The End of History or a New Beginning?

By

Stanley Jay Feldman Ph.D. Chief Valuation Officer

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Valuations of public and private firms have and will continue to decline as inflation accelerates and interest rates increase. But these developments are not symptoms of a traditional economic cycle but rather reflect serious cracks in the global economic infrastructure and that have significant negative secular implications for the global economy going forward.

Since 1980 and prior to the pandemic there have been two inflection points in the global economy- 1982 and 1991. In 1982 the inflation cycle that trampled on the financial markets came to an end. This occurred for three reasons. With Reagan's approval, the Fed tightened and drove the US economy into a very serious recession and inflation began its long secular decline. Reagan's actions effectively reduced the power of the trade unions. Finally, the move to become more energy efficient reduced the growth in demand for oil and limited to an important degree OPEC's monopoly power. The stock market roared ahead and by the end of the 1980s, the S&P was a magnitude higher than it was when the decade began. The second inflection point was 1991. The fall of the Soviet Union was a watershed moment, and captured by Francis Fukuyama's famous 1989 article, "The End of History". And yes, the world had fundamentally changed; the Cold War was over, liberal democracies prevailed and global peace appeared inevitable. But beneath the new political reality was a more fundamental development; the realization that technology would allow the developed world to access the resources (labor and capital) of the less developed economies and it was this connection that has been the force driving the global economy that produced very low inflation rates in the US and the developed world. Globalization has increased the global capacity to produce, and even when demand is fueled by outlandish growth in money and credit, supply, for the first time in history, appeared not to be a binding constraint. Hence, low inflation and of course low real interest rates. For the last thirty years globalization has provided the basis for the greatest increase in wealth in human history, and of course the stock market was simply reflecting this. By the way, all of this was happening while Federal debt was increasing, and the dollar was increasing in value relative to other fiat currencies, but this is a story for another day.

We have arrived at a third inflection point- a New Beginning, for lack of a better term, that is a break with the optimism of Fukuyama's world. This new world has already unleashed negative forces that will be with us for a long time. The pandemic underscored the interdependency of the global economy and how an unexpected development could negatively impact the global supply chain. While my original thought was that we would be living with supply chain disconnects for the medium term- two years post pandemic- it has become clear that the supply chain detachments are more serious than I expected. The Ukraine war has added to the severity of the supply chain disconnects, and the result is that global capacity to produce has been significantly reduced. My estimate is that capacity is currently less than 90% of where it was pre-pandemic. Just for the record, the Fed is not in a position to reduce actual inflation and it does not have the political backing to reduce expected inflation. Put differently, the Fed would need to raise the yield curve by 400 basis points at a minimum and this rate increase would send the global economy into a recession. This will not happen if for no other reason that this could drive nations that borrowed in dollars into bankruptcy. Additionally, triggering a global recession will not serve the West's foreign policy objectives to degrade Russia's military. The last thing NATO nations want is to deal with the domestic fallout of a global recession while simultaneously addressing Russia's militarism. Firms that operate globally are now realizing that in order to meet local demand, they need to have local suppliers rather than depend on the global supply chain. Well, this changes things a great deal since producing at low cost now includes the cost of either waiting for what is needed or not getting it at all. Hence, access to local supply, even if the cost is much greater than the global alternative, is better than waiting and not being able to produce in the meantime. This is already happening. Tesla is considering not taking orders if it cannot deliver the car within a year. In this world inflation stays high, shortages of some materials and labor occur episodically, and we are in a world of high interest rates- but not high enough to rein in inflation-and slow growth better described as stagflation.

I have a great deal of respect for ARK's Cathie Wood. Her response to my argument is that "more problems, more problems for technology to solve and it will". I agree, but my experience is that we always underestimate how much time it takes for tech to save the day. In the late 1980s, I wrote a paper entitled the "Third Industrial Revolution". The feedback I got from my friends at Harvard and MIT was the paper was interesting, but you have a few screws loose. My focus was on how manufacturing will change based on AI, and more importantly how the service sector will become more productive. I was generally correct about the developments I described, and I did invest on the themes I noted. But what I missed was the amount of time it takes for technology to gain traction. This occurs for three reasons. The first is trial and error before the technology scales and this always takes more time than you think. The second is the pushback from legacy technology suppliers. The third relates to what we economists call adjustment costs. Replacing the old with the new first requires removing the old, which takes time and typically uses resources that would ordinarily be available for profit creating activities. In addition, the new technology is generally expensive, and so total adjustment costs are generally very large. Maybe this time around the transition speed will be faster, and if so the period of high inflation, high interest rates, and slow growth will not last as long as I think. I am not sanguine about this development.