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NAVIGATING THE LONG ROAD TO RECOVERY

Summary

Much has been written about the cause of this financial crisis. At its core, it's a public health crisis that's resulted in a financial crisis. Similarly, a lot of ink was spilled on the global financial crisis of 2008. But there has been little discussion on why our financial system appears so fragile and unable to withstand these events without the need for extreme intervention by governments and central banks. This seems particularly strange to me given we live in an era where there is no shortage of capital chasing opportunities and where saving for retirement is mandated in most modern economies. So, what's going on?

The forces at play

I believe there are three significant forces at work, each contributing to surmounting instability. **Firstly**, we are seeing the reverse of the post-World War II baby boom. **Secondly**, there has been a transformation of the retirement system from one of a defined benefit system to an accumulation system, which appears ill-suited to most people's risk tolerance. **Thirdly**, financial leverage is both amplifying the problem as well as increasing the risk that we may never escape the current debt trap we are in.

In each case, these events that have been unfolding over a long period of time. While it may appear obvious in hindsight, the importance of them may have been overlooked. In particular, they do not appear to be well explained by modern economic theory; perhaps simple demand/supply dynamics may describe what is happening.

Why demographics matter?

If you think about an economy in simple terms, people demand goods, other people supply them and price is the point where they are balanced. The price should be at a level that covers the cost of production as well as a level of profit. As populations grow, they demand more goods. If supply remained static, the price would need to increase. However, if there is no restriction on supply, it should also increase to meet demand and so an economy grows. In general, this assumes we all behave the same. In reality, supply and demand factors are heavily dependent on age.

As people go through different periods of their life, what they consume and how much they consume changes. As populations age, consumption tends to decline. If the population also starts to decline, the reverse of what I described above also happens: people demand less, so either prices fall to compensate for lower demand and/or supply contracts, which means the economy contracts.

Unless either the total population is changing or the composition of the population is changing, there is little reason to expect economic growth to be any greater than the reinvestment of profits. Even then, if that doesn't increase the volume of consumption, then all that happens is prices trend lower. Adjusting the cost of production or the share of profit will have some impact on the overall equation, but unless there is a change in the level of consumption, it's unlikely to be significant.

Since 2011, we have been reporting that there has been a material shift in the demographic profile, compared to the previous five decades. As we head towards the mid-2030s, we expect this will accelerate and overall population growth will stagnate, even more so without continued immigration.

Retirement isn't all that it's cracked up to be

Providing for your retirement is generally thought of as a good thing and in many ways it is. However, I believe this has created a few problems that have increased instability in the financial system. When the idea of providing for retirement was first envisioned, it was mostly considered as a defined benefit system. Either a pension paid directly by the government at a fixed rate and adjusted for inflation or, as it later evolved in private pensions, to a fixed percentage of final salary, adjusted for inflation.

In a defined benefit world, market volatility and risk are ultimately assumed by the pension provider. But as we see pension schemes globally move that risk away from the pension provider, and directly onto the investor via accumulation schemes, this has potentially changed behaviour. While there is always the argument of choice for investors, and the fact that some investors may like this outcome, the reality that we see when markets become volatile—and in particular when stock markets fall—is that investors tend flock to cash and become focussed on the short term for what should be a long-term investment.

Dealing with volatility

Most investors are not comfortable with significant volatility, although this is often a feature of the asset allocations required to meet long-term objectives. This risk becomes even more pronounced as people head towards retirement and no longer have the time to recover from any significant loss. It seems that people are neither comfortable with volatility nor able to manage balancing asset allocations to navigate the changing market conditions. This dynamic exacerbates moves in markets which, given their systemic importance to the long term financial wellbeing of investors, prompts governments and central banks to step in to stem losses, regardless of the cause of the volatility.

Access to Investments

The other issue I see from this move to fund a retirement system for all is that it assumes there are sufficient productive investment opportunities to absorb all of these funds and that changes to the size of the pool won't impact markets and valuations. There appears to be a shortage of liquid assets to meet demand and we have seen a trend for investors to own a wider variety of longer dated, illiquid assets to address this shortfall. These assets are often difficult to transfer to other investors or to sell quickly. This, coupled with the number of people moving from accumulation phase to retirement over the next 10 years, is going to exacerbate the issue, even if asset allocations remain stable, because balances will need to decline to pay pensions. Further, with lower growth, declines in investment returns, and potentially lower populations, we could witness even more instability as demand for investment assets changes.

Leverage in markets

This is possibly the hardest one to observe, but could be one of the biggest contributors to excessive volatility which has created the need for wide spread bailouts. These bailouts contribute further to the amount of leverage (debt) in the system and we potentially spiral to a point of no return.

Leverage in markets can take multiple forms and while it has the potential to lift rising markets, it can be quite destructive as it unwinds. It could be argued that some of the recent growth in equity markets stems from companies being able to borrow cheaply and to pay equity holders higher dividends or to buy back equity, both of which can create short-term improvements to equity prices. But this also increases the riskiness of both debt and equity, and may offer no real long-term benefits unless there is an improvement in earnings.

Leverage can also be used to create investment vehicles that take greater market risk than the capital invested, such as leveraged share funds and risk parity funds. These funds have the potential to lift rising markets, as each leveraged buyer is chasing two or more sellers on the way in but, equally, each leveraged seller needs to find two or more buyers on the way out.

Generally, the use of leverage under normal market conditions will have some impact on prices. But in markets that are stressed, leveraged sellers are likely to be joined by other sellers to accelerate price declines. As equity prices fall, those companies that have taken on extra debt now have less equity buffer to cover that debt. This can lead to credit rating downgrades (which may spill over into selling in bond markets) or covenant breaches on loans (which can adversely affect bank balance sheets). This, in turn, can lead to companies needing to reduce leverage either by raising equity or repaying debt. If this occurs when an economy is also in a deeply distressed state, earnings may fall, creating a larger feedback loop where companies can quickly become insolvent, particularly those with weaker balance sheets to begin with. This is why high yield debt or 'junk bonds' tend to suffer more than investment grade debt in these times.

When governments and central banks step into support distressed markets, they too then look to either borrow funds from investment markets or use some form of debt monetisation. This only increases the amount of leverage in the system. Perversely, while you might expect this to potentially lift the rate of return required by investors to fund these activities, the opposite occurs, and as government debt levels rise globally, bond yields and other borrowing rates have fallen to extremely low levels or even negative yields (effectively you as the investor are paying the borrower to take your money).

So, is there a way out of this financial mess?

The answer is 'possibly'. The bigger question is will that solution be palatable to the broader electorate? The problem with the current situation is that each time the government and central bank interfere and markets recover, we see companies start to increase leverage. And when governments try to unwind their debt programs, yields start to rise to a point where instabilities in debt markets start to appear, because interest burdens or debt refinancing becomes prohibitive. As such, the level of debt in markets is not falling.

The most obvious solution is to reduce debt outstanding. However, there appears to be little or no appetite for governments to raise additional revenue to repay/reduce the debt outstanding, and given the changes to demographics is likely to have on economic growth, and the need to continue to expand the amount of assets available to meet pensions, there appears very little anyone can do to reverse the current situation without significant economic pain and a subsequent decline in living standards.

If left to run its current course, it raises the spectre of corporate debt defaults and the possibility of major government debt defaults (or extreme currency devaluations). High levels of government and corporate debt have occurred in the past (most recently after WWII) and the usual way governments and central banks reduce the debt is to foster higher economic growth and encourage inflation (high government debt levels and debt monetisation are considered to be inflationary by many economists). We have seen little inflation in recent years, and improvements in technology and an aging population are mildly deflationary. The likely damage to economic growth from the current viral outbreak and global shutdown would suggest previous solutions are unlikely to work.

In the past, where government debt was this high, most countries' money supply was pegged to a gold standard or another currency, such as the USD (i.e. to the value of something that was considered a scarce resource). In more recent times, economies have moved to a system where a country can control its own money supply (known as fiat currency). This makes it difficult to know for sure if the same outcome (inflation) will occur under a system where money supply is technically unlimited.

In this type of system, a country cannot default (at least on debt in its own currency) because it can print money. However, the consequences of having a huge deficit and debt burden relative to a countries' GDP is likely to result in a significant decline in the value of its currency relative to others (i.e. the exchange rate).

There is also a newer theory know as **Modern Monetary Theory** (MMT), whose proponents believe it's possible to run very high government deficits without the need to raise taxes or traditional debt. This is still fairly controversial and unproven, but could potentially form a way of transforming the method of financing future bailouts if needed. To some, quantitative easing is already following this path. Even if this were to provide an alternative means of managing the process of future bail outs, it's unlikely to solve the underlying issues that have led to the fragility of the financial system and will potentially just kick the can down the road for future generations to deal with.

Conclusion

Perhaps there needs to be some rethinking of how we look to fund our retirement system given the inability of markets to offer attractive investments without resorting to unproductive leverage or locking investors into illiquid assets without an adequate transfer mechanism. Admittedly, any transfer mechanism relies on another investor wanting that asset, which in times of stress may not hold even if such a mechanism existed. It does raise the question: "Is there a role for governments to play in rethinking the structure of the system rather than just bailing it out when it isn't working as expected?"

Also worth consideration is whether a cap on leverage is appropriate. Often the answer to how much is too much is obvious after the fact, rather than before a crisis. Given the leverage caps placed on banks after the GFC to protect the financial system, is it a major stretch to argue that if other companies and investors require similar bailouts to the banking system, then they should also be restricted in some way to avoid this in future?

As with higher taxes or reduced government spending, I doubt either would be popular even if they appear necessary.

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