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Key Takeaways

- The long-term impact of low interest rates has been net-negative for global growth.
- A normalization of interest rates is crucial for capital accumulation, rising productivity, and, ultimately, higher long-term growth.
- In this new environment of higher interest rates, higher returns can also be captured — but only if investors reorient portfolios away from those investment classes that needed zero rates to thrive and towards those that have languished over the last decade.

ASK FORSTRONG:

Will the end of the ultra-low interest rate era be a continuing headwind for financial markets?

How best to describe market vibes in 2022? Investors do not have to look far to see a booming trade in the apocalypse forecasting genre. Take a stroll through the section and all the headlines read like scenes from a Mad Max movie. Energy rationing in Europe. Renewed tension in the Taiwan Strait. Ever-widening political fault lines in America. Then, toss into the plot sanctions, blockades, infrastructure attacks and embargoes on raw materials, and the category really feels bleak.

Unsurprisingly, all of this has weighed heavily on financial markets. A June 2022 survey showed money managers more bearish than during the market lows of March 2009. That same month also saw the highest stock market volatility since 1928.

But there is a key support to all this gloom too. A growing counsel of doom is now warning about the end of the zero-interest rate era, that apparent Eden built on an abundance of cheap capital and easy funding rounds for the tech sector. Many are now looking back wistfully on the last decade as a kind of economic nirvana. In fact, their argument is compellingly simple: if low rates boosted asset prices, then naturally, higher interest rates should depress valuations.

It's a nice narrative, but there isn't much evidence to support it. Yes, the initial impact of low rates is always a crowd-pleasing elixir. When the 2008 global financial crisis hit, Fed Chair Ben Bernanke — an avid student of the Great Depression — was determined not to repeat the failures of the 1930s, cutting the benchmark fed funds

rate to 0%. He also introduced a comprehensive kit of unconventional tools: notably, forward guidance and trillions in government bond purchases (which, at the time, Bernanke estimated were equivalent to another 300 basis points of rate cuts). Everyone knows the story from there: markets initially soared on government wings.

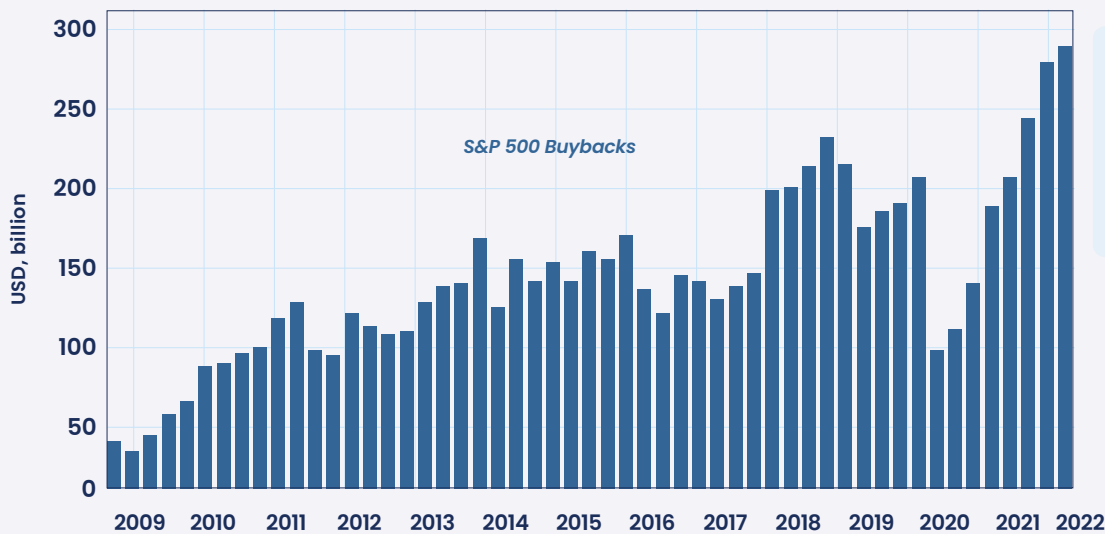
The Legacy Of Low Rates

But the longer-term impact of low rates, particularly if they remain low for long periods of time, always leads to lower growth. Why? For one, low rates hinder the process of creative destruction. Look no further than the Japanese economy, where rates have been stuck at zero for years and where lifeless companies with poor profitability survived on fresh rounds of debt, simultaneously sucking crucial resources from more dynamic companies. Since the early 1990s, the Japanese economy has faced a series of rolling “lost decades”. Another one in the 2020s is likely.

Low rates also lower the incomes of retirees and savers, who are then forced to suffer from negative real returns on their fixed income instruments (what Keynes colourfully called the “euthanasia of the rentier”). The net result is widening wealth skews and a shrinking middle class — trends that impede inclusive and broad-based economic growth.

Most importantly, however, low rates discourage saving and investment. But capital accumulation is crucial for lifting productivity and longer-term growth. Consider that the 2010s were the decade of massive company buybacks. That makes sense. Why would companies, even those flush with cash, engage in real business investment when growth is uncertain, and capital near-free? Over the short-term, corporate executives can hit quarterly earnings targets far easier with financial engineering than long-term investment initiatives. As it was, a capital spending cycle, with the resulting rising wages and higher growth, never took hold. Instead, the recovery from the 2008 financial crisis was the most anemic since World War II.

A Bull Market in Financial Engineering



Sources:
Macrobond, S&P
Dow Jones Indices,
Forstrong Global
Asset Management

What’s worse, the investment that did take place mainly went into productivity-dragging distractions — digital games, social media and other consumer internet technology. Sure, some of these are modern conveniences, but they are hardly industrial breakthroughs. Compare that to earlier episodes of capitalism, which generated advances in electricity, key infrastructure and other innovations that lifted productivity across industries.

Yet, for the last decade, Silicon Valley was a huge magnet for talent. Those involved in tech-startups often made a fortune, despite working for companies that never turned a profit or created value for the public. All this, of course, has come with a longer-running cost. For example, in the resource extraction business, we now have a shortage of mine engineers. New projects take far longer to complete. New technology to make extraction faster and more cost-efficient has also been scant.

No surprise, then, that the world is facing enormous deficits in key commodities. A wide range of other research-intensive fields have suffered as well,

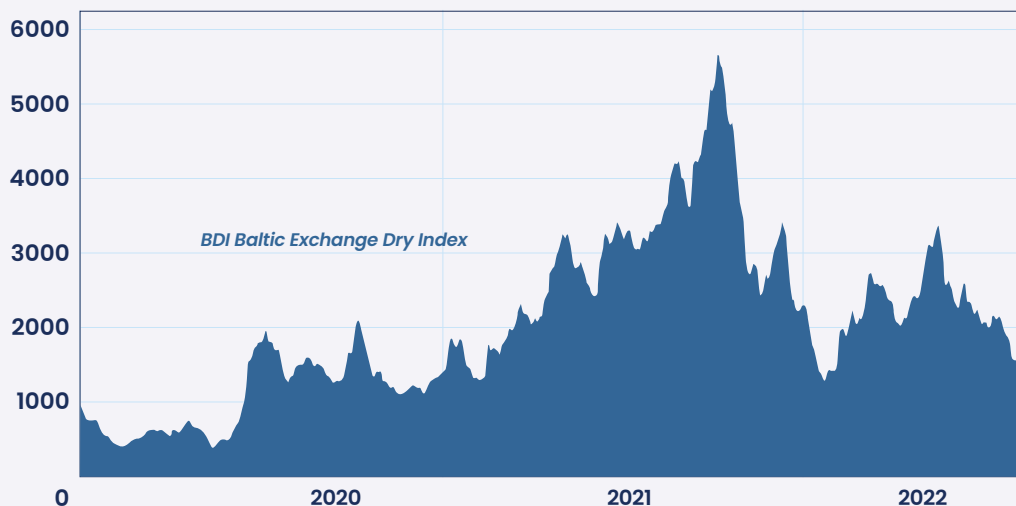
as endless rounds of low rate-funded venture capital pushed the best and brightest into game development and ad optimization (and, sadly, into building algos for cryptocurrencies).

Revenge Of The Real Economy

Yet now comes a plot twist. Inflation is back and the move away from zero interest rates has come with a significant bear market, crushing asset prices of all types. Investment classes that thrived on low rates, like profitless tech companies have seen trillions vanish as hot money fled the sector.

What happens next? To prevent further market carnage and ever-rising rates, inflation must start to moderate from here. But consider what is now happening in real time: pandemic supply-driven inflation is quickly resolving itself. The backlog of orders and delivery times are falling. Shipping costs are also falling rapidly. The global economy is rebalancing quickly as the recovery process broadens out and various sub-sectors adjust.

Shipping Costs are (Finally) Normalizing



Sources:
Macrobond, Baltic Exchange, Forstrong Global Asset Management

Even turning to the grand canvas of geopolitics — a key source of inflation this year — supply chains are adapting. Here, let's not kid ourselves: global governments are showing that shrewd multipedal political maneuvering can keep cross-border trade booming. For example, the International Energy Agency reluctantly admitted that recent Western sanctions against Russia have had limited impact on their oil output. The country's current account surplus swelled to a record US \$138.5bn in the first half of 2022, as energy flows quickly re-routed to other countries like India and Turkey. Or, consider that amid increasing US-China tensions, Covid lockdowns and ongoing hefty tariffs, China's exports have continued to gain global market share, underscoring the attraction of the country's global competitiveness.

The fabric of globalization has proved so densely woven it has resisted attempts at a full unravelling. Markets are still underestimating the speed and flexibility of the global supply and production response. This will help tug prices lower in the period ahead.

What about demand-driven inflation? Here, we anticipate stickier conditions. Yes, growth is moderating which will lower aggregate demand somewhat. But the big surprise over the summer, contrary to widespread recessionary fears, has been global growth that remains relatively resilient, despite rising rates.

Why is this happening? In the 2010s, the need for consumers to repair balance sheets necessitated a far lower interest rate. An extended period of debt reduction, cleansing of excesses and overall financial system repair was needed. Today, we simply do not have the same economic and financial imbalances. The economy is on far firmer footing and several dynamics are different: a robust

labour market, healthier consumer balance sheets and a well-capitalized banking system. Interest rate hikes have landed on a white-hot economy, not one balanced on the edge of recession.

Now, heightened demand is convincing executives that capital is worth outlaying — a sign that individual businesses are buying into their own prospects (even as they remain gloomy on the world economy and higher rates). In fact, shortages have quietly kickstarted a robust recovery in capital investment. This was the key missing ingredient in the post-2008 recovery and is crucial for lifting capacity, productivity and, ultimately, stabilizing inflation. Eventually, this will lead to stronger earnings and sustainably higher interest rates, even if growth decelerates for the next few quarters and central bankers can't stick a soft landing (don't hold your breath for it).

Investment Implications

Make no mistake: inflation remains a real threat. The pathway of central bank hikes could yet cause more market carnage. But what if, reacting to the liftoff from zero rates, the bulk of the bear market has already occurred? A large market adjustment happened in the first half of 2022, pricing in lower earnings and higher inflation expectations. After the extreme levels of pessimism registered in June, it would not be rare for markets to climb the proverbial "wall of worry" from here. The bar has been set low to deliver positive surprises.

Yet there is a glaring dynamic in today's market positioning. Investors, still enamoured with the narrow leadership of the last decade, continue to "buy the dip" in US growth and tech stocks and, mind-bogglingly to us, government bonds in the West.

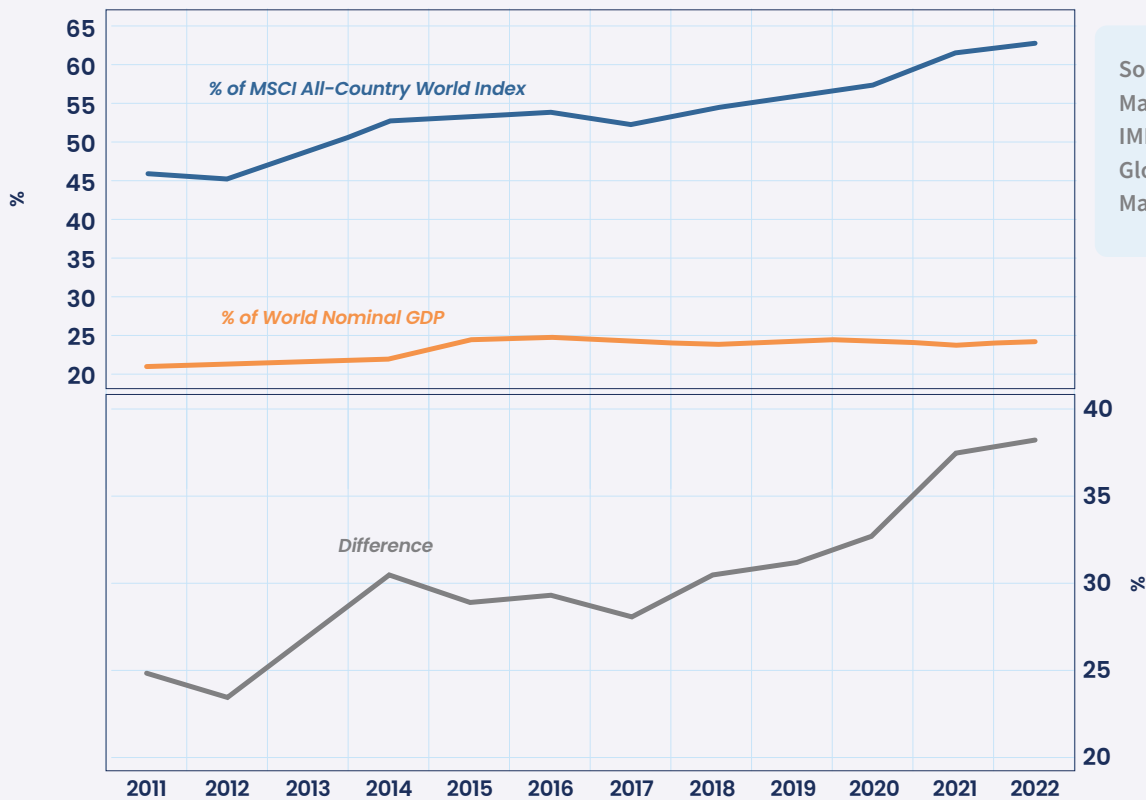
The real issue is that most investors remain anchored to the secular stagnation period after 2008. In other words, most simply do not believe we can ever escape low interest rates. And so, the world capital of hot money remains in the perceived safest country — the US; a region where a decade-long tear in the 2010s has led to lofty valuations and a swollen share of global stock market capitalization of over 60%, from a low of 45% (and, a level far above its roughly 25% of global GDP).

Comparatively, many investment classes that had struggled with chronically weak demand and dismal pricing power in the era of low inflation are

primed for outperformance: international value stocks which trade on far lower multiples and far higher dividend yields, select resource-exporting emerging market equities and global sectors with pricing power (banks, industrials, healthcare).

Investors should feel relief with all of this. Having wandered through a desolate landscape of low yields over the last decade (feeling like an extra in a Mad Max movie), the world is now normalizing. Higher returns lie ahead — but only if investors reorient portfolios away from those investment classes that needed zero rates to thrive and towards those that have languished over the last decade.

United States: A Sustainable Divergence?



Sources:
Macrobond, MSCI,
IMF, Forstrong
Global Asset
Management