

For its part, the war in Ukraine potentially ushers in a new period of cold-war style factionalism and global fragmentation. That fragmentation will be political and economic and will have -negative consequences for supply chains and trade flows.

Demographics and ageing populations

Conventional wisdom has it that an ageing population is a disinflationary force. The theory is that as populations age, saving rates rise, reducing pressure on ever diminishing resources.

We think about it this way. As populations age, dependency ratios rise. In other words, the share of the population that is productive declines and that smaller share of the population is relied on to produce goods and services for an increasing proportion of the population that is unproductive.

Population ageing is only disinflationary if an alternative labour source can be found – that used to be China (see section on China below).

A declining share of the population in work seems to us to lean towards tighter labour markets and add to wage and inflation pressure, especially in a world of moribund

productivity growth, an affliction facing most developed economies.

We have just witnessed this phenomenon in action through the Covid lockdowns as labour participation dropped sharply and not everyone has returned to work, contributing to significant labour shortages and wage inflation.

A new wage price spiral?

Much of the disinflation of the past two decades has been the result of the lack of a mutually reinforcing cycle of higher inflation fuelling inflation expectations, leading to wage increases which in turn fuel higher inflation.

Much of that can be sheeted home to the earlier demise of the unions and collective bargaining power.

The world is arguably on the cusp of an emergence of a new wage price spiral as inflation, particularly for key household expenditure items as food and energy, squeezes household disposable incomes leading to heightened wage demands which then feeds back into higher inflation. Firms are better able to pass the costs of higher wage bills onto consumers in an environment of high and generalised inflation.

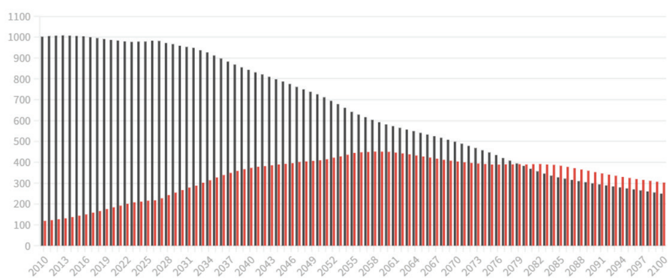
Labour bargaining power hasn't been this strong since the zenith of the union movement. It seems only set to rise given broader demographic and productivity challenges.

The end of the era of China as a major global disinflationary force

The era of China as the world's factory and a significant source of global disinflation is at an end. China's pivot from over reliance on investment and exports towards consumption and "common prosperity" are leading to lower growth, though arguably more sustainable growth.

China working-age population, 65+ population

Projections, millions



Source: Shanghai Academy of Social Science

At the same time, however, the country is already facing into some "old world" challenges. Their working age population has been in decline since 2014 and productivity gains are harder to come by. Furthermore, the country is facing into these challenges before it has become a rich country.

This combination of factors seems to us to usher in the end of period of China acting as a major disinflationary force in the global economy.

It also points to on-going tensions between China and the United States as both vie for political and economic supremacy, especially with respect to technology, the answer to both countries' productivity challenges.

Lower potential growth

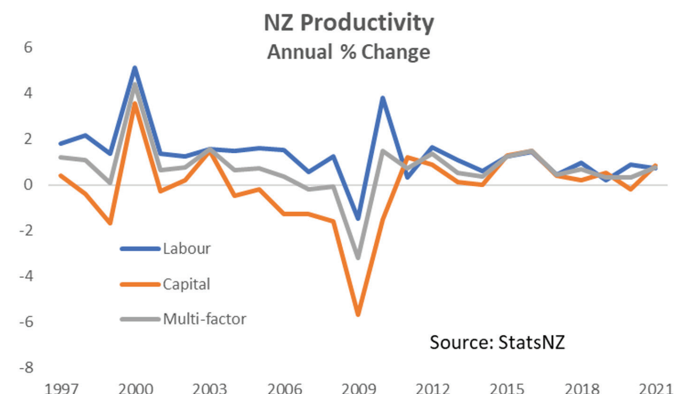
Potential growth is the rate of GDP growth that is consistent with a country's inflation target. Growth running higher than potential (a positive output gap) will tend to put upward pressure on inflation, while growth running below potential (a negative output gap) will put downward pressure on inflation.

As with globalisation, structural drivers of lower potential growth are not a new phenomenon, but they are now being exposed given the pressing need to get growth below potential and create negative output gaps.

Determinants of potential growth are essentially (working age) population growth, how much we invest, and the productivity of both.

Poor productivity is a double whammy for some countries where not only labour productivity growth is poor, so too is the productivity of capital.

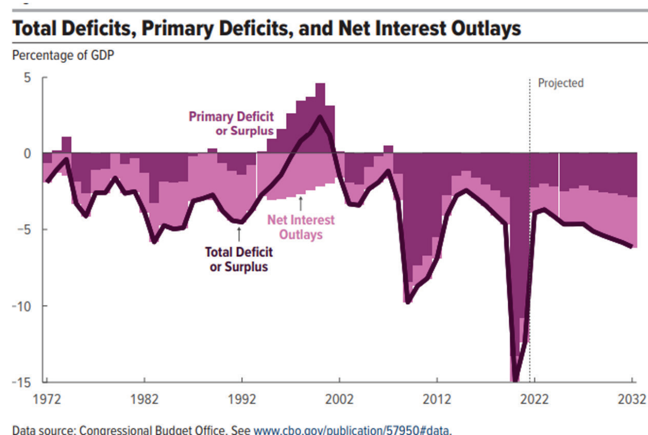
We are in that boat in New Zealand. As we have failed to deal with our abysmal labour productivity problem, we have resorted to immigration to fuel the labour needs of business. Immigration fuelled population growth has seen a significant proportion of our capital invested in housing and housing-related infrastructure, or non-productive investment. Over the last 10-years, our multifactor productivity (labour and capital combined) has averaged only 0.75% per annum.



Fiscal Challenges

Public debt levels are higher now than they were prior to the Global Financial Crisis. Government spending has been ill-disciplined. Periods of macro- economic support have not been followed by necessary consolidation.

Now, as interest rates rise, many countries are now facing into rising debt servicing costs. In the US, the Congressional Budget Office estimates US debt servicing costs will triple over the next, a function of rising planned outlays, persistent deficits and rising debt, and rising interest rates.



Data source: Congressional Budget Office. See www.cbo.gov/publication/57950#data.

At the same time, there are increasing calls on government spending, from the near term to relieve the impact on household budgets of sharply higher inflation (which should be short-term and targeted) to longer term challenges of reducing inequality, boosting generally low growth, meeting climate change commitments, and, more recently, increasing spending on security and defence.

As potential growth wanes, it's essential for Governments to maintain productivity and growth friendly tax policies.

Unfortunately, this doesn't add up, though it doesn't stop politicians, as we are currently witnessing in the tussle for the leadership of the UK Conservative Party, promising to address climate change AND cut taxes at the same time.

Interest rates: lower for longer is over

The relative economic calm of the "Great Moderation", the period from the early 1980s until the Global Financial Crisis (and arguably resumed following the GFC) brought many benefits. Inflation was lower, the macro-economic environment was more stable and real (inflation adjusted) bond yields were in trend decline.

It wasn't all good news, however. Over that same period economic growth trended lower and inequality (both wealth and income) rose.

As we head into a period of rising structural inflation forces, coupled with lower potential growth, we are likely to see greater macro-volatility. Central banks will take a necessarily more activist approach to managing inflation to target, despite the growth outlook.

We have just witnessed the European Central Bank end its negative interest rate policy with a larger than expected 50bp hike as the regions sits on the brink of recession. That's because the recession is emanating from the supply side of the economy. Central banks must not resile from their primary commitment to maintain price stability.

Furthermore, the retreat of globalisation and demographic challenges argue for a reversal of the long-term decline in real bond yields. If inflation expectations rise, that could exacerbate an even greater move upwards in nominal yields.

Policy priorities

Monetary and fiscal policy normalisation is paramount. Monetary policy must regain the primacy of its primary policy tool – interest rates. Its arguable whether the newly conventional tools of quantitative easing and negative interest rates will be as effective during the next economic crisis.

Fiscal buffers need to be restored and fiscal discipline improved. New spending must meet the narrow criteria of supporting social outcomes and/or improving productivity. Promises to increase spending and cut taxes at a time of record public debt levels must be challenged. Politicians will need to make the hard calls about the sustainability of policies such as universal pension entitlements, especially as rising life expectancy continues to put pressure on the public purse.

Policymakers need to prioritise a long-term plan to raise the productivity of both labour and capital. This includes improving educational outcomes across primary, secondary, and tertiary institutions. Policy settings must encourage greater labour participation and productive investment. Meaningful, enduring partnerships need to be built and maintained between business and government regarding work training.

Implications for investors

A more challenging and potentially volatile economic environment argues for greater active management. This is both at the sector (Dynamic Asset Allocation) and stock-selection level.

The future likely holds a more challenging environment for equities but one ripe for active investors as some sectors will perform better than others at different points in the cycle. More volatility means more cycles and greater opportunity to add value through more frequent sector

rotation. In general, lower growth and higher inflation will favour consumer staples and healthcare, and firms with pricing power.

Sovereign bonds will be challenged by higher inflation and rising debt levels. There will be opportunities to add value as economic volatility increase. Timely exposure to a well-diversified credit portfolio will be important, as the cycle permits as well as an exposure to green bonds to capture the benefits of the transition to a greener planet.

Caution will be required in selecting corporate bonds, as while their yields have risen recently to more attractive levels, the slowing world growth picture makes a potentially-prolonged credit rating downgrade cycle the likely next development. Some securities will lose their Investment Grade status, which could suppress returns from these bonds further.

In a changing environment, Strategic Asset Allocation will benefit from more regular reviews and the incorporation of additional levers. Portfolios are expected to benefit from increased exposures to asset classes that will perform well during periods of low growth and higher inflation, including global listed property and global listed infrastructure. Thematic and uncorrelated assets such as Carbon market exposure will also assist us defend the risk-adjusted returns to investors.

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