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CIO's View

Life After Easy Money

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A decade of monetary stimulus is gradually giving way to a new era of fiscal stimulus. This issue of IQ explores a range of forces that will influence corporate performance — and, ultimately, asset prices — as the age of easy money draws to a close.

CIO's View

What a difference a quarter can make for markets and investors. Going into 2018, we argued that steady synchronized growth around the world and contained inflation would provide another supportive year for risk assets. At the same time, we cautioned that given where we were in the cycle and concerns around valuations, investors should prepare for a possible equity market correction and focus on downside risk management. This was especially true in the face of three anomalies that had puzzled investors over the last few years and which we flagged in our Global Market Outlook for 2018: historically low market volatility, low inflation despite continued declines in unemployment, and low productivity growth. As monetary stimulus yielded to fiscal stimulus, and a decade of easy money ended, we expected that the macro and market backdrop would become more challenging to navigate, with new risks and opportunities taking on greater significance for companies and investors. Specifically, in our Gray Swans risk forecast for the new year, we singled out tax reform, protectionism and inflation as the forces to watch.

The Return of Volatility and Inflation Risk

While our core view for 2018 remains intact, several of the dynamics we described have already played out in the first quarter of the year. Volatility, inflation and productivity growth have all shifted higher now. We saw a dramatic return of volatility in February as investors, highly attuned to changes in inflation expectations, reacted to a strong US wage report. Yields spiked and over the next few trading sessions, the S&P 500 sold off by 10%. More recently, we have seen markets swoon at the prospect of significant tariffs contemplated by the US administration and the risk of potential trade wars.

Meanwhile, CFOs and investors around the world are still digesting the implications of the most important structural changes to the US tax code in a generation. While many companies have already used the revenue boost to buy back stock and increase dividends, there are multiple indications that the immediate expensing opportunity in the new tax code will incent significant capital investments. For investors focused on inflation risk in the US, there is concern around the effect of additional stimulus on top of strong fundamentals. But as our Senior Economist Simona Mocuta points out in this issue, capital investments made against the backdrop of full employment will feed directly through to productivity growth improvements and therefore help contain inflationary pressures.

The End of International Tax and Trade Norms?

So what will life after easy money be like for companies and investors? At the very least, it will be more complex and more uncertain as the Trump administration challenges international norms across a variety of fronts, including trade and tax policies. In our investment roundtable discussion, global tax policy expert Mihir Desai of Harvard's Business and Law Schools drills down into the instability the new US tax policy is inadvertently likely to create around the world. Desai applauds the core components of the historic tax reform: a lower corporate tax rate in line with headline rates around the world and a territorial system meant to remove incentives for US multinationals to offshore revenue. However, additional international taxes layered on top of this core, he says, have undone many of the positive effects. Instead they have increased complexity and the uncertainty of what the new rules will actually mean for US multinationals. They also seem to violate a number of international norms and so could be challenged for years at the World Trade Organization and other forums, while also opening the US to the risk of retaliatory tax cuts from other countries. Meanwhile, our investment teams weigh up the effects for global bond and equity investors, including the implications for private equity.

State Street Global Advisors Strategist Elliot Hentov argues that the tax cuts will also worsen the US trade deficit and heighten the risk of further protectionist moves from the Trump administration. This could be especially true as mid-term elections approach in November. While there is strong evidence that China has engaged in unfair trade practices, most trade experts argue that the blanket tariffs proposed thus far are a blunt instrument for challenges that require a more surgical approach to avoid all-out trade warfare. Investors must carefully monitor the unintended consequences of the US administration's tax and trade policies and be prepared for choppier markets, including greater currency volatility.

The Tangible Value of Intangibles

Finally, we also introduce the economist Jonathan Haskel of Imperial College, London, to our investment roundtable. Jonathan's book, *Capitalism Without Capital: The Rise of the Intangible Economy,* documents the structural shift in the global economy as companies driven by the value of their intellectual rather than physical property come to dominate capital investment. In both the US and UK, investment in intangible assets now outstrips that of tangible assets. This has a number of important implications, not the least of which is how to adapt traditional territorial taxation approaches to assets that are easily transferred across territorial boundaries. Moreover, traditional accounting approaches used to value and expense intellectual property and other intangible assets can give rise to mispricings that skilled managers can exploit. We also see evidence that the value of some intangible assets might be more sensitive to environmental, social and governance (ESG) issues, so that the importance of ESG factors is growing as the value of companies shifts from tangible to intangible. That is why we engage with our portfolio companies on a range of ESG themes through our asset stewardship practice and our investment teams consider ESG factors in their strategies. This year we called on companies to disclose their compliance with the corporate governance best practices we helped launch through the Investor Stewardship Group. Whether it is analyzing the winners and losers of changes to global tax regimes, the return of inflation risk or the rise of intangibles, life after easy money is providing fertile ground for skilled stock pickers to identify new growth and value opportunities.

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Glossary

Inflation. The rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling.

S&P 500 Index. A market value weighted index of 500 stocks that reflects the performance of a US large cap universe made up of companies selected by economists.

Volatility. The extent to which the price of a security or commodity, or the level of a market, interest rate or currency, changes over time.

Yield. The income return on an investment, such as the interest or dividends received from holding a particular security.

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