

The Price We Will All Eventually Pay

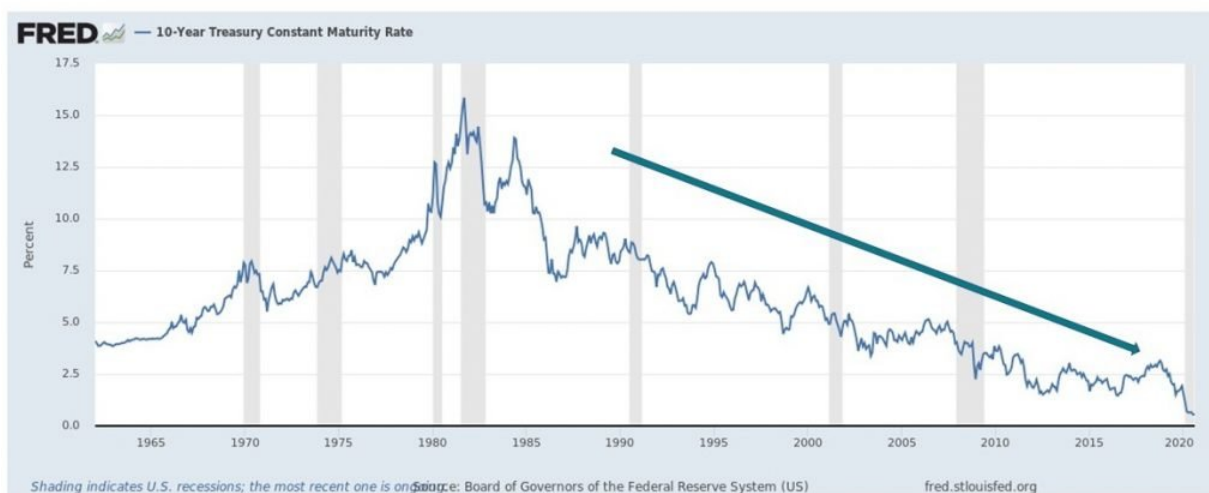
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As investors, we have a habit of focussing on the most recent events and forgetting history.

Much focus over the past few months has been on the containment of COVID-19 around the world and the emergency measures used by central banks and governments to limit the economic impact of lockdowns on individual countries. This time however, unlike during the financial crash of 2008, the response has not been coordinated across countries as more nationalist agendas are playing out around the world. Be it Brexit, Donald Trump's re-election campaign or the simmering tensions on the border between India and China, this is no longer a world in which global coordination can be taken for granted.

Strangely, this is not necessarily a bad thing as the global economic system has become unbalanced in many ways in our view.

We wrote nearly a decade ago that the interconnected global economic cycles of the past few decades had left us sceptical of theories such as decoupling (of emerging markets from developed markets), ever decreasing inflation expectations and the ability of central banks to retain their independence at times of major stress in local economies. We believe the global financial system is more heavily reliant on the US Federal Reserve now than at any point in history and this has created imbalances that are not new. The liquidity provided by the US central bank is pivotal in the global economy today. So, why are we highlighting this now?



The chart above shows the long-term benchmark government interest rate in the United States. As you will see, this peaked at over 16% in September 1981 and is now yielding less than 1%. That is to say, the US government can now borrow at below 1% even though inflation is forecast to be above this. In fact, many large US companies can borrow at below 1% because their borrowing rates are priced off the government borrowing rate. In the short term this is very positive for the US government and these companies.

Our worry is the medium-term impact of COVID-19 on the ability of governments to actually increase economic activity in light of the chart above. The downward trajectory of interest rates did not start in 2008 and neither has it been arrested by

central bank actions since then. The current pandemic is just another reason for interest rates to remain lower for longer: it is not the cause. The cause, we believe, is an as yet unexplained structural imbalance between demand and supply in the global economy, which leaves central banks and governments less able to determine outcomes through policies than they imagine.

It is highly likely that the next decade will bring with it a significant change in the way in which globalisation is enacted as countries grapple with a new reality for trade and investment. This will be built on at least the two pillars of the USA and China (Europe could well be the 3rd). Interest rates will not remain near zero forever, but they are pointing to a more fundamental issue in the global economy that needs to be acknowledged in our view.

We will leave you with a question this week: if the largest economy in the world can borrow at next to no cost today, who will ultimately pay the price?

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