Covid-19: accelerating our journey to inequality

Part I of II

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Heraclitus, the ancient Greek philosopher, realised more than 2,500 years ago that the world was in constant flux. The only constant in life, as the saying goes, is change. Well, in 2020, the year dominated by the COVID-19 pandemic, the rate of change was fierce. And investors need to reflect, reset and think carefully about what the future may hold for our post-pandemic world.

In our two-part whitepaper that follows, we analyse the broad forces we are observing in the global economy today, including their drivers and implications. We build on our internal research published in 2019 and review the latest research on many of the dynamics we are seeing today.

Our analysis leads us to believe that **the forces driving low economic growth, increased indebtedness, low interest rates and asset inflation will only strengthen in a post-COVID-19 world**. Furthermore, we identify inequality as an important consequence of our economic system and **we see it becoming more extreme in a post-COVID-19 world**.

Not only does increasing inequality have important political implications, it also carries with it important (negative) side-effects to our broader economic system, including: slower economic growth, increased indebtedness, increased financial risks and greater political capture.

Ironically, the price of preserving the overarching structure of our economic system is perhaps making it work more beneficially and equitably for the broader population.

We also derive the key investment implications that are guiding the construction of our Montaka portfolios today. These include a preference for: (i) equity exposure over fixed-income; (ii) businesses which are likely to deliver high-quality growth over a long period of time; (iii) businesses with strong and expanding data advantages; (iv) businesses which enjoy a relatively wealthier customer base – on either the consumer side or enterprise side; and (v) businesses which avoid the complexities and increasing risks of cross-border supply-chains – particularly with respect to Chinese borders.

LOW RATES, ASSETS INFLATE

In our 2019 whitepaper, Low Rates, Assets Inflate, we considered the likely drivers of the low interest rate world in which we found ourselves, particularly around demographics, indebtedness, technology, globalisation and the structure of the international monetary and financial systems. On the basis of our analysis, it became clear that these drivers of interest rates are much more structural in nature, not cyclical; and much more global in nature, not local. Indeed, it was the multi-decade time horizon of these drivers that underpinned our uncommonly held hypothesis at the time that low inflation and low interest rates were here to stay for an extended period. **It followed, therefore, that there was also a high likelihood that equities were generally under-priced.**

In addition to analysing the key drivers of long-term interest rates, we also looked at the implied return spread, over and above the risk-free rate, that equities were pricing in. In short, equity spreads were at record levels at a time when spreads in other asset classes (e.g. fixed income, property) had compressed. **A normalisation of equity spreads would likely result from equity price inflation, we concluded.**

EXPANDING THE ECONOMIC MODEL

While our initial analysis was primarily concerned with the drivers of long-term interest rates, we arrived at a conclusion that had something to say about asset prices – and equity prices, in particular.

But there are other significant drivers within our economy that exacerbate asset price inflation and even result in feedback loops that compound the dynamic. We expand our economic model below by considering: (i) reduced competition and productivity; (ii) political and regulatory capture; (iii) declining worker power; and (iv) inequality.

We view inequality as a particularly important consequence of our economic system. The importance is both political in nature, as well as economic, given the feedback into the system and compounding of these dynamics that results from inequality.

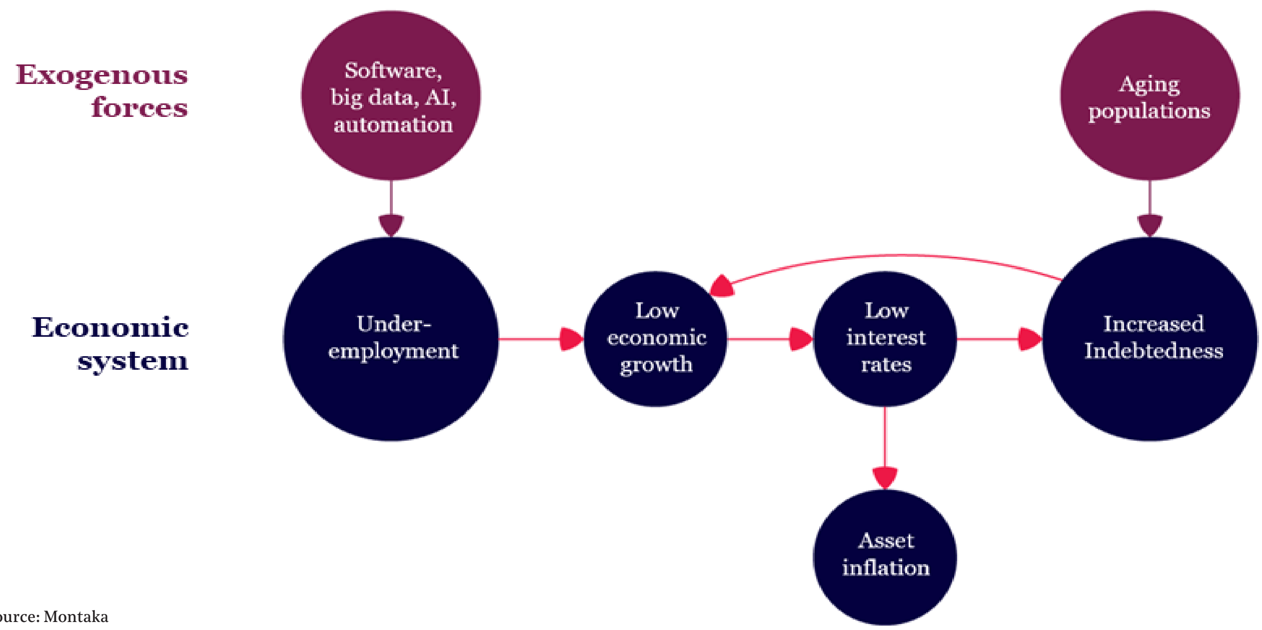
Reduced competition and productivity

A recent study suggests that low intertest rates lead to greater market power for industry-leading businesses and weaker productivity growth generally[1]. The study analysed the impact of persistently low long-term interest rates on industry market structures and productivity growth.

The paper shows that, when interest rates are lower, "*industry leaders invest more aggressively to keep industry followers at bay, which in turn disincentivises industry followers from investing... leading to lower market competition and growth... a contractionary effect on the supply-side by increasing market concentration and reducing productivity growth.*"

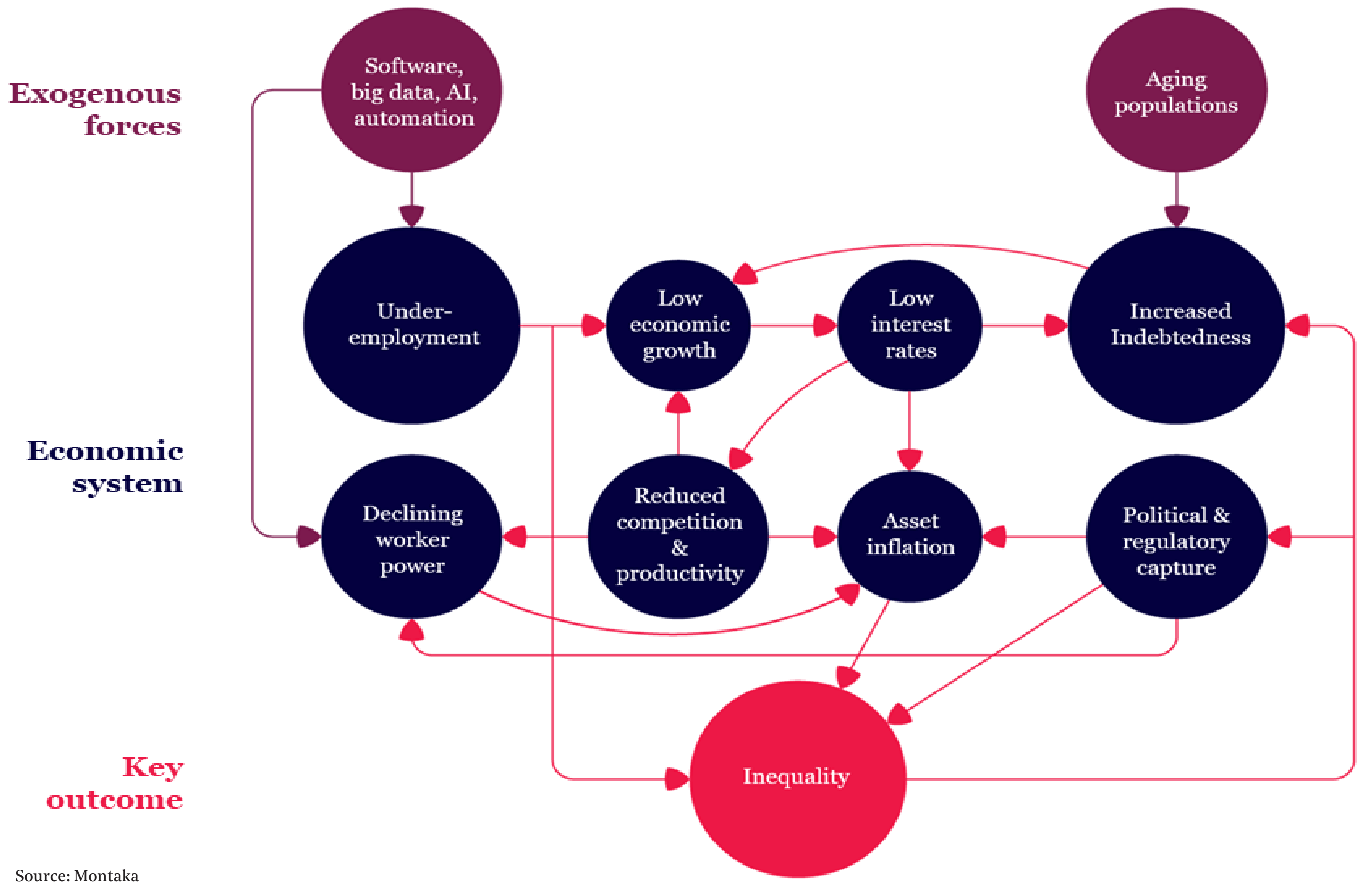
Consider Microsoft, for example. Estimates for its true level of investment, including intangible investments, are running at US$19 billion annually[2]. There is no question that the enormous investments being made by Amazon, Microsoft and Google in the cloud, for example, have all but eliminated the incentive for any serious competition outside of these three. But this effect is not just observed in the technology sector (which finances little growth with borrowings).

Key drivers of long-term interest rates



Source: Montaka

Expanding the economic model & the importance of inequality



Source: Montaka

The paper notes that "... *the productivity gap between the 90th versus the 10th percentile firms within industries has been increasing since 2000... The rise in within-sector productivity differential is also global, again suggesting a common global cause such as a decline in interest rates.*"

Rising market power, or reduced competition, can lead to unhealthy side-effects in an economic system over the long-term.

Specifically, recent research shows that a rise in market power of firms can exacerbate declining labor share; rising profit share (driving asset price inflation); income and wealth inequalities; and rising household sector leverage[3].

Political and regulatory capture

Political and regulatory capture is the idea that wealthier individuals and corporations can extract a disproportionate share of self-interested representation. This form of capture exists to varying degrees in all democracies and has become particularly intense in the US over recent decades.

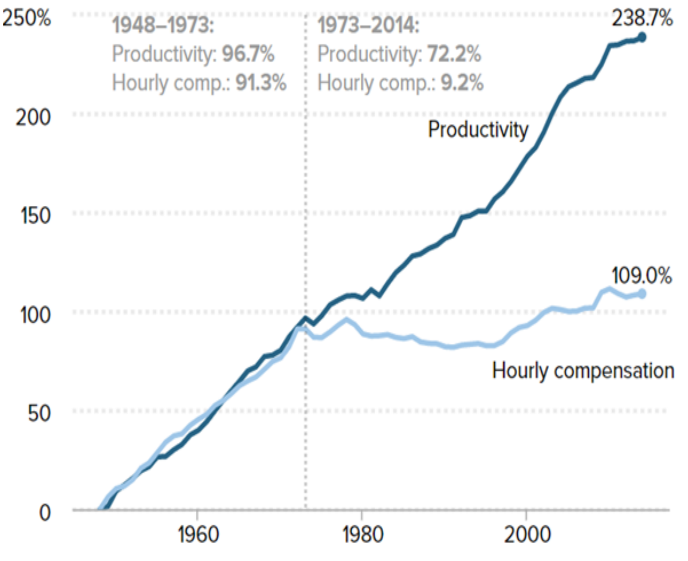
Take the 2001 Bush tax cuts, for example. Approximately 40 percent of the benefits of these tax cuts went to the richest one percent who, by virtue of their wealth and ability to make enormous political donations, are amongst the most influential cohort in the US electorate. Then consider, as the political capture only continued to strengthen in the subsequent 16 years, that Trump was able to sign into law a set of tax cuts that delivered more than 80 percent of their benefits to the richest one percent. Such tax cuts serve to inflate asset prices and exacerbate wealth and income inequality within the economic system.

Furthermore, one could sensibly argue that policy responses to major recent economic crises have tended to favour Wall Street overwhelmingly, versus Main Street. From the taxpayer-funded bailout of many large financial institutions in the 2008 Global Financial Crisis; to the subsequent decade of accommodative monetary policies to support the economic recovery; to the extraordinary new measures unveiled by the Federal Reserve in 2020 to combat the COVID-19 crisis, including its new US$750 billion corporate bond buying program.

This is not an argument against large-scale policy actions in the face of a crisis. Rather, it is an observation that wealthier cohorts of the economic system tend to fare disproportionately better from these policies.

Comparison of productivity & labour compensation

Cumulative percent change since 1948



Note: Data are for average hourly compensation of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services minus depreciation per hour worked.

Source: Economic Policy Institute

Declining worker power

There has been a long-run, structural decline in the power of the worker globally. Again, using the US economy as an example, worker power has been in long-run decline which has resulted in subdued wage growth (see chart above), inflated corporate profitability and asset price inflation[4].

Driven in large part by the political and regulatory capture described above, labor union membership in the US has declined from 24% to 6% over the last 47 years.

Motivated by the economic benefits outlined above, influential wealthier cohorts of the economic system have been effective in weakening labor laws and its enforcement over time.

Furthermore, employers have lower-cost alternatives to domestic labor which further erode US worker power. First, manufacturing can be shifted to lower-wage countries, thereby reducing demand for domestic labor. And second, lower-cost technology can be used to displace domestic labor. As artificial intelligence enables new, previously unimaginable, forms of automation it is likely the force of this latter effect will only strengthen.

Inequality

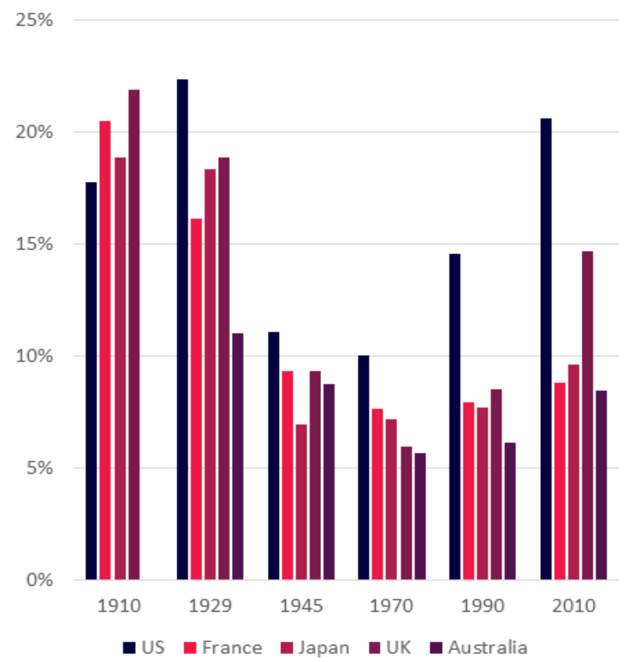
We view inequality as a particularly important consequence of our economic system. Whether it is the impact on employment and worker power from powerful new forms of technology; or the structural asset price inflation that our economic system is creating; or even the direct effects of political and regulatory capture: **higher inequality is the natural result.**

An examination of the share of total income to the top one percent over the last century is shown in the chart below. Share of total income includes both (i) share of wages income; and (ii) share of income from capital. We make the following observations:

- Early in the twentieth century the world's major economic systems were highly unequal in terms of total income, with Australia being the notable exception.
- Post two world wars, income inequality had reduced significantly. Reasons for this included: (i) the destruction of physical capital; (ii) the consumption of capital post-depression to preserve quality of life; (iii) financial repression by governments; (iv) weak real-estate and stock prices; and (v) new unfavourable policies around regulation and taxation. This period of reduced inequality remained for at least three decades as the baby boomer generation was born and grew into their adult years.
- By the 1980s, the US and the UK had commenced their sharp increase in income inequality. In large part, this was driven by the arrival of "super-managers" – that is, those corporate executives that could extract disproportionately large bonuses and equity awards. Notably, this increase was observed to far lesser degrees in Europe, Japan and Australia.
- Today, the US finds itself back to pre-WWII levels of inequality with the top one percent capturing approximately 20 percent of national income, up from 10 percent 40 years ago. (That 10 percent increase in share for the top one percent was effectively donated by the bottom 50 percent, the data shows). As we discuss in Part II, the economic system is set to drive inequality even higher in our new post COVID-19 world.

Top 1% share in total income

Percent



Source: Piketty, "Capital in the Twenty-First Century," 2014

In his extraordinarily detailed analysis on the subject, economist Thomas Piketty observed in Capital in the Twenty-First Century that, "*The history of inequality has not been a long, tranquil river. There have been many twists and turns, and certainly no irrepressible, regular tendency toward a natural equilibrium... The history of inequality has always been chaotic and political.*"[5]

More simplistically, it appears that the economic systems of recent centuries naturally drive inequality higher over the long-term. It is only through very disorderly redistributions of wealth that inequality has reset lower.

The idea behind the long-term upward pressure on inequality is worth highlighting because it relates to some of our prior observations and analyses with respect to demographics, growth, interest rates and asset price inflation.

As Piketty points out: "*If the rate of return on capital remains significantly above the growth rate [of the economy] for an extended period of time (which is more likely when the growth rate is low, though not automatic), then the risk of divergence in the distribution of wealth is very high... In a quasi-stagnant society, wealth accumulated in the past will inevitably acquire disproportionate importance... What this means is that the owners of capital - for a given distribution of wealth - potentially control a larger share of total economic resources.*"

This is the important long-run connection between low economic growth, low inflation and low interest rates on the one hand; and high asset prices and high inequality on the other. As can be observed by the schematic of our economic model above, we believe the drivers of growth, inflation and interest rates – both exogenous and endogenous – all point to subdued levels for a protracted period of time.

And if this turned out to be the case, perversely, this would be consistent with very long-term economic history. As Piketty points out: "*Inflation is largely a twentieth century phenomenon. Before that, up to World War I, inflation was zero or close to it. Prices sometimes rose or fell sharply for a period of several years or even decades, but these price movements generally balanced out in the end. This was the case in all countries for which we possess long-run price series.*"

So there we have it: **an economic model, at least as we see it, that naturally promotes asset price inflation and inequality.**

* * *

In Part II of our whitepaper, we examine the side-effects of inequality. It turns out that inequality, in and of itself, drives up indebtedness, hinders growth, exacerbates financial risks and ultimately leads to political instability. These are genuine economic costs which benefit no one – not even the beneficiaries of higher inequality.

We also derive the key investment implications that are guiding the construction of our Montaka portfolios today.

Covid-19: accelerating our journey to inequality

Part II of II

The year of 2020 has been dominated by the effects of the COVID-19 tragedy. And investors need to reflect, reset and think carefully about what the future may hold for our post-pandemic world.

In Part I of this two-part whitepaper, we expanded on our 2019 analysis of the drivers of long-term interest rates and asset price inflation. We identified other important drivers within our economy that exacerbate these dynamics, including: (i) reduced competition and productivity; (ii) political and regulatory capture; (iii) declining worker power; and (iv) inequality, which appears to us to be a very important consequence of our economic system.

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SIDE-EFFECTS OF INEQUALITY

We separate the side-effects of inequality into two broad categories: (i) economic; and (ii) political (which, of course, themselves carry economic implications). These are explored briefly below.

Economic Side-Effects of Inequality

A logical starting point in considering the economic side-effects of inequality is the simple acknowledgement that, "*While most people spend close to everything they earn on goods and services, the rich do not... [Give a rich person an extra dollar] and it will probably be used to accumulate additional assets*[6]." This is pointed out by Klein and Pettis in their excellent new book Trade Wars are Class Wars.

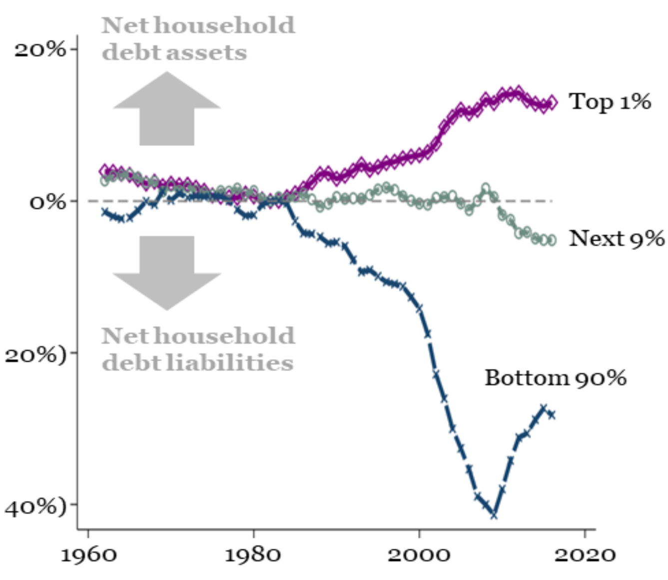
They go on to add that: "*For the world as a whole, rising inequality means the value of those assets is necessarily contingent on continued increases in spending by people who have progressively lower shares of national income. The only way to make this work is rising debt.*" And this is exactly what we have seen in the world's largest economy, particularly over the last 40 years – the period during which income inequality increased significantly in the US.

A further study shows that large inequality-driven debt burdens by households and governments lowers economic growth and, thus, natural interest rate levels[7].

Specifically, the authors develop a framework which shows how "*rising income inequality and the liberalisation of the financial sector can push economies into a low interest rate-high debt environment.*" This sounds familiar.

Net Household Debt — by Wealth Dist'n

Scaled by US national income relative to 1982 levels



Source: Mian, Straub, Sufi, "The Savings Glut of the Rich," July 2020

At the core of this framework is the same observation made by Klein and Pettis, that "*borrowers and savers differ in their marginal propensities to save out of permanent income.*" The implication here is that: "*as borrowers reduce their spending to make debt payments to savers, the latter, having greater savings rates, only imperfectly offset the shortfall in borrowers' spending.*"

We would add to this one additional idea for consideration: when borrowers reduce their spending to make debt payments to central banks as owners of trillions of dollars of sovereign, mortgage and (now) corporate debt – and the only economic agents which do not invest or consume – then the incremental demand created from these payments is zero, leaving nothing but a reduction in borrowers' spending. And this, in turn, exacerbates weaker economic growth.

There is an important cross-border effect at play here as well, as the title of Klein and Pettis' book suggests. The logic goes like this:

- Households are effectively net importers.
- Because the rich have disproportionately high savings rates, other households are effectively deprived of income they could have otherwise used to buy additional imports.
- This deprives the economy of consumption and drives up national savings (defined, in this case, as national production minus national consumption). And these savings need to be absorbed abroad by deficit economies (such as the US) which suffer the consequences of higher indebtedness and reduced employment.
- The result is that, as Klein and Pettis put it: "*Inequality within countries can cause imbalances between them... Rising inequality has produced gluts of manufactured goods, job loss, and rising indebtedness. It is an economic and financial perversion of what global integration was supposed to achieve.*"

Relevant case studies of this dynamic include the significant inequality that exists in Germany and China; combined with the enormous excess savings gluts that are effectively exported to the US economy. The enormous wave of capital that has been pushed into the US economy over recent decades has not been helpful – at least from the perspectives of productivity, indebtedness, financial risk and economic growth.

A recent study[8] analysed the effect of savings gluts on productivity. According to the authors: "*We show that the integration of developing countries in international financial markets – and the associated savings glut – might generate a slowdown in global productivity growth, by triggering an effect that we dub the global financial resource curse.*"

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The dynamic is described as follows:

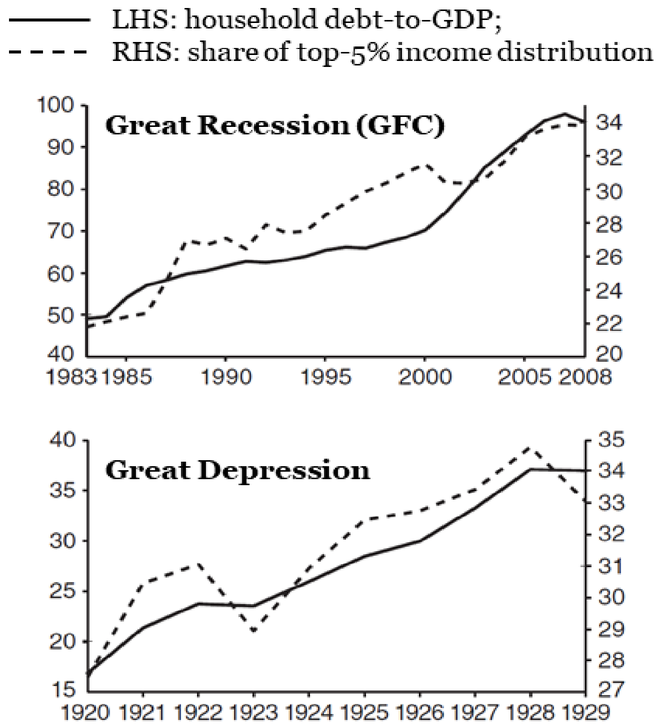
- Capital inflows allow US agents to finance an increase in consumption.
- While higher consumption in tradeable goods can be imported from abroad, non-tradeable consumption goods (e.g. construction) must be produced domestically.
- "*In order to increase non-tradeable consumption, factors of production migrate from the tradeable sector toward the non-tradeable one. The profits earned by firms in the tradeable sector thus drop, reducing firms' incentives to invest in innovation. As investment declines, the result is a slowdown in US productivity growth.*"

Finally, a logical long-term consequence of high inequality is heightened financial risk. And there is evidence that inequality leads to higher leverage and financial crises endogenously[9].

Authors observe that both the Great Depression and the Global Financial Crisis were preceded, over a period of decades, by a sharp increase in debt-to-income ratios among lower- and middle-income households.

The study presents a model in which a crisis driven by greater income inequality arises endogenously: "*By accumulating financial wealth, top earners allow bottom earners to limit the drop in their consumption, but the resulting large increase of bottom earners' debt-to-income ratio generates financial fragility that eventually makes a financial crisis much more likely.*"

Debt build-ups prior to crises



Source: Kumhof, Ranciere, Winant, "Inequality, Leverage and Crises," 2015

Political Side-Effects of Inequality

One of the most obvious and direct side-effects of higher inequality is greater political and regulatory capture, as we defined in Part I. What is perhaps less obvious are the political externalities of this self-reinforcing feedback loop which we briefly describe below.

When inequality is high, democratic systems face a fundamental question: how can a political system that gives the ballot to all coexist with an economic system that concentrates wealth in the hands of the few?

As well articulated by political scientists Jacob Hacker and Paul Pierson in their new book, Let Them Eat Tweets: "*Extremely unequal societies have a hard time finding that delicate balance between protecting ordinary citizens and reassuring the privileged few*[10]." The authors study the historical record to uncover a clear pattern of behaviour by those political parties on the right facing this Conservative Dilemma: "*Whenever economic elites have grossly disproportionate power and come to see their economic interests as opposed to those of ordinary citizens, they are likely to promote social divisions.*"

Furthermore, in a recent study of 450 political parties in 41 democracies between 1945 and 2010, it was found that when inequality was higher, parties on the right ramped up their emphasis on divisive noneconomic issues, especially those surrounding race, ethnicity, religion and immigration[11]. This might sound somewhat familiar to observers of the US political environment over the last four years – and particularly in the lead up to the recent 2020 general election.

This is, perhaps, one important reason why large-scale reversals of income inequality within the context of democracies have not happened orderly, historically. Not only do plutocrats fight to retain their power but, in order to do so, tend to resort to outrage-stoking, thereby exacerbating political instability.

Piketty puts a finer point on the political instability that naturally arises from very high levels of inequality and suggests that stronger economic growth – which reduces the relative importance of accumulated wealth in the past – is the only way to avoid such political instability over the long-run.

"*The only logical exit is structural growth, which is the only way of balancing the process of capital accumulation... Otherwise capitalists do indeed dig their own grave: either they tear each other apart in a desperate attempt to combat the falling rate of profit [i.e. investment returns] (for instance, by waging war over the best colonial investments, as Germany and France did in the Moroccan crises of 1905 and 1911), or – particularly at the government level – will likely play a major role in exacerbating the low-growth, low-interest rate environment that we see elevating the relative importance of wealth accumulated in the past and exacerbating the political side-effects of inequality.*"

COVID-19: AN ACCELERANT OF THE ECONOMIC MODEL

The COVID-19 pandemic has accelerated a number of very important trends – particularly around technology adoption as many worked virtually from home, customers accelerated their digital consumption behaviours and corporates accelerated their digital transformation journeys, as we detailed in our last whitepaper: Winning in the age of digital transformation.

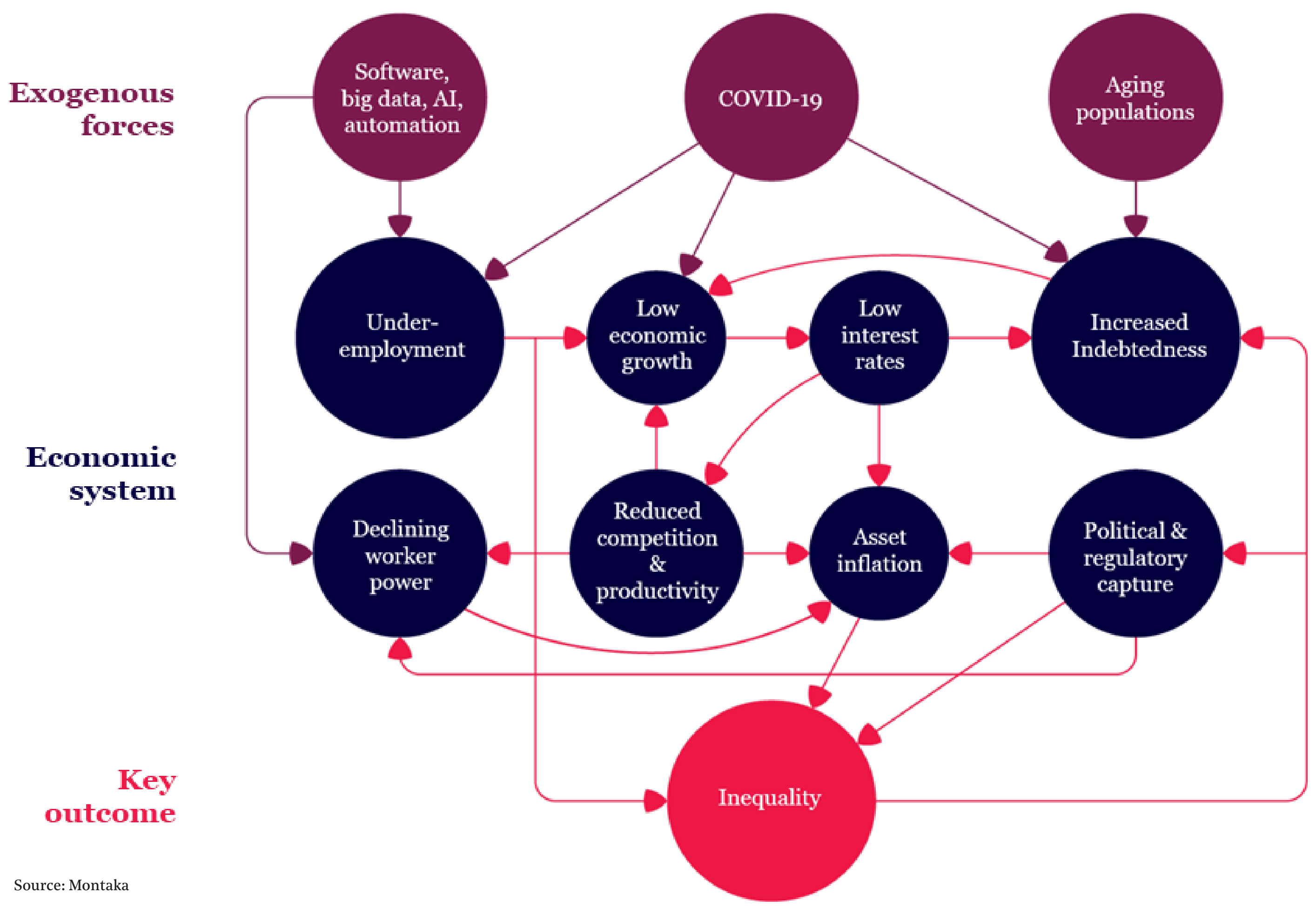
But the pandemic will also accelerate the dynamics of the economic model we describe leading to lower growth, lower interest rates, higher indebtedness and financial risks, asset inflation, greater political capture and, of course, significantly higher inequality, in our view.

Even the direct adverse effects of COVID-19 have not been evenly distributed. Between March and July, 2020: 28 percent of workers in families making less than US$40,0000 a year were laid off, considerably higher than the 13 percent of workers from families with incomes over $100,000 a year[12].

Over the long-run, we expect COVID-19 to have acted as an accelerant to an economic system that was already driving inequality higher. Increased indebtedness – particularly at the government level – will likely play a major role in exacerbating the low-growth, low-interest rate environment that we see elevating the relative importance of wealth accumulated in the past and exacerbating the political side-effects of inequality.

Across the board, fiscal deficits for 2020 are blowing out. In the US, for example, this level of deficit spending (as a proportion of GDP) has not been experienced since 1945.

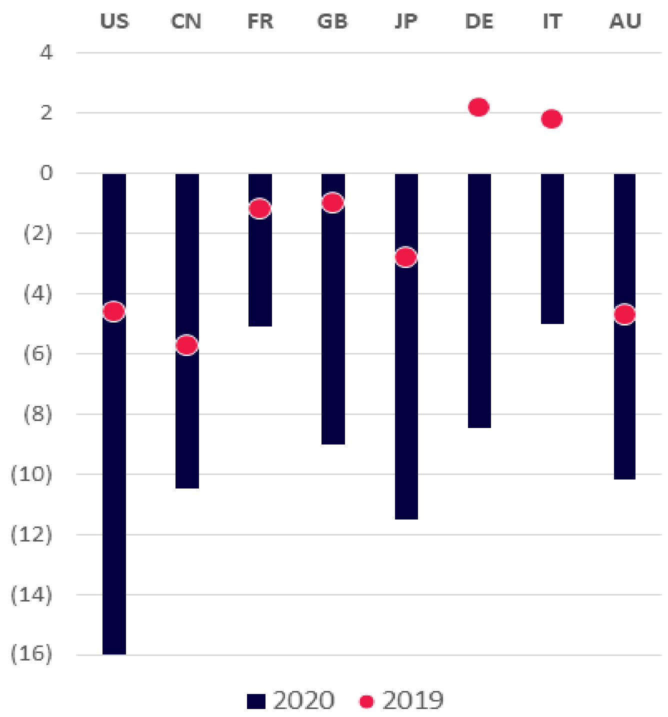
COVID-19 — the great accelerant



Source: Montaka

Expected fiscal deficits for 2020

Percent of GDP



Source: BIS; IMF; CBO

THE SPECTRUM OF LONG-TERM POLITICAL OUTCOMES

The economic system that we observe today tends to drive inequality higher – especially in the context of the three major exogenous forces that make today's situation historically unique: (i) aging populations; (ii) COVID-19; and (iii) powerful new forms of technology – particularly around big data, AI and automation.

And inequality is a very important economic parameter in its own right, we believe, because of its negative side-effects on our broader economic system: lower economic growth, increased cross-border imbalances, increased indebtedness and financial risks, and increased political and regulatory capture.

But at the end of the day, so says Thomas Piketty: "*Inequality is neither economic nor technological; it is ideological and political*[13]."

We therefore must consider the spectrum of long-term political outcomes to the issue of inequality. Very simplistically, we see the range of possible long-term political outcomes as falling between the approximate goalposts of:

- **Entrenched plutocracy** – in which inequality increases so much that once-democratic political institutions become completely captured by a small powerful plutocracy; or
- **Political redistribution** – in which the political benefits to lawmakers of wealth redistribution outweigh the backlash from plutocrats. Measures included in such a scenario range from taxes on capital and estates, to forms of universal basic income, to widespread money-financed fiscal programs (under the Modern Monetary Theory framework).

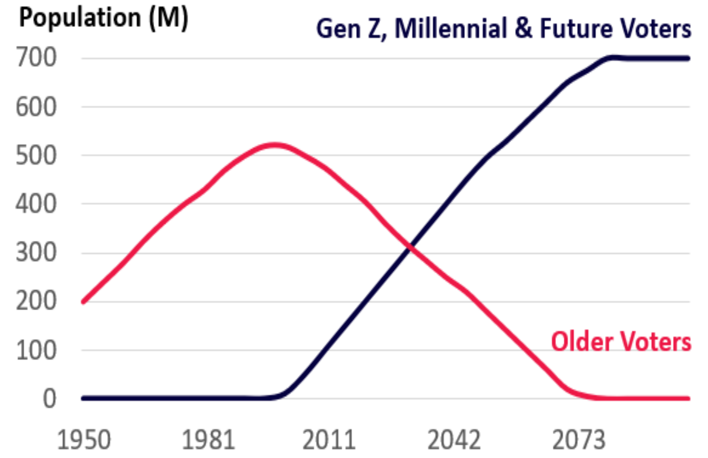
We do not have the answer as to which path shall prevail. We do, however, note that the Bank of International Settlements (BIS) sees a possible middle-ground scenario that we would describe as a soft-form compromise by plutocrats, as published in its most recent Annual Economic Report.

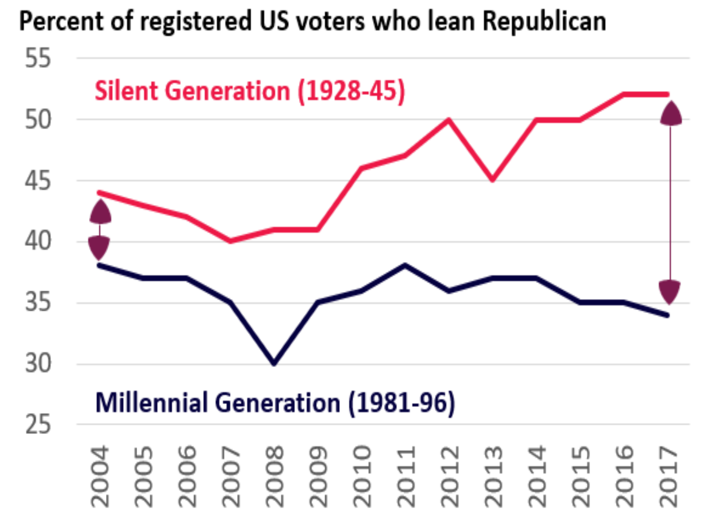
"*But as we peer further into the future, a quite different picture could emerge. In this case, we would be speaking not of inflation evolving within the current policy regime, but of a more fundamental change.* ***Here the economic landscape would, in some respects, look like the one that materialised immediately after the Second World War.*** *This scenario could come into being if a lengthy pandemic were to leave a much larger imprint on the economy and the political sphere.* ***In this world, public sector debt would be much higher and the public sector's grip on the economy much greater, while globalisation would be forced into a major retreat.*** *As a result, labour and firms would gain much more pricing power.* ***And governments could be tempted to keep financing costs artificially low, allowing the inflation tax to reduce the real value of their debt, possibly supported by forms of financial repression***[14]."

This scenario likely carries with it a reasonable probability over the longer term, especially in the context of the evolving ideological demographics, as illustrated below.

Consider that, by the end of this decade, the voting cohort represented by Millennials, Gen Z and younger generations will be as large as the voting cohort of older generations across the G7 nations. And Millennials (and younger generations) tend to be less conservative than their older generational counterparts; and, interestingly, this ideological gap has widened quite significantly over the last decade. Through this lens, the scenario of an entrenched plutocracy will likely become increasingly less tenable over the coming decades.

Demographics of Ideology





Source: Deutsche Bank; UN; Haver; Pew Research Center

CONSIDERATIONS FOR INVESTMENT PORTFOLIOS

Given the economic system we observe and the range of possible long-term political outcomes, we see a number of broad implications for investors to be mindful of when constructing portfolios.

First, the economic environment is perversely favourable for equities (and highly-unfavourable for fixed income assets). The most plausible long-term path out of our global mountain of indebtedness is via financial repression, as described by the BIS above.

In short, real interest rates will remain depressed (and likely negative) for an extended period of time. This is a painful environment for fixed income assets and a wonderful environment for equities in general.

Second, we believe it is logical to own businesses which can deliver high-quality growth. There are two parts to this idea: (i) high-quality; and (ii) growth. With respect to high-quality, we make the observation that, in the low-growth world that naturally results from the economic system we described above, the most resilient and sustainable growth stories are those which relate to penetration or disruption, rather than those which derive their growth from the broader economy. With respect to growth, we make the observation that true equity opportunity costs (and, therefore, equity discount rates used in the valuation process) are likely in decline. Mathematically, the value of higher-growth businesses benefit more from declines in equity opportunity costs, than for lower-growth businesses, all else equal.

Third, owning those businesses which have sustainable data advantages and are winning from the new technology revolution that is taking place makes sense, in our view. And similarly, those businesses being disrupted by these new forms of technology should be avoided. Obvious examples of those businesses with such data advantages include Amazon, Facebook, Alphabet and Microsoft.

Fourth, in a time of accelerating inequality, wealthier customers are preferable and are more likely to enable the high-quality growth we seek (described above). These customers include both wealthier consumers and larger corporates. On the consumer side, Apple has demonstrated the enormous value of a relatively wealthier customer base (versus the Android customer base); as has Salesforce and ServiceNow on the enterprise side.

And fifth, we believe investors should consider a preference towards businesses which are contained within borders, or stable economic blocs. Given the increasing cross-border imbalances which naturally stem from higher inequality (described above), we see a high probability of ongoing economic nationalism, trade disputes as well as a likely decoupling with China – at least along the dimensions of critical technology and data.

Investment Implications

1 Equity exposure

2 High-quality growth

3 Technology winners

4 Wealthy customers

5 In-border containment

Montaka Global Investments

Readers should not be surprised to learn that our Montaka portfolio composition is consistent with these key long-term investment implications.

* * *

In closing, we observe that the economic system which has evolved and delivered great benefits to so many is at risk of being undermined over the long-term by the very side-effects the system itself creates.

Ironically, the price of preserving the overarching structure of our economic system is perhaps making it work more beneficially and equitably for the broader population.

The question is: are plutocrats wise enough to recognize this conundrum and willing to make the necessary long-term investments in the economic system? It is perhaps the mother of all marshmallow tests for the preservation of capitalism as it was originally intended.

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