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DON'T BELIEVE IN SOFT LANDING PIXIE DUST

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Key Takeaways

- A soft landing scenario, synonymous with a return to the benign inflation and low growth of the 2010s, is now a strong consensus. Don't hold your breath for it.
- Most forecasts today place too much emphasis on risks from higher interest rates and not enough on the upside from rising corporate revenues and higher household incomes.
- Continuing "upside surprises" in growth and inflation will lead to flows into equities (from cash and bonds) and rotation within equities (from defensive and tech sectors to cyclical and international markets).

Ask Forstrong: Are we headed for a soft landing?

Do fairytales ever come true in macroeconomics? They did in 1995, 1986 and, stretching back even further, the late-1960s. For those not spending weekends with their nose buried in financial history, we refer to the fabled soft landing. During those periods the US Federal Reserve raised rates and, like sprinkling pixie dust all over the economy, serenely lowered inflation without crushing growth. All other tightening cycles since 1960 did not have such happy endings: nine of them led to recession.

Can the Fed stick the landing again today? Many believe they will. Bank of America's sweeping global survey tells us that nearly 70% of fund managers now assign a soft, velvety landing as the most likely scenario. A consensus this strong is a rare thing in today's polarized world.

Looking back, this has been a strange cycle. Since the pandemic, world economies have moved in a sloppy cyclical pattern, with asynchronous upturns and downturns. Consumer goods boomed after every household rushed out to buy a new shed, an air fryer and two Pelotons. Then, as lockdowns were lifted, services boomed as everyone got a haircut and boarded a plane to the Mediterranean (not the worst idea). Different re-opening timelines among different nations added to the economic volatility.

What happens next? As none of this has taken the shape of a traditional, well-defined economic cycle,

determining "where we are" in the cyclical roadmap has been challenging. Then, consider all the other raw material thrown at investors over the last few years — government shutdowns, Silicon Valley banking implosions, bickering geopolitics abroad (China versus America) and closer to home (Trump behind plexi-glass or behind the Oval Office desk in 2024?), not to mention living with the ambient terror of the online doomster community continually warning of potentially overlooked looming disasters. No surprise that all this drained investor confidence — a stampede into cash has been the key investment trend of 2023. Higher confusion translates into higher cash weightings.

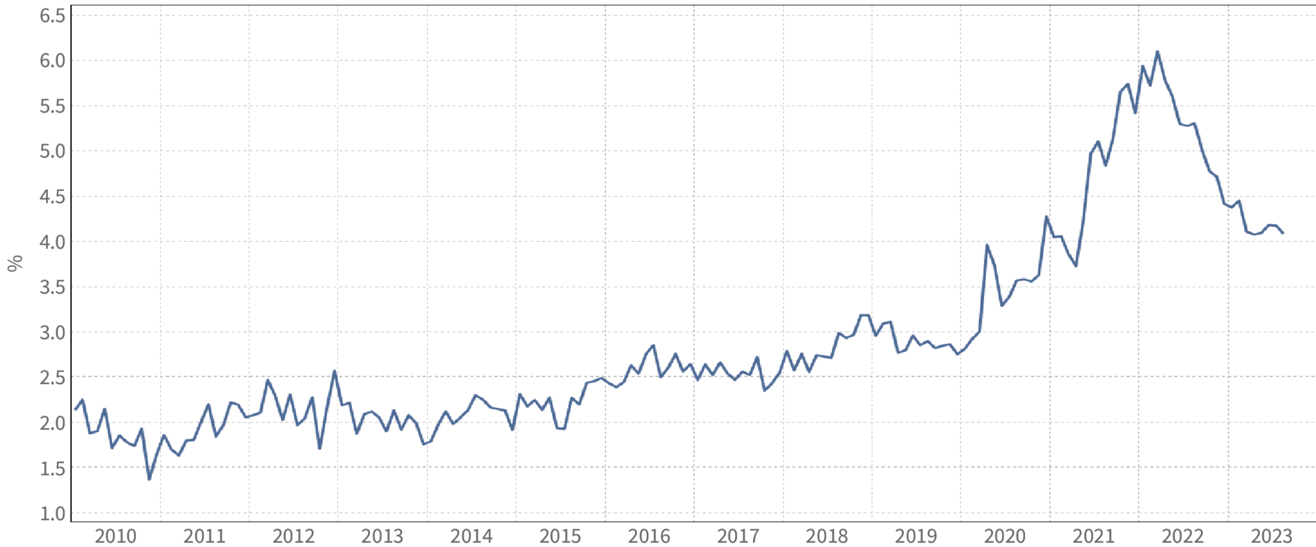
But don't let all this clutter your worldview. So far what defines the 2020s decade are upside surprises. Surprise growth. Surprise inflationary pressure. Surprise labour market strength. Many investors have been caught on the wrong side of the trade. In fact, as recently as February of this year, markets were pricing in a rate-cutting cycle starting this month. Then, in March, many pointed to the failure of Silicon Valley Bank as the end of this rate-hiking cycle (with the view that the Fed always hikes until "something breaks"). Yet the economy has continued to power ahead.

The Lost Kingdom Of Higher Nominal Growth

Investors should expect this resilience to continue for some time. This is not to say that the lagged effects of tighter monetary policy are not a risk. But what about lags from that aberrational decade of low interest rates in the 2010s? What has quickly come into view is that both companies and consumers had plenty of time to "term out" their debt. It turns out that most indulged. Companies locked in low rates for extended periods, while consumers ran into the arms of fixed rate mortgages at 1.5% – 3%.

That means that the dreaded refinancing cliff is not imminent. Yes, higher rates are a headwind but, in an environment of higher nominal growth, companies and consumers are better able to manage the increase in capital costs over many years. Evidence has surfaced that this is already happening: credit markets have been remarkably well-behaved. Defaults have remained relatively low and high-yield spreads have remained tight. Bank lending is now even turning back up.

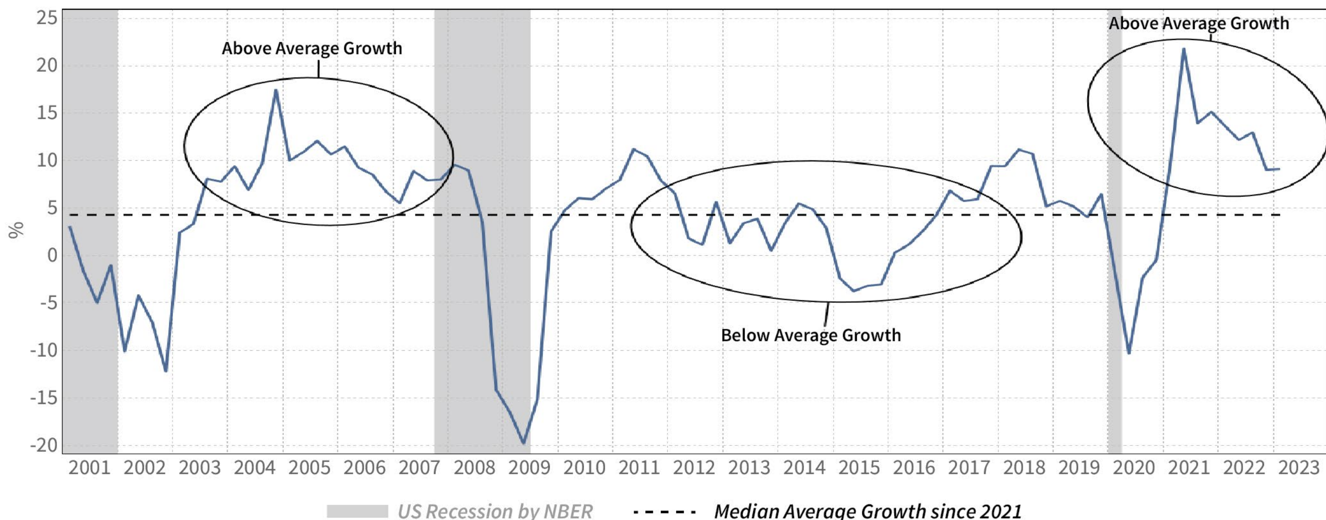
All of this is a key reason that recession forecasts (which have now been reduced to a smoldering husk) have been off the mark. Investors have placed too much emphasis on higher interest rates and not enough on rising corporate



Sources: Macrobond, Federal Reserve, Forstrong Global Asset Management

revenues and higher household incomes. The key difference between this cycle and all other cycles over the last four decades is higher wage growth. After stagnating for years, workers wages are now on a tear. Yes, prices are rising but so are hourly earnings, growing at a 4 – 5% clip. With labour shortages persisting, wage strength will continue.

Trends in corporate income are similar. Revenues have continued to beat estimates, even if margins are coming down and management teams are willing to take small hits on volume to push the topline up further. This is the exact opposite of what occurred in the 2010s, when broad corporate revenues remained sluggish for the decade.



Sources: Macrobond, S&P Global, Forstrong Global Asset Management

Few investors today have experienced the type of traditional revenue and income-driven cycle seen all the way back in the 1950s and 1960s. But those decades provide the best perspective on how this cycle will play out. Labour shortages and a corresponding capex boom prolonged the cycle. Steadily rising nominal growth never led to a big earnings collapse. And governments persistently spent as tax revenues continued to climb.

Looking ahead, more upside surprises will occur. Government spending shows no sign of slowing, with policymakers, whether you agree with them or not, nearly unified on future spending plans on climate change, state-led investment in the green transition, and new patterns developing in global trade. Astonishingly, America's federal deficit is projected to double from 2022 to 2023, a jump only surpassed by major crises such as WWII, 2008's GFC or the coronavirus pandemic.

What's more, while markets are laser-focused on downside risks in China, we are entering a world where other emerging markets are becoming growth locomotives by themselves. Importantly, India, long deficient in critical infrastructure, is now deep into a major capex boom, as evidenced by a steep rise in gross capital formation and surging private sector new project announcements. Increased infrastructure investment and trade is integrating more of the world's developing economies into the global economy at an accelerated pace. So much for deglobalization. Excluding China, these countries comprise more than 3 billion people, where demographics are favourable, incomes are growing, and constructive dialogues are leading to a surge in cross-border commerce and economic partnership.

Investment Implications

Of course, all of this is inflationary. Higher nominal growth will feed into secularly higher inflation. The risk today is that central bankers prematurely celebrate taming inflation, only to see prices plateau at an elevated level or even re-accelerate. Hardly a soft landing scenario.

How can investors win in this environment? Amid higher growth and inflation, investors need to think differently. There is no magic door carved into the side of a mountain or lost kingdom here. Rather, a simple framework should guide investors through this new terrain: avoid investment classes reliant on cheap capital (i.e. everything that did well in the 2010s) and aggressively accumulate productive assets in the real economy with pricing power, and high and rising dividends. Continuing "upside surprises" in growth and inflation will lead to flows into equities (from cash and bonds) and rotation within equities (from defensive and tech sectors to cyclical and international markets).

With that positioning, investors can still live happily ever after.

Tyler Mordy, Spetember 2023