Why the outlook for stocks, bonds and real estate markets has rarely looked this bleak

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Sir John Templeton famously said that the four most dangerous words in the investing world are “this time it’s different.” But this time, in my opinion, it is indeed different.

Over the past 40 years, the world has experienced a bull market in stocks, bonds and real estate because of low inflation, low real interest rates and the advent of globalization (with the fall of the Berlin Wall and the end of the Cold War).

But investors became complacent. Fear of missing out and greed dominated the markets, sentiment and trading. Years of excesses at all levels of governments and in both the professional and retail investment communities created pressure inside a dormant volcano that it is now ready to explode, leading to the mother of all busts.

Here is why I think so.

There are secular adverse changes in globalization, as well as in inflation and real interest rates that augur a bleak outlook for the stock, bond and real estate markets.

First, the secular trend toward globalization has ended.

- The pandemic disruptions have prompted a major rethink on how companies outsource production. Companies now place higher importance on having goods for manufacturing and distribution close by.
- The invasion of Ukraine by Russia sounded the death knell for globalization, and will accelerate the process of deglobalization.

Second, there are secular forces that are pushing up both long-term inflation and real interest rates.

In the short run, inflation is driven by the heightened intensity of economic activity and the pressure that places on productive capacity and the labour and commodities markets. But in the long term, it is taxes, economic efficiency and productivity, as well as structural demand/supply imbalances, that affect inflationary expectations.

The real interest rate – that is, the rate once inflation is stripped out – is driven by the vicissitudes of the economy (i.e., the business cycle) in the short term, while its long-term (secular) trend is affected by factors that change only slowly – technology and demographics.

The business-cycle effect is transitory; it is the long-term trend that is the problem this time.

The decline in long-term inflation is over, and we are now on the other side of the mountain, with long-term inflationary pressures building.

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 because of low population growth. These workers will demand higher wages.

- Pandemic-related deficits and ballooning debts will require higher taxes. Many have likened the pandemic to the cost of a world war. They are expensive, creating deficits and debt that must be dealt with.
- A pause in globalization may lead to higher inflation as companies, trying to guard against supply-chain interruptions, bring production back to North America. That means a higher production-cost environment.
- Whereas historically, central banks have acted in a countercyclical fashion, in the past 10 to 15 years they have been increasing money supply in a more permanent fashion and this will also add to long-term inflationary pressures.
- During the credit crisis of 2007-08, aggressive quantitative easing did not produce higher inflation. 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.
- Finally, years of underinvestment in the oil and gas industry, heavy regulation and the ESG craze have shifted not only the oil price dynamics, but also that for all commodities. For example, mining companies are returning capital to investors rather than investing it to increase production for fear of ESG regulations. This implies major shortages in metals down the road at a time when demand will be increasing due to renewable energy and electric vehicle production.

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

1. Demographic developments are pushing the real interest rate trend higher. Baby boomers have been retiring and are now dipping into their savings for their spending needs, which reduces the supply of funds.
2. This demographic shift is happening in the face of increased demand for capital by corporations 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, not unlike what had happened in the late 1970s.

The U.S. Federal Reserve may not be able to help this time, as it will be facing 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.

Moreover, equites have recently tipped into a bear market. The past eight bear markets, as reported by MacNicol & Associates Asset Management, have been fought by the U.S. Fed via interest rate cuts and quantitative easing. In the current bear market, the Fed is raising interest rates.

The Fed may abandon the inflation mandate to support the financial system as it has done in the past, but given the amount of debt outstanding in the presence of all structural changes referred to above, this may lead to financial markets and the economy falling too quickly to bail out. The markets have yet to discount this outlook.

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