Global Macro – March 2021 (Institutional Use Only)

StoneX

THREE UNCONVENTIONAL ARGUMENTS FOR SECULAR INFLATION

Bottom Line:

1 – Asia's devaluations, overinvestment, and demand repression caused the great moderation of inflation since the 1990s
2 – Asia has aged: its growth will slow, its factories close, and its currencies will soar, creating inflation in the West
3 – Due to widespread concentration since 1980, US monopolies have gained a lot of hidden pricing power
4 – ESG and the fossil fuel divestment movements will raise energy costs, like the oil shocks of the 70s

Inflation is the senility of democracies.
Sylvia Townsend Warner

Bloomberg Businessweek's "death of inflation" cover will likely be remembered as one of these obvious contrarian signals which everyone should have seen. Two-year breakeven inflation rates have risen to a 13-year high of 2.7% and my crazy April 2020 call for stagflation seems a lot less crazy today. Yet, **the current debate on inflation is so focused on the short-term ("too much stimulus! Money printer goes BRRR!!") that it misses the true drivers of *secular* inflation.**

The case for secular inflation is rooted in the "great moderation" of the 90s. The first part will show how China's 1994 devaluation, which led to the Asian currency crisis of 1998, spread **its export-driven growth model of currency manipulation and demand repression.** Asia effectively subsidized consumer prices in the West by over-investing in cheap manufacturing capacity, a logical model for economies with limited domestic demand and huge youth bulges. However, the median age of most Asian exporters has risen above that of the U.S. Stability and the preservation of retirees' standards of living will take precedence over "growth-at-all-costs" policies. **Over the next decade, Asia's growth will slow dramatically, its wages will rise, its factories will close, its surpluses will melt and its currencies will rise sharply**. **For the rest of the world, this will be a massive and unexpected inflationary shock.**

Second, the application of the "consumer welfare standard" by antitrust agencies since the 1980s created a massive loophole which allowed for the concentration of many industries, especially in the tech sector. **Thanks to their massive moats, oligopolies and monopolies have acquired great pricing power**, which I expect they will exercise once labor costs start rising.

Third, the ESG and the fossil fuel divestment movements have become large enough to starve the fossil fuel sector. Investment in cheap conventional energy is at multi-decade lows and shale players are not drilling despite soaring oil prices. Like the oil shocks of the 70s, the ESG movement is forcing massive improvements in energy efficiency at the cost of **a decade of stagflation.**

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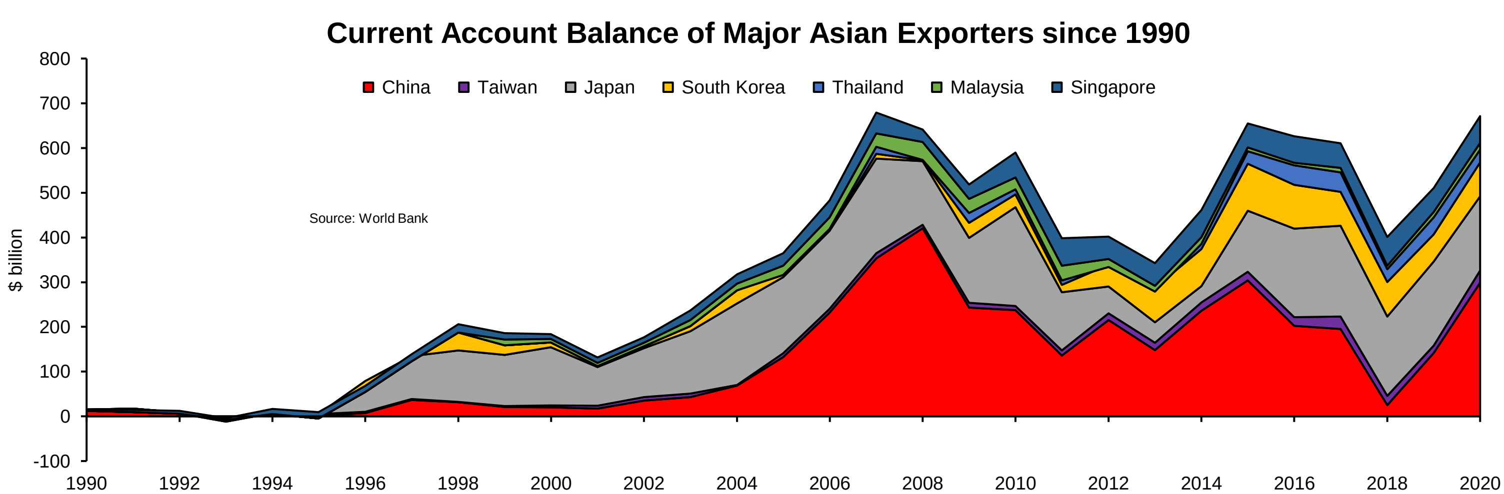
The End of Asian Currency Repression

Devastating wildfires start with a single match and the roots of global events can usually be traced to a seemingly insignificant cause. When China abolished its official exchange rate of 5.8 RMB to the USD in favor of the center of the swap center rate of 8.7 RMB per dollar in 1994, most economists saw the move as a desperate technical adjustment to save a hopelessly-centralized economy. In a 1997 article, The Economist shrugged that "China's exports are still mostly low-end manufactures, such as toys and shoes". The same article causally mentioned that "China's factory wages, at an average $60 a month, are just one-third those of Thailand" without realizing that **China's insanely low labor costs would eventually lead to the "great moderation" of the late 90s in the West, the East Asian crisis, the explosion of the U.S. twin deficits, the commodity supercycle of the 2000s, the de-industrialization of the West, the rise of populism, the opioid crisis, and the election of D. Trump in 2016.**

The official exchange rate of the Chinese Yuan was devalued by 57% from 1989 to 1994 at a time when Chines productivity was soaring thanks to Deng Xiaoping's four modernizations. A billion-strong population, with a huge youth bulge, comparatively high education, and a millennial culture based on hard work and thrift went from being repressed by an absurd collectivist system, hermetically sealed borders, and a ridiculously overvalued exchange rate to Wild West capitalism, free trade, and an artificially cheap currency.

China's fire spread to its neighbors: Thailand had to devalue the Bath in 1997 to restore the economy's competitiveness. Emerging markets currencies all collapsed in short order, culminating with the 85% plunge of the Indonesian Rupiah by the summer of 1998. When the crisis eventually passed, all Asian countries curtailed their domestic consumption and hoarded dollar reserves to maintain the competitiveness of their exports – and avoid the humiliation of IMF "rescue packages". **China had exported its growth model of currency manipulation and demand repression to the entire Asian continent**. The consequences of this monumental shift soon became obvious: the current account balance of China, Taiwan, Japan, South Korea, Thailand, Malaysia, and Singapore grew from a small deficit in 1993 to surpluses of $139 bn in 1997, $237 bn in 2004 and $679 bn in 2007. After a brief dip following China's stimulus and a drop in Western demand after the Great Financial Crisis, **Asian surpluses soared back to $670 billion last year.**



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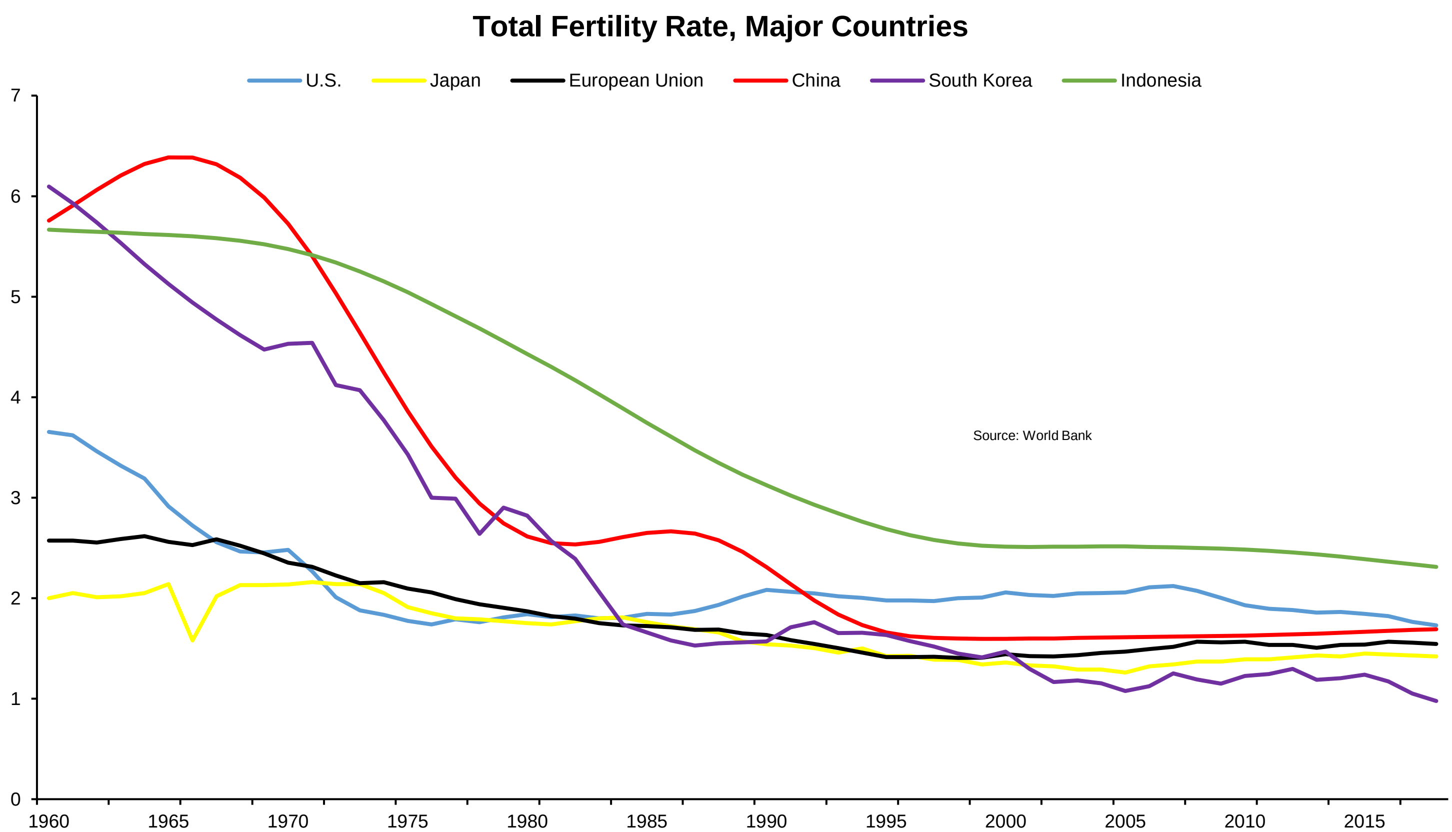
What are the implications of Asia's $670 billion surplus? In layman's terms, it means that half of the world's population works hard and tightens its belt to finance the consumption of the other half. As K. Marx observed in *Das Kapital*, all value is "crystallized labor": everything we consume comes from the labor of others. **The suppression of Asian wages via artificially low exchange rates created the "great moderation" of 90s, the deflationary 2010s, and the rise of a previously unthinkable $15 trillion bubble in negative-yielding debt.**

China and the rest of Asia did not subsidize Western consumers out of kindness, but out of necessity. China's total fertility rate peaked at 6.4 children per woman in 1966, with similar levels in Thailand, South Korea, and Indonesia: **massive youth bulges entered the labor force in the early 90s**. Providing jobs was paramount, or else, Asian governments would have suffered the same fate as the Middle East's strong men during the Arab spring. Since local demand was too weak to absorb this supply, Asia turned to exports. And since large-scale factories are the fastest way to employ masses of low-qualified workers, Asia became the manufacturing hub of the world.

THIS STORY IS OVER. After an unexpectedly short demographic transition, South Korea's total fertility rate has fallen to 1, Thailand's to 1.5, and China's to 1.7. Even relatively poor, more-or-less democratic, and Muslim Indonesia is barely above the replacement level. **Asia no longer needs bustling factories, weak currencies, and rapid export growth.**



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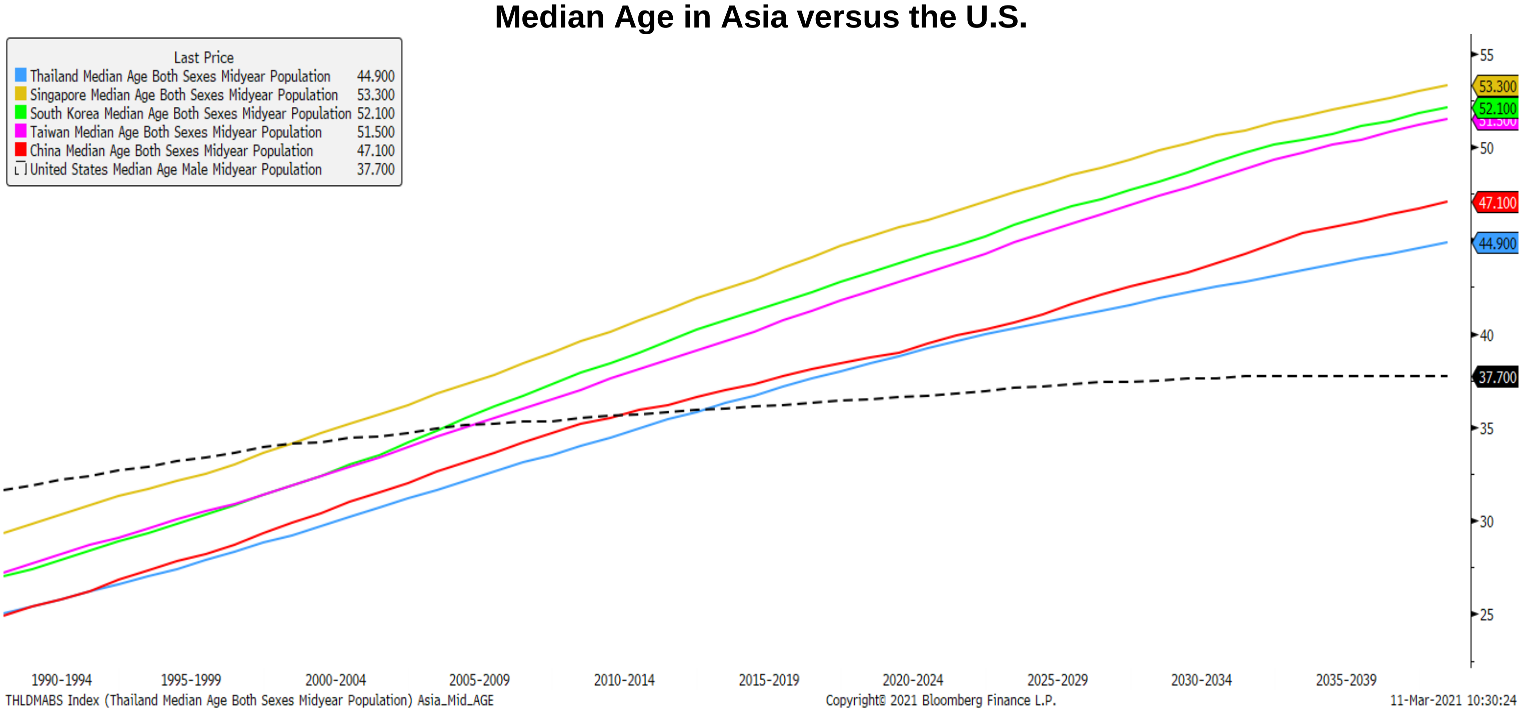
The median age of all Asian major countries has surpassed that of the U.S. in the past two decades. By 2040, the median age will be 53 in South Korea, 47 in China, and 45 in Thailand, versus 37 in the U.S. As the experience of Europe and Japan shows, **older populations do not care much for growth and jobs**. Stability and the preservation of retirees' standards of living is a lot more important when about half of the electorate is too old to hold a job. The manufacturing sector can shrink as working-age populations decline. Conversely, whatever growth ageing economies can manage comes from the service, tourism, and "lifestyle" sectors - where Asia has a big deficit.

The macro implications are simple: **over the next decade, Asia's growth will slow dramatically, its wages will rise, its factories will close, its surpluses will melt, and its currencies will rise sharply**. **<u>For the rest of the world, this will be a massive, and unexpected, inflationary shock</u>**, just as the suppression of Asian currencies and wages in the 1990s created secular dis-inflation, and eventually deflation, in the West.

China's newly-announced five-year plan already confirms this forecast. As my esteemed friends at Gavekal pointed out, **the 148 wish-list of policies to be enacted in the 2021-2025 does not mention a numerical growth target for the first time in China's modern history**. This shift is a revolution for a country where central planners and provincial governors' careers depended on meeting the magical target set in Beijing.

Many sections of the latest five-year plan almost sound as if they had been drafted by the European Commission: growth must be sustainable, inclusive, and focused on innovations in the key sectors of artificial intelligence, green investments, and technological self-reliance. **As China and, by extension, Asia, abandons its model of cheap labor, growth-at-any-cost, subsidized manufacturing, and repressed currencies, the rest of the world will experience *<u>secular</u>* inflation.**

Median Age in Asia versus the U.S.



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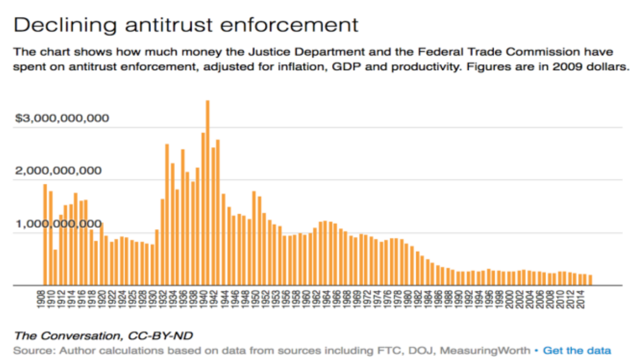
The Cartelization of the U.S. Economy

The two most eye-opening books I have read about the U.S. economy in the past decade were T. Philippon's ***The Great Reversal: How America Gave Up on Free Markets*** and D. Hearn & J. Tepper's ***The Myth of Capitalism: Monopolies and the Death of Competition***. These two books powerfully document **how every sector of U.S. economic life, from airlines to telecoms, healthcare to banking, and big tech to political lobbying, has become increasingly concentrated in the past 30 years.**

Investors should read both books to grasp the complex causes of this megatrend but I would single out the Supreme Court's 1979 *Reiter v. Sonotone Corp*, which set the Consumer Welfare Standard as the litmus test for in antitrust enforcement. Rather than establishing that a company had monopoly power, antitrust regulators now had to prove that monopolies raised prices for consumers. Big tech companies, whose products are "free" (or rather, which found other ways to monetize their customers' data and attention) rushed through this loophole. "**Consumer-friendly" monopolies** (if it sounds like an oxymoron, it is because it is one) **mushroomed as antitrust enforcement collapsed after the 1980s** (chart below).

Proponents of "hipster antitrust" have recently tried to push the Federal Trade Commission and the Department of Justice towards more muscular antitrust enforcement against the big tech monopolies but they have faced strong resistance due to big tech's generous political contributions and efficient lobbying. Also, the fact that the U.S. senate and Congress is filled with confused boomers who do not understand the difference between an app and a website is an unsurmountable barrier to the adoption of intelligent regulation of the information economy.



Granted, the concentration of the U.S. economy into large monopolies or oligopolies has not led to the price increases which standard economic theory would have predicted – yet. Why? First, big tech monopolies have found other ways to generate income, mostly by selling goods which did not have a price before: their customer's data and their right to privacy. If these practices are progressively restricted and taxed, big tech will have to start charging for their products. Second, big tech firms have focused on growing their user bases, rather than their profits. Amazon did not turn a profit in its first 11 years of existence. E. Musk has made Tesla more valuable than all other car companies combined without ever earning a dollar on the (relatively few) cars it sold. **In this era of easy-money and flush VC funds, tech firms did not raise prices because they did not need to turn a profit**.

But the purpose of the unsurmountable competitive moats which were built in the past two decades is to eventually gain pricing power. If Netlix doubled its price, no one under the age of 40 would return to old TV. If, God forbids, Google started charging for Google Maps and email, would anyone revert paper maps and stamps? This nightmare scenario has already started for users of popular password-storing service LastPass who were trapped in paying $36 a year if they wanted access to their online lives. **The unprecedented concentration of the U.S. economy creates a hidden risk of an inflationary spiral once prices and labor costs start to rise.**

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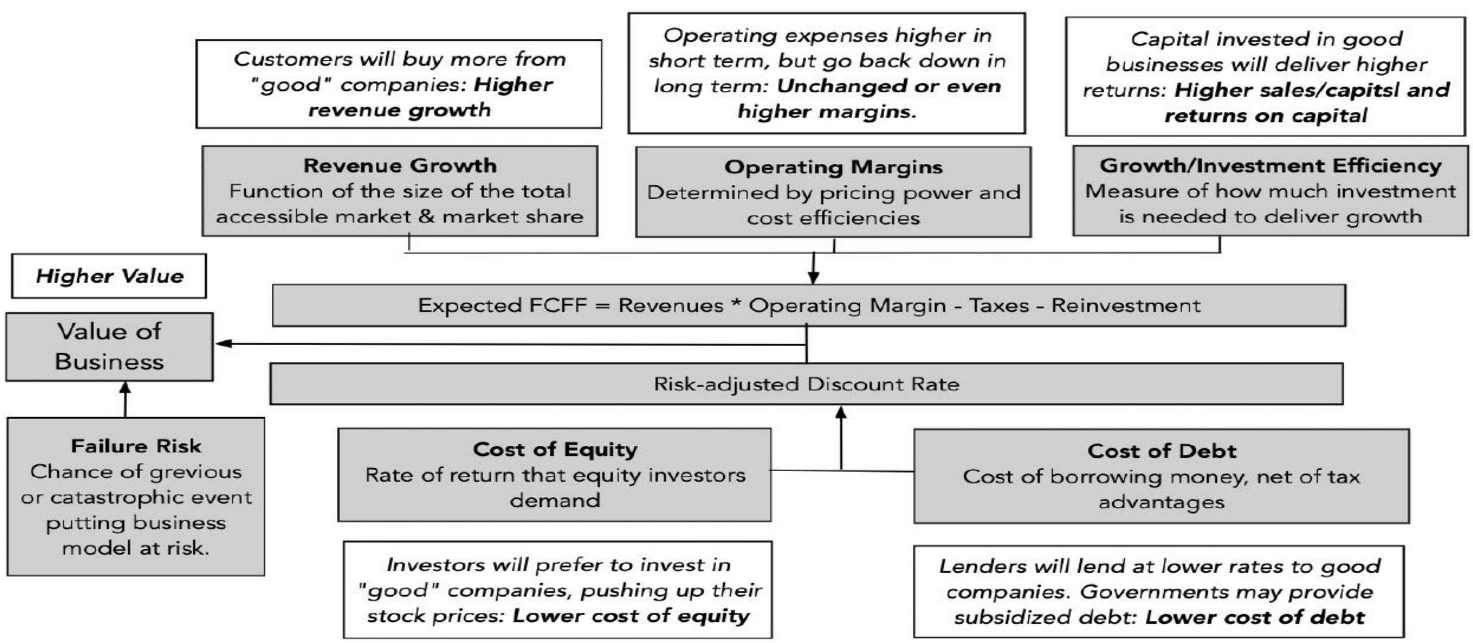
There Is No ESG Free Lunch

As I explained in "the ESG Bubble: Saving the Planet, Destroying Societies", ESG investing has gone parabolic in 2020 and signatories of the UN's Principles for Responsible Investment collectively manage $100 trillion in assets. **The ESG sector is big enough, and will likely keep growing, to change the global allocation of savings and have macroeconomic effects –** which is its intended goal.

ESG's marketing pitch, which has been bolstered by the sector's strong performance in 2020 is summarized by the diagram below, courtesy of Damodoran and Cornell's excellent paper "Valuing ESG: Doing Good or Sounding Good".

Figure 2: The Payoff to Being Good: The Virtuous Cycle



In the words of Blackrock's Larry Fink, "sustainability and climate-integrated portfolios can provide better risk-adjusted returns to investors." Yet, arguing that investors can have their cake (i.e. be environmentally and socially virtuous) and eat it (i.e. beat the market) violates the basic law of economics.

If complying with ESG standards lowered volatility and increased investors' returns, markets would have already implemented them. ESG's *raison d'être* is that the free market, when it is driven only by the profit motive, will create costs for other stakeholders – society, workers, and the environment. ESG investors' efforts to internalize these external costs may be morally just and socially optimal, but ***they are a cost which did not show up in the consumer prices***. By definition, the rise of green standards and the demand for more responsible goods and services from governments, investors, and consumers will raise prices.

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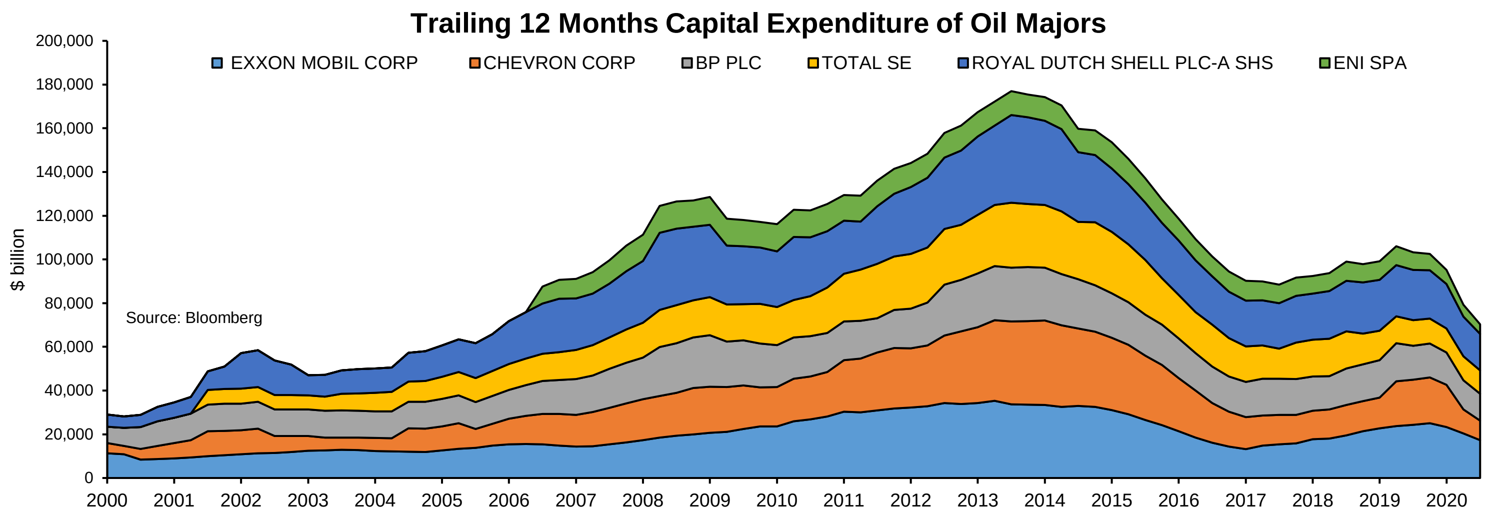
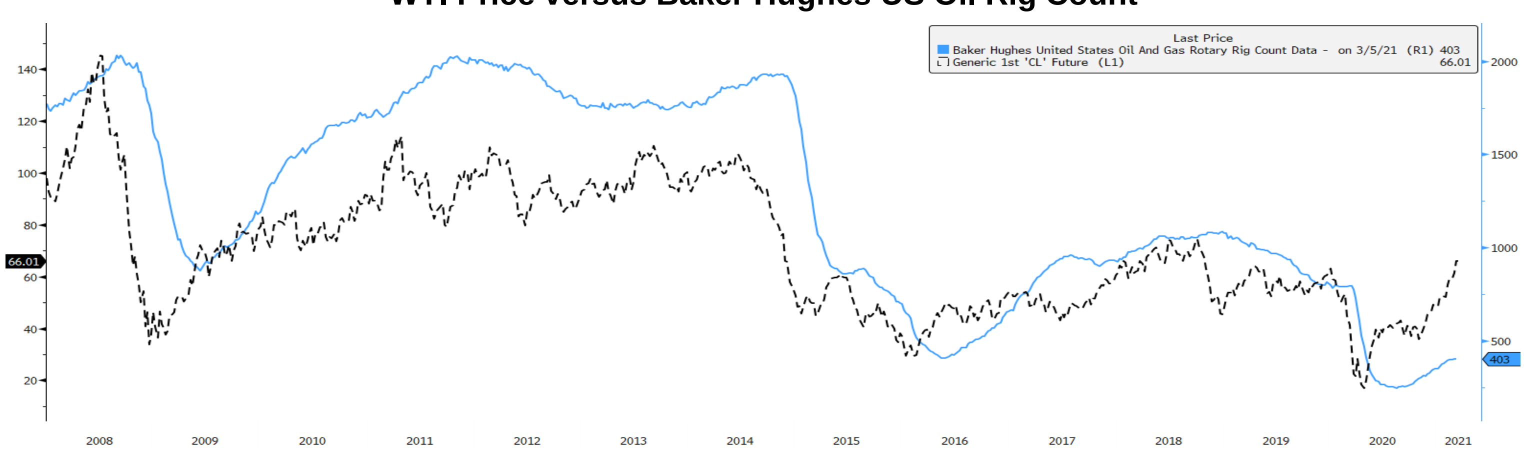
The energy sector is already experiencing the power of ESG and the fossil fuel divestment movement. As of April 2020, a total of 1,192 institutions and over 58,000 individuals representing $14 trillion in assets worldwide have committed to a divestment from fossil fuels. As investors divest from fossil fuel producers, oil majors had to cut investment: **capital expenditure by Exxon, Chevron, BP, Total, Royal Dutch Shell and ENI fell to a 15-year low of $ 72 billion in the past twelve months**.



Similarly, U.S. shale producers have not responded to the rise of WTI prices above $60 a barrel. As shown in the chart below, the U.S. rig count followed the price of oil with a three-month lag in prior cycles. Yet, it has been almost a year since oil prices fell to zero and below and the rig count still remains 80% below its 2014 level. **As capital no longer flows to the fossil fuel sector, production will no longer respond to price signals, leading to permanently higher energy prices**. This is good news from an environmental point of view as higher prices deter waste: the oil shocks of the 70s eventually forced Western economies to become much more energy efficient. But **higher energy costs also created a decade of stagflation, which remains my baseline scenario for the 2020s.**

WTI Price versus Baker Hughes US Oil Rig Count



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