

# Buying the dip? Beware - this time it's not going to end well



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Buying the dips as a strategy has worked well over the past 10 years – primarily with the help of the U.S. Federal Reserve. Such an approach to investing has worked because none of the secular forces behind inflation, real interest rates and globalization had changed. But I am afraid that buying the dips may no longer be as safe a strategy as it was.

Many structural changes are taking place regarding not only inflation and real rates, but also globalization and geopolitics. We are at an inflection point of world history with serious consequences for world stock markets and the global economy.

## **Why is the secular trend of real interest rates on the way up?**

1. Demographic developments. Baby boomers have been retiring and have stopped saving; in fact, they are in their decumulation years, which reduces the supply of funds available for lending or investments.
2. This happens in the face of increased demand for capital by companies that need to embed innovation and new technologies into their production processes, as well as by governments that need to borrow to fund structural deficits.
3. To clear the demand-supply imbalance, the real interest rate trend is pushed up as suppliers of capital demand more attractive rates, not unlike what happened in the late 1970s.

## **Why is secular inflation on the way up?**

1. We may be reaching a peak in productivity growth as experienced baby boomers retire and are replaced by less experienced workers who will nevertheless be in high demand owing to low population growth. These workers will demand higher wages. This means higher inflation down the road.
2. Pandemic-related deficits and ballooning debts will require higher taxes. Not unlike the two world wars of the last century, the pandemic has been expensive and will require heightened taxes to deal with deficits and accumulated debts.
3. A pause in globalization may lead to higher inflation as companies, trying to guard against supply chain interruptions, will be bringing production back to North America to an environment of higher production costs.
4. Whereas, historically, central banks have acted in a countercyclical fashion, in the last 10 to 15 years they have been increasing money supply on a more permanent fashion and this will also add to long-term inflationary

pressures. It is worth remembering that the rampant inflation of the 1970s was caused by monetary policies that financed massive budget deficits and were supported by political leaders.

5. During the credit crisis of 2007-08, aggressive quantitative easing did not produce higher inflation, as QE was happening while banks and individuals were deleveraging and these two were offsetting each other. But in recent years, there has been an overaggressive QE program without any offsetting effect, and this will also lead to higher inflation.

6. Years of underinvestment in the oil and gas industry, heavy regulation and the environmental, social and governance (ESG) craze have shifted not only the oil price dynamics, but also the price dynamics of all commodities.

7. Unprecedented supply chain disruptions in the face of massive monetary and fiscal stimulus, and ballooning demand along with decreased global trade are increasing prices. The labour market is incredibly tight. Wages are rising. A wage-price spiral, if it persists, will lead a further surge of inflation.

### **Why has the secular trend toward globalization come to an end?**

There is no doubt that the world will look different in the aftermath of the pandemic and the Russian invasion of Ukraine.

1. Companies' gradual transition toward more local production has been in place since 2008, with exports falling as a share of GDP. The trend accelerated during the pandemic because of significant supply chain problems. Companies now place higher importance on having goods for manufacturing and distribution close by.

2. The invasion of Ukraine will change the world as we have known it. It will intensify de-globalization. Moreover, geopolitical tensions tend to spread – Taiwan versus China, Turkey versus Greece, South Korea versus North Korea, and so on.

Over the past 40 years, the world has experienced a bull market in stocks, bonds, and real estate owing to low inflation, low real interest rates and, with the fall of the Berlin Wall and the end of the Cold War, the advent of globalization. Rising inflation, increasing real interest rates and de-globalization – with the possible erection of a Berlin-like wall in Ukraine and the start of a new Cold War – augurs a bleak outlook for the stock, bond, and real estate markets. The markets have yet to discount this outlook.

The U.S. Fed may not be able to help this time as it is caught in a Catch-22. The ballooning debt issuance around the world, including margin debt, in recent years has made economies and financial markets very sensitive to interest rate increases. The Fed could abandon the inflation mandate to support the financial system, but given the amount of debt outstanding amid all the structural changes referred to above, this may lead to financial markets – and economic growth – declining too quickly to be rescued. What happened to the Greek economy in the 2010s comes to mind. As a result, beware of buying the dips.

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